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AFP® PAYMENTS GUIDE TO

Unlocking the Cash Conversion Cycle

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Companies pursuing growth strategies often focus on two key components: increasing sales and reducing supplier costs. However, another key driver frequently overlooked is having an efficient working capital management strategy that supports an organization's short and long-term growth goals and overall business objectives.

MUFG Union Bank, N.A. is pleased to sponsor our sixteenth AFP Payments Guide titled *Unlocking the Cash Conversion Cycle*. This guide provides useful information on the Cash Conversion Cycle and how Treasurers can impact and improve it through accounts payable, accounts receivable, and inventory management.

Increasingly, an effective working capital management strategy uses digitalization to streamline payment processes within the supply chain. New digital working capital solutions generate data that can provide greater insights to inform Treasury decision-making as well helping business-line leaders see how procurement decisions affect working capital and the bottom line.

In this guide, CFOs and Corporate Treasurers can read case studies and best practices for managing liquidity and working capital to realize efficiencies that can add value. We intend to give this guide to our corporate, commercial, and institutional clients.

MUFG has been a long-standing supporter of the AFP in delivering education, resources, and tools for treasury professionals to help them achieve their business goals. In addition, we are proud to sponsor the AFP Pinnacle Awards to recognize innovation that drives excellence in treasury and finance.

Best regards,

Ranjana B. Clark
Head of Global Transaction Banking
MUFG

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INTRODUCTION

All organizations know the importance of managing cash and working capital; without them, organizations simply cannot exist. Yet, when targeting growth, too many organizations focus on trying to increase sales or to reduce supplier costs, while ignoring the potential benefits of efficient working capital management. A renewed focus on internal processes can unlock working capital “trapped” in the cash conversion cycle, which is then available to be recycled back into the business. Freeing this cash has a direct impact on the business’ bottom line. It allows the business to grow, without making another sale, simply because working capital that was previously being used to fund an inefficient process can now be invested to help the company achieve its strategic objectives.

This guide starts by outlining the core working capital relationship: the cash conversion cycle (CCC). It then explores why managing the CCC is important and identifies ways treasury can influence it via the three key levers: accounts payable, accounts receivable and inventory management.

THE CASH CONVERSION CYCLE (CCC)

The CCC represents the time required to convert cash outflows associated with production into cash inflows through the collection of A/R. In short, the CCC is calculated as the average age of inventory (days inventory) plus the average age of A/R (days receivables) minus the average age of A/P (days payables).

The CCC highlights the critical nature of monitoring the:

- Amount of time it takes to sell inventory
- Length of time between when a sale is made and when cash is collected
- Actual disbursement period

The attached spreadsheet has examples and examines each component of the CCC with sample financial data.

[DOWNLOAD THE SPREADSHEET HERE](#)

$$\text{DSO} = \frac{\text{Accounts Receivable}}{\text{Revenues}} \times 365 \quad \text{DIO} = \frac{\text{Inventory}}{\text{Cost Of Goods Sold}} \times 365 \quad \text{DPO} = \frac{\text{Accounts Payable}}{\text{Cost of Goods Sold}} \times 365$$

$$\text{CCC} = \text{DSO} + \text{DIO} - \text{DPO}$$



UNDERSTANDING THE CASH CONVERSION CYCLE

The cash conversion cycle is a measurement of the time a company must finance the costs of making products or delivering services before receiving payment for them. It is calculated using the following equation:

$$\text{Cash Conversion Cycle} = \text{Days Inventory Outstanding (DIO)} + \text{Days Sales Outstanding (DSO)} - \text{Days Payable Outstanding (DPO)}$$

The three core concepts are:

- **Days Inventory Outstanding (DIO).** Days inventory applies primarily to manufacturing companies, as it provides a measurement of the time it takes to turn raw materials and other inputs into the sale of finished goods. DIO is a combination of raw materials in the warehouse, work-in-progress and unsold finished goods. Services companies have a very short DIO due to their limited inventory.
- **Days Sales Outstanding (DSO).** Days sales (or days receivable) is the average time it takes for the company to collect payment from customers following the sale of finished products. For companies that sell cash on (or before) delivery, DSO will be a few days; for those that sell on credit, DSO will be close to their normal credit terms.
- **Days Payable Outstanding (DPO).** This is the average time between procuring raw materials and other inputs and paying the suppliers. During this process, the company's suppliers are providing the goods on credit. If the company usually has to pay cash on (or before) delivery, then the DPO will be close to zero. If the company pays all its suppliers exactly 30 days after ordering, then its DPO will be 30 days.

The **cash conversion cycle** is the average time between when a company has to pay for raw materials and when it receives payment for the finished goods. For a services company, it is effectively the average time between the day the service is provided and payment is received.

Put another way, DIO and DSO are the average time between a company procuring raw materials to manufacture its products and receiving payment from customers for the sale of those products. This is financed by a combination of supplier credit (DPO) and company-sourced financing, either from reserves or external borrowing.

Every company will have a different CCC, which is determined by both its own internal efficiencies and the conventions and practices in the markets in which it operates — standard payment terms vary both by industry sector and by country. In theory, companies will try to minimize their CCC, which can be done by reducing DIO (e.g., by operating a lean production cycle) and DSO (e.g., by accelerating collections) and/or by increasing DPO (e.g., by delaying payment to their suppliers).

From a cash flow perspective, it is evident that the faster a product can be made, sold and converted into cash, the better it is for the company. From a shareholder's perspective, the lower the CCC is, the smaller the working capital funding requirement and, consequently, the more value created for shareholders.



REVISITING THE CASH CONVERSION CYCLE

All companies view cash — and working capital more generally — as the critical assets needed to achieve their business objectives. Managing working capital efficiently provides companies with a degree of resilience against external events, a position emphasized by the impact of the 2020 global lockdown on business activity and the associated cash flows.

By reviewing the way working capital is managed, companies can influence their CCCs, strengthening their business and building shareholder value. There are three key levers:

- **Increasing DPO.** Trying to extend DPO (i.e., to increase the use of supplier credit) has been a common way to improve the CCC. Procurement decisions are squarely within a company's control, and finance is able to determine when to make payments to suppliers. Moreover, it can often be easier, especially for larger organizations, to impose longer payment terms on their smaller suppliers than to identify efficiencies elsewhere. More generally, while it is good for the company's own working capital position to delay payment as long as possible, it should consider the impact of delaying payment on its own supply chain. It may not make good long-term business sense to put suppliers in a position where their own cash flow is under pressure.
- **Reducing DIO.** Establishing lean procurement and production processes has long been seen as an effective way to reduce the CCC. Inventory management software allied to “just-in-time” methodologies allowed companies to reduce the DIO and minimize warehousing costs. However, as the effects of the 2020 lockdowns affected physical supply chains globally, many organizations have been reviewing their “just-in-time” processes, and reassessing the robustness of their supplier base, making reducing DIO more difficult.
- **Reducing DSO.** The final lever is to accelerate receivables, albeit in an environment in which customers are seeking to preserve their own cash. Companies are looking to do two things to improve their DSO: make their internal receivables processes more efficient by taking advantage of tools to capture and process data more quickly, and make it easier and more convenient for customers to pay.

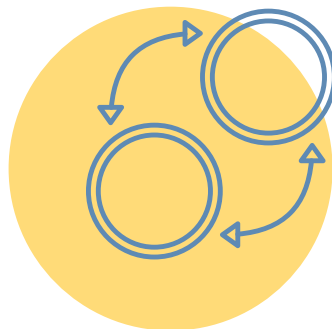
At a time when it might be difficult to obtain support for the implementation of new processes and technology solutions aimed at improving the CCC, it is instructive to understand why managing the CCC is so important for the business as a whole. In addition to operating more efficiently, improvements to the CCC can support the business in the following ways:

- **Strengthen the physical supply chain by focusing on the financial supply chain.** The experience of the last 18 months shows that delays or weaknesses at any one point has the potential to disrupt the whole supply chain, especially when based on a “just-in-time” methodology. Companies want a robust supply chain. While it is possible to replace a failed supplier, this comes at the cost of performing credit checks and onboarding the new supplier, who may well face many of the same issues that the original, failed supplier suffered.
- **Identify trends and problems.** Tracking the CCC by focusing on details may also help identify problems that are masked by a higher-level focus.
- **Develop more accurate cash forecasts.** Obtaining more certainty through better visibility means the company can reduce its overall borrowing requirement (with a more confident view of forecast cash positions) and/or reduce its surplus short-term cash balances, many of which are held for precautionary reasons. Instead, companies can recycle cash back into the business, especially if they are having to hold more inventory or stock to accommodate uncertainty in the physical supply chain. Even if not, cash returned to the business

will likely generate higher returns than invested surplus cash, given the still relatively low interest rate environment.

- **Improve operational controls.** There are many levers available to improve profitability, although many are outside the company’s direct control, such as being able to increase sales or reduce external debt. Instead, focusing on enhancing internal efficiencies can create value without any third-party engagement, with the added benefit that greater operational efficiencies will likely lead to improved operational controls.
- **Enable more flexible capital planning.** Ultimately, having better visibility of cash and tighter control of the CCC will give treasury and the wider finance function more flexibility over their capital allocation decisions. Notably, treasury will have to hold less cash to cover unanticipated cash positions, meaning capital can be allocated to specific business purposes or returned to shareholders.

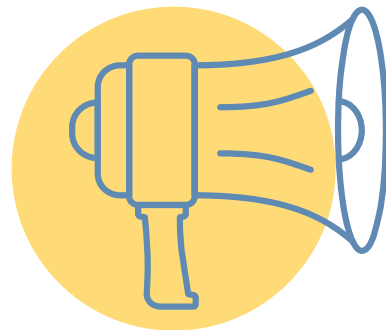
Keep in mind that the potential benefits of reducing the CCC will vary according to each company’s individual circumstances. Borrowers, especially those with strict covenants, may track a range of metrics, some of which will be improved with a tighter focus on the CCC. Cash-rich entities will have a different perspective and may, for example, be keener on making their own supply chains more robust. The company’s industry sector will have an impact too; for example, many retail companies have a very short DSO because they can receive payment from their customers before they have to pay their suppliers.





HOW TREASURY CAN INFLUENCE THE CCC

Much of the activity that drives the CCC is outside the direct control of treasury and finance. Changing procurement habits and increasing sales are two ways to directly affect the CCC, neither of which is within treasury's control. That said, treasury can have a major influence on the CCC in two ways. First, treasury can introduce, or help with the introduction of, more efficient ways of processing the data and payments associated with the physical supply chain. Second, treasury can help the other parts of the organization understand the financial implications of the business decisions they make. Treasury's influence within the organization as a whole is growing, in part due to a trend towards the centralization of policy-setting (and, in many cases, operations too) and the emergence of technologies that allow treasury to identify and share more detailed insights with the rest of the business. By focusing on the individual elements of the CCC, treasury can help identify potential efficiencies.





REDUCING DSO

There are two key phases in the accounts receivable process, both of which can likely be made more efficient. First, make it easy as possible for customers to pay. Then process any incoming cash as efficiently as possible so it can be recycled back into the business. The following actions can help:

- **Automate invoicing.** Eliminating the manual processing of invoices reduces the risk of error that can result in invoices being disputed by customers, thereby extending DSO while the queries are resolved.
- **Consider accepting new types of payment instruments.** Central to making it easier for customers to pay is choosing to accept their preferred payment method. This is more of a challenge for retail-facing companies, with the rapid development of various electronic payment channels ranging from mobile payment schema to emergent digital currencies. Before accepting new payment instruments, you will need to balance the benefits derived from the greater convenience for customers with the costs of accepting the payments and being able to process the accompanying data.
- **Encourage customers to use more efficient payment instruments.** Consider trying to persuade customers to pay via digital/electronic methods, especially if they habitually use paper-based instruments. Digital payments are more efficient to process than paper-based equivalents and give rise to fewer exceptions. Moreover, as companies seek enhanced visibility over cash, shifting to payments that can support more associated data will add value. If customers are reluctant to switch to digital payment methods, identify solutions to speed up the clearing and settlement of paper instruments, such as the use of remote deposit scanners.
- **Incentivize early payment.** Finding ways to incentivize early payment will help to accelerate the collection process too. One solution is to analyze customer receivable patterns, then offer an early payment discount (e.g., 0.5% discount for payment within 10 days) for slower payers.
- **Provide credit to customers.** One way to increase sales is by providing access to credit. Car sales has been supported by personal finance schemes for decades, and ecommerce platforms offer “buy now, pay later” credit facilities online as a tool to increase sales (e.g., Afterpay, Klarna, affirm).
- **Automate cash application.** Consider the use of AI-based solutions to accelerate the reconciliation process, meaning cash can be recycled back into the business. Automation will also free up time for accounts receivable to focus on managing any overdue accounts.

Case Study: Improving processes to reduce DSO

Days Sales Outstanding (DSO) is the key metric to monitor the efficiency of accounts receivable and has two key drivers: the contractual terms offered to customers (i.e., the payment terms) and the level of past dues (i.e., the extent to which customers pay later than agreed payment terms). When Rohan Chaddha, Executive Cash Manager, GE Healthcare, went to review his organization's DSO, he found the biggest opportunity to reduce DSO was by improving the order-to-cash process to address the level of past dues.

Chaddha mapped out the order-to-cash process and identified a number of opportunities for improvement, such as to reduce the time taken to generate and send invoices to customers. As a consequence, GE Healthcare adopted a series of changes to the order-to-cash process aimed at accelerating and improving the accuracy of the invoicing process, the most important being a shift from manual to electronic invoicing.

At the same time, Chaddha recognized that the collection method was inefficient, with customers still using checks to pay. Intuitively, switching to electronic collection tools was an easy win. "It can take between three to seven days to collect payment by check, with transition time adding to DSO," explains Chaddha. "The pandemic enabled us to shift a large proportion of the check payments to collection via wire and ACH payments."

The gains for GE Healthcare have been significant, leading to a meaningful reduction in DSO as a result of the changes.

Treasury can support sales in other ways, too:

Advise on customer creditworthiness. Treasury can advise the sales department on ways to improve the ways they assess customer creditworthiness prior to agreeing payment terms. For regular customers, artificial intelligence can identify any changes in payment patterns. If a customer starts paying later, finance can warn the accounts receivable team, who can in turn investigate whether that is a sign of a weakening credit. If so, sales can be advised to avoid a worsening problem. The same technique can also help to determine whether buying credit insurance is warranted.

Setting early payment discount rates. Offering early payment discounts can help to accelerate DSO, although determining an appropriate discount can be difficult, especially during periods of low interest rates. One option is to offer a discount for early payment in return for the customer increasing its purchase volume. Treasury can help sales set appropriate discount rates that balance the target of reducing DSO with the need to retain profitability.





REDUCING DIO

Much of the process of managing inventory more efficiently revolves around the production process, especially as companies are reconsidering their “just-in-time” approach. Decisions to hold higher levels of inventory as a protection against supply chain and logistics problems will adversely affect DIO.

Even so, there are ways to link inventory to future cash flows as a way to manage risk. For example, one company uses technology to track orders from large buyers that can associate the inventory being used to fulfil those orders. If those orders change, it is then easier to adjust inventory levels, reducing the risk of the company holding excess inventory.

In addition, being able to capture relevant data from the company’s inventory management system may help to tighten the cash forecasts. For example, if

supply chain problems result in an increase in work in progress and an increase in DIO, this may also result in a delay in the timing of anticipated sales payments and, consequently, an increase in the CCC, which will need to be financed. Having an early warning of such delays can help treasury determine the most efficient way of financing that additional working capital.

Inventory management is more difficult for finance to directly influence, so treasury will have to partner with the underlying business units to achieve improvement to the CCC. In many organizations, having a longer DIO is the result of a strategic decision, such as the consequence of the company customer support policy, although the decision is made at the expense of having additional capital locked up in non-earning assets.





EXTENDING DPO

Managing the payables side should, in theory, be easier because you have more control over the various processes. Even so, there are ways to improve the process in order to achieve more efficiency, some of which may not result in a strict increase in DPO but will lead to improved working capital management, nonetheless. The following actions may be helpful:

- **Use payment terms.** If you are paying more quickly than your agreed payment terms, it may be possible to delay payment to extend your credit. Any decision to delay payment should be communicated to vendors, even if payment is still within the agreed terms, as the information will help your suppliers manage their own cash flow in advance. Any change that affects payment to strategic vendors requires careful analysis before decisions are made or communications sent as an unexpected change in your payment practices may result in strategic vendors reassessing their relationship with your company.
- **Improve accounts payable processing.** There are a number of different technology solutions that can improve AP processing. Giving suppliers access to portals to upload invoices will help to reduce your processing costs when compared to paper-based processing. Suppliers can also view invoice status, which will help them forecast their own cash flows. By digitizing the process, three-way matching in the procurement process can be automated, reducing potential fraud, and the improved data can also be used to update the cash forecasts.
- **Provide finance to suppliers.** Automating invoice processing can also be combined with a dynamic discounting solution. Dynamic discounting allows

your suppliers to arrange to collect payment early, with a choice of discount rates depending on the payment date they select. This will have the effect of reducing DPO, although it will improve the suppliers' cash positions.

- **Consider solutions that use third-party finance.** The use of supply chain finance and procurement cards replace supplier credit with bank credit to finance DPO. Both techniques have the effect of accelerating payment to your suppliers, so they can strengthen your suppliers' cash positions without extending your cash conversion cycle. Using these solutions is only worthwhile if the cost of the funding is lower than other working capital funding costs.
- **Consider converting suppliers to lower cost alternative payment types.** With payment technology evolving rapidly, most organizations will have some scope to reduce payment processing costs by working to convert suppliers to lower-cost alternatives. Treasury should understand the cost of processing all different types of payment in order to capture the most value from each one. While the fee charged by the payment processor is important, every stage in the payment process from initiation, through the preparation of payment files, to reconciliation all have some cost attached. You can group suppliers by payment type, then identify opportunities to convert users of each type to a lower-cost alternative. You will need a communication plan before engaging with suppliers and to recognize that some suppliers may decide not to shift to a particular payment type for their own internal reasons.

Case Study: Switching payment methods for AP

The treasurer of one company planned a campaign to improve working capital by streamlining vendor payment methods. The problem was persuading the procurement organization to reach out to the vendors in order to switch from sending ACH and check payments to using virtual cards. Two key benefits were outlined: 1) it improved the company's working capital position through the changes in cash flow patterns and improved processes the company adopted, and 2) because the use of virtual cards was tied to a rebate scheme, it also earned cash back for the business.

The company's bank was key to the success of the campaign. It worked with the treasurer to explain the benefits of virtual cards to the internal stakeholders, and it provided examples of how other organizations were using virtual cards. Following implementation, the treasurer was able to go back to the internal stakeholders, share the results and celebrate a successful implementation.

Finally, by having a clear communication plan for this project, the treasurer will more easily be able to sell future projects to the business, too.

Improve efficiency of intercompany payments.

Eliminating the unnecessary movement of funds between different group bank accounts will increase the cash available to fund working capital. Using a netting structure is one solution, as long as netting is permitted in the relevant jurisdiction. In-house banks with virtual bank accounts are also becoming more

popular across all types of companies. From a working capital perspective, virtual accounts allow group entities to effect intercompany payments without any impact on the group's aggregate cash position. Unlike in a traditional bank account structures, there is no potential loss to float as funds are moved between group entity bank accounts.

Case Study: Managing the supplier base through vendor segregation

Until recently, one retail company allowed its suppliers to dictate to procurement regarding how they wanted to be paid. From the retailer's perspective, this supplier-led approach led to major inefficiencies. The retailer has a broad supplier base, ranging from local small businesses to large, global partners. The retailer was managing multiple payment channels across each class of supplier.

To try to improve efficiency within accounts payable, the retailer, led by treasury, changed its strategy towards supplier payments. It actively segmented its supplier base, primarily based on size. It now promotes separate offerings, including factoring, invoice discounting and credit card payments, to each of the different segments.

Treasury's objective is to strike a balance between having a stronger, well-financed supplier base and generating additional income on excess liquidity..



LINKING THE CCC TO THE PHYSICAL SUPPLY CHAIN

Focusing on the details of the cash conversion cycle, or financial supply chain, should also have benefits for the management of the physical supply chain. Moving towards digitization will provide more opportunities for treasury to interrogate data across all three elements: suppliers, inventory and customers. On the supplier side, the use of different payment methods and techniques will help to strengthen the supply chain by identifying ways to support their cash flow. Using AI tools to identify trends and patterns will allow treasury to advise sales of any potential problems with customers' cash flow. Automation of payment and reconciliation processes will also allow

for more data to be captured and, because it is likely to be standardized, to be interrogated more easily. Removing manual processes will reduce the risk of error and fraud. Auditing, reviewing and updating the automated processes will help to ensure the operations are as efficient as possible.

From a liquidity management perspective, gaining insight to data will also help the company to use cash more efficiently, with a lower requirement for the holding of excess precautionary cash (whether held in bank accounts or in drawn down credit lines) will result from higher confidence in the forecasted positions.

Understand how data flows through the organization

All organizations have access to plenty of data, both generated internally and provided by third parties, including banks. Treasury needs to be able to interrogate this data to develop cash forecasts and glean insights on customers and suppliers to share with the business as a whole.

“A treasurer new to an organization should talk to the system architect to understand the systems the company uses, and how they interact. The treasurer can use this information not only for forecasting purposes, but also to map out the organization's gaps in digital transformation, close the gaps by collaborating through cross-functional projects, and act as a bridge between fintech companies/technology and the organization. I think this leads to an organically improving cash cycle through collaboration and use of technology.” Tanya Kuznetsova, Director of Treasury and Cash Cycle Transformation, Baptist Health Care.



DIGITIZATION: THE NEW FRONTIER?

The link between financial and physical supply chains means there are many ways for treasury to support the business in managing the CCC — and plenty of opportunities to take advantage of improvements to manage capital to create shareholder value. In fact, there is consensus that the deepening digitization of treasury activities offers many additional potential benefits, for two broad reasons. First, digitization promises opportunities to perform standard activities more efficiently. Second, digitization is based on data which, if interrogated intelligently, can provide much greater insight to cash and working capital. Treasury departments are already starting to hire IT engineers and data analysts to complement the work of treasury practitioners.

Digitization also brings uncertainty, especially if it is accompanied by a wider business transformation. Will companies take over from traditional lenders as a source of financing to both suppliers and customers? Many banks are already nervous about how digital currencies might affect their ability to manage their balance sheets and are seeking new ways to work with fintech companies to deepen relationships with their corporate clients.

For all the uncertainty, treasury professionals are in a great position to support their businesses as their role evolves and technology develops.





TAKEAWAYS

Treasury can play a key role in improving their organization's cash conversion cycle, thereby reducing reliance on working capital finance and making the business more resilient as the economic outlook remains uncertain. Taking action to improve the efficiency of the accounts receivable cycle can result in significant improvements in DSO. Similarly, changing processes within the accounts payable cycle can help the organization improve visibility over its cash and, consequently, manage liquidity and working capital more efficiently. Treasury cannot directly control inventory in the same way, but the department can offer insight to the wider business to help it manage inventory more efficiently. In the same way, treasury can offer advice to help the business understand how procurement and sales decisions affect working capital and, therefore, influence the bottom line.

Direct actions treasury can take include:

TO INFLUENCE DSO

- Automate invoicing to reduce errors and processing costs.
- Make it easier for customers to pay.
- Encourage customers to use more efficient payment methods, especially electronic payment methods.
- Identify potential problem customers and incentivize early payment.

- Consider tools that extend credit to customers to increase sales.
- Automate cash application to recycle cash back into the business more quickly.

TO INFLUENCE DIO

- Partner internally with business units to understand demand planning for inventory.
- Utilize internal software and/or the ERP system to better understand inventory flows.
- Establish an internal working group with the procurement/purchasing teams to improve inventory planning.
- Partner with FP&A to assist in inventory modeling and management.

TO INFLUENCE DPO

- Manage payment terms as part of a discussion with suppliers.
- Improve AP processing, notably by shifting from paper to electronic invoicing tools.
- Offer funding to suppliers, whether from own funds or from third parties such as banks, to strengthen the physical and financial supply chains.
- Adopt cost-effective payment methods, again by shifting to electronic methods.
- Implement more efficient payment cycles, both for intercompany and supplier payments, to ease forecasting and better manage liquidity.

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