

THE STAPPAS PERSPECTIVE

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RATIOS TO HELP BUSINESS OWNERS SUCCEED part 2

In the last issue we discussed ratios that can help a business owner plan for a profitable operation. Those ratios were based on the profit and loss financial statements of the business. In this issue we will discuss ratios that are based on the balance sheet of the firm's financial statements. These are the ratios that determine if the business is truly financially successful or not.

ACCOUNTS RECEIVABLES COLLECTION PERIOD: Do you know how long it takes your customer to pay your invoices? This ratio tells how long it takes to collect money that is owed to the firm. In other words, if a firm generates an invoice today how long will it take to collect the funds? The formula is: Average Collection period = $365 * \text{accounts receivables} / \text{sales}$

EXAMPLE

Sales =	\$1,500,000	
Accounts receivables=	200,000	
Average collection period=	48.67	days

How important is this information? It illustrates the importance of implementing a continuous and effective collection process. How much more cash would the firm have if it reduced its average collection period by just two days? An additional \$8,205. Here is the formula: Collection period desired * sales / 365 = Accounts receivables, then subtract the current actual receivables from the desired amount.

EXAMPLE

Collection period desired	46.67	days
Sales	\$1,500,000	
Receivables @46.67 days	191,795	
Added cash	8,205	

The faster a firm collects on its receivables, the better the cash flow.

DAYS PAYABLE: This ratio shows how many days it takes a firm to pay its accounts payables (vendors). This ratio is similar to accounts payable turnover (above.) The business may be losing valuable creditor discounts by not paying promptly and a possible creditor or banker can evaluate a firm's ratio to determine if credit will be issued. The formula is: Days payable = $\text{accounts payable} / \text{cost of goods} * 365 \text{days}$

EXAMPLE

Accounts payable	\$200,000	
Cost of goods (vendors)	750,000	
Days to pay	97.33	days

Inventory Turnover: This ratio shows how many times in one accounting period the company turns over (sells) its inventory and is valuable for spotting under-stocking, overstocking, obsolescence and the need for merchandising improvement. Faster turnovers are generally viewed as a

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positive trend; they increase cash flow and reduce warehousing and other related costs. The formula: cost of goods sold/inventory.

EXAMPLE

Cost of good sold	\$750,000
Inventory	350,000
Turnover ratio	2.14 times

This ratio indicates that the inventory is turned over, on average, just a little over two times or every six months. This indicates that the inventory is probably too high. Controlling inventory is extremely important to the financial success of any business. Too much inventory indicates substantial "tied up" and non-productive cash.

RETAINED EARNINGS: Every business owner should know this number; in fact it is imperative to know this number. Retained earnings represents the total earnings (profits) generated by the firm since existence. An important item since it indicates the effectiveness of management in managing the firm for profits. Retained earnings do not represent surplus cash or cash left over after the payment of dividends. Rather, retained earnings demonstrate what a company did with its profits; they are the amount of profit the company has reinvested in the business since its inception. These reinvestments are either asset purchases or liability reductions. This figure indicates the ability for the firm to generate profits.

NET WORTH: Another extremely important number to know since it determines the value of the firm and determines the financial strength of the firm. It is important for the firm to show an increasing net worth over the years and indicates the ability of the firm to generate value. For example a zero net worth indicates that a firm is barely surviving. A negative net worth indicates that the firm is technically bankruptcy. A positive and growing net worth indicates a financially strong and growing firm. Also, this is an important figure relied on by bankers and, as a general rule, a firm can expect to be able to borrow up to six times its net worth.

NEXT ISSUE: Additional formulas to help analyze the financial strength, or weakness, of your firm and to determine your investment return

PREPARE FOR SUCCESS

To be successful every firm MUST show a "good" net profit and must ALWAYS have adequate "liquidity" and MUST develop a STRONG balance sheet,

REMEMBER -- COMPANY'S DO NOT PLAN TO FAIL, THEY JUST FAIL TO PLAN

About Our Organization...

We provide complete and total STRATEGIC PLANNING consulting services to individuals that own and operate their own business as well as our exclusive BMA service that provides complete bookkeeping (saves an average of \$18,000 per year) and complete payroll (saves up to 70%). We help our clients succeed. Please contact us for more information. Call us or visit our web site for additional information.