FINANCIAL LITERACY

Maximizing Your Business

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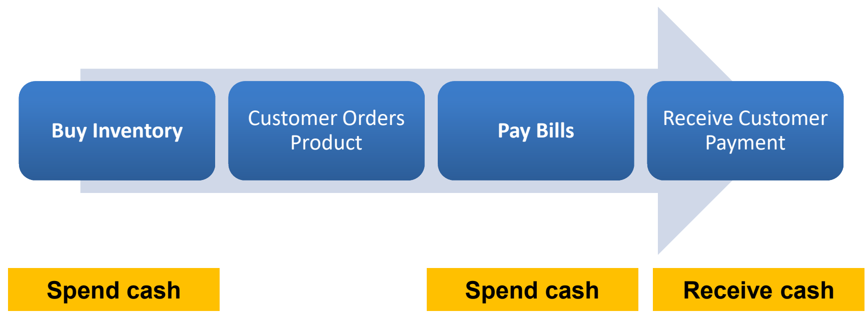
An Educational Session sponsored by the Chartered Professional Accountants of Canada (CPA Canada)

Common Questions Business Owners Ask

- Sales are great, why don't we have any cash?
- Do we have enough cash to pay expenses?
- How much cash do we need for expansion?
- Can I free up some cash from the business?
- How can I get customers to pay sooner?
- Are we managing cash efficiently?

Typical business cycle



A business must have cash available for its operating activities

Understanding working capital

Working Capital is a measure of the liquid assets available to be used in the operation of the business

Working Capital = Current Assets – Current Liabilities

Current Assets
- Cash
- Inventory
- Accounts Receivable

Current Liabilities
- Accounts Payable

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Examining working capital

Current Assets	
Cash	$10,000
Inventory	$20,000
Accounts Receivable	$75,000
Total Current Assets	$105,000

Current Liabilities	
Accounts Payable	$15,000
Total Current Liab.	$15,000

Working Capital = Current Assets – Current Liabilities

$90,000 = $105,000 - $15,000

$90,000 is available to support the operation of this business

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Working capital and sales growth

Sources of additional working capital

- Existing funds (e.g. cash on hand)
- Additional investment by owners
- New investors
- Lenders

Additional sources of working capital should be identified before they are needed for growth

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Understanding operational efficiency

Operational efficiency can be measured by how quickly sales are converted to cash

Key efficiency ratios:

- Days in inventory
- Collection period
- Payment period
- Cash conversion cycle
- Inventory turnover

Improving operational efficiency can reduce working capital amount

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Examining efficiency – Days in inventory

How long inventory stays in the company before sale

$$\boxed{\frac{\$20{,}000}{\$18{,}000/30} = 33 \text{ days}} \qquad \text{Days in Inventory} = \frac{\text{Ending Inventory}}{\text{Cost of Goods Sold per Day}}$$

Ending inventory can be found on the balance sheet

Cost of goods sold can be found on the profit and loss statement

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Examining efficiency – Collection period

How quickly payment is received from customers

$$\frac{\$75{,}000}{\$50{,}000/30} = 45 \text{ days}$$

$$\text{Collection Period} = \frac{\text{Ending Accounts Receivable}}{\text{Revenue per Day}}$$

Ending accounts receivable can be found on the balance sheet

Revenue can be found on the profit and loss statement

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Examining efficiency – Payment period

How quickly vendors and suppliers are paid

$$\frac{\$15{,}000}{\$18{,}000/30} = 25 \text{ days}$$

$$\text{Payment Period} = \frac{\text{Ending Accounts Payable}}{\text{Cost of Goods Sold per Day}}$$

Ending accounts payable can be found on the balance sheet

Cost of goods sold can be found on the profit and loss statement

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Examining efficiency – The Cash Cycle

The cash conversion cycle measures the length of time cash is tied up in the company

$$\text{Cash Conversion Cycle} = \text{Days in Inventory} + \text{Collection Period} - \text{Payment Period}$$

53 days = 33 days + 45 days – 25 days

The cash conversion cycle is also known as the cash collection cycle

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Examining efficiency – Inventory turnover

Inventory turnover measures how many times per year a company sells (turns over) its inventory

$$\frac{\$18{,}000}{\$20{,}000} = 0.9 \text{ times}$$

$$\text{Inventory Turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Inventory}}$$

Ending inventory can be found on the balance sheet

Cost of goods sold can be found on the profit and loss statement

Improving efficiency – Inventory

- **Evaluate customer demand/sales**
  - Align inventory with projected sales
  - Eliminate slow selling items
  - Reduce “safety” stock
- **Optimize order cycles and quantities**
  - Receive deliveries more frequently
- **Utilize direct ship**
  - Expensive/slow selling items
- **Eliminate obsolete inventory**

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Improving efficiency – Collection period

Improving efficiency – Payment period

Improving efficiency – Example

10% reduction in inventory

- Days in inventory drops to 30 days

Improved collection process

- Implement electronic payments – save 4 days
- Invoice promptly – save 5 days

Improved payment process

- Pay bills when due – 3 days later

38 days = 30 days + 36 days – 28 days

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Improving efficiency – Example

Current Assets	
Cash	$10,000
Inventory	$18,000
Accounts Receivable	$60,000
Total Current Assets	$88,000

Current Liabilities	
Accounts Payable	$16,800
Total Current Liab.	$16,800

Working Capital = Current Assets – Current Liabilities

$71,200 = $88,000 - $16,800

Improving operational efficiency reduces working capital by $18,800

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Improving efficiency

Efficiency ratios should be calculated and monitored

- Ratios should be compared to the industry
- Trends should be analyzed
- Adverse changes should be investigated

Improved operational efficiency can free up working capital

- Carrying less inventory
- Getting paid sooner

Resources

- Glossary of Terms
- Implementation checklist
- *5 tips for building your cash flow* (Business Development Bank of Canada) **cpacanada.ca/flbdc**
- *How to get control of your company's finances* (Business Development Bank of Canada) **cpacanada.ca/flbdc**

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Glossary of Terms

Working Capital – A measure of the liquid assets available to be used in the operation of the business. (*Working Capital = Current Assets - Current Liabilities*)

Operational Efficiency – The ratio between the inputs required to run the business and the outputs gained from business operations.

Days in Inventory – How long inventory stays in the company before sale. The lower the days in inventory, the less working capital is required. (*Days in Inventory = Ending Inventory / Costs of Goods Sold per Day*)

Collection Period – A measure of how quickly payment is received from customers. The quicker a company receives payment from customers, the less working capital is required. (*Collection Period = Ending Accounts Recievable / Revenue Per Day*)

Payment Period – A measure of how quickly vendors and suppliers are paid. The longer a business is able to hold on to cash before paying suppliers, the less working capital is required. (*Payment Period = Ending Accounts Payable / Cost of Goods Sold Per Day*)

Cash Conversion Cycle – A measure of the length of time cash is tied up in the company. Also known as Cash Collection Cycle. (*Cash Conversion Cycle = Days in inventory + Collection Period + Payment Period*)

Inventory Turnover – A measure of how many times per year a company sells (or turns over) it's inventory. (*Inventory Turnover Ratio = Costs of Goods Sold / Inventory*)

Q & A

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