

Visual Learning Maps

Introductory Financial Accounting



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VIRTUAL TEXT BOOK

Liquidity... **ONGOING MANAGEMENT - 1 of 2**

In managing any business, a constant concern is the cash position of the business – and how to improve it. Key questions:

- Are we collecting our accounts receivable efficiently?
- In merchandise operations; how well [fast / slow] is our product moving?
- How burdensome is interest expense?

Are We collecting Accounts Receivable Efficiently?

This number tells you how many times the average accounts receivable turned over during the accounting period. Businesses monitor this number every accounting period because it is a cash flow indicator.

Accounts Receivable Turnover

$$\frac{\text{Net Sales}}{\text{Average Accounts Receivable}}$$

The higher the number is the better. Higher numbers mean that accounts receivable are turning over faster – a positive momentum. A lower number means that accounts receivable are turning over slowly – cash inflows are tardy.

There is no one ideal turnover number for all businesses. The turnover target number varies by industry and by business within industries because:

- Some businesses require “payment upon receipt of invoice,” some businesses provide customers with “10 days” or “30 days”; and have patience with customers beyond those time periods.

Once you know the “Accounts Receivable Turnover” number, there is another piece of arithmetic that communicates clear information that is useful – it tells owners and managers the average collection period in days. It simply divides the number of days in a year by the accounts receivable turnover.

Liquidity... **ONGOING MANAGEMENT - 2 of 2**

Accounts Receivable...continued

Average Collection Period in Days

$$\frac{365}{\text{Accounts Receivable Turnover}}$$

This number should be close to the policy of the business in its account collections; i.e. if a business has a policy with customers that accounts are due in 30 days – the number should be close to 30. If the number is significantly higher than the policy number, it means that the business is collecting cash slower than it should – an action plan is needed in the collections department.

How Well [Fast / Slow] is Our Product Moving?

This number tells you how many times the inventory turned over during the accounting period.

Inventory Turnover

$$\frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

Merchandising businesses pay constant attention to inventory levels because:

- Not having enough inventory means orders cannot be filled, thus customers will go elsewhere and may be lost forever
- Having too much inventory means increased expense for space, obsolescence, spoilage, shrinkage and handling.

The higher the number is - the better. Higher numbers mean that inventory is moving faster into the hands of customers.

A lower number means that inventory is staying longer at the warehouse; and therefore creating more cost.

There is no one ideal turnover number for all businesses. It depends on the industry; but each industry has turnover objectives and it is measured every accounting period. A business that sells ice cream will have a higher turnover rate than a business that sells luxury cars.