PAYLINK

ACCOUNTS RECEIVABLES ANALYSIS

AS PART OF YOUR CREDIT POLICY





Cash is the life blood of any business. Analyzing a companies cashflow and identifying/analyzing any gaps or improvement needed is an ongoing process and critical for the success of a company. When a company becomes more concerned about cash then profit, the end is near.

In this article, we will look at three things to consider when analyzing the cashflow of a company. Days Sales Outstanding, Accounts Receivable Turnover Ratio, and the Time Value of Money. All are metrics that can be used to understanding the overall accounts receivables process of a company.

DAYS SALES OUTSTANDING (DSO'S)

For any business, large or small, it's important to keep your accounts receivable to a minimum. Keep in mind, Cash is KING for any business. To get a handle on your accounts receivable, you must first determine how long it takes to collect on an account. Days sales outstanding (DSO) is a metric that can help you understand how long it takes clients and customers to pay you.

DSO represents how efficiently a business collects payments, which impacts a company's profitability. Analyzing DSO can help pinpoint issues in your accounts receivable process and help forecast cash flow. Tracking DSO over time helps identify trends that will help inform your cash flow forecast.

If a company has a high DSO, consider evaluating your Credit Policies, including to whom is extended credit. If the DSO begins to climb, it may mean more of your cash is tied up in accounts receivable. A high DSO may indicate an approaching cash crunch.

DSO FORMULA

The formula for calculating DSO is fairly straight forward:

(Current Accounts Receivable Balance/Total Credit Sales) x Number of Days =DSO

Let's use an example of a business that has $10,000 in accounts receivable on January 1, 2020. The next month, on February 1, 2020, the business has $12,000 in accounts receivable. The business also sells $8,000 in credit sales between January[1] and February [1].



Use these steps to calculate DSO:

01 Calculate average account receivable

First, we'll find the average accounts receivable over the time period being analyzed:

($10,000 + $12,000) ÷ 2 = $11,000 average accounts receivable

02 Find total credit sales

In this case, we know that total credit sales over the time period being analyzed is $8,000.

03 Find the total number of days in the time period

January has 31 days, so 31 will be the number of days we use in the DSO formula.

04 Apply these numbers to the DSO formula

Using the DSO formula, we can calculate days sales outstanding with the numbers we've found. Given the DSO formula:

(Accounts receivable ÷ total credit sales) x number of days = standard DSO

($11,000 ÷ $8,000) x 31 = 42 days sales outstanding

HOW DSO AFFECT BUSINESS FINANCES

Generally, a low DSO ratio is better for your business. But your ideal days-sales-outstanding ratio depends on your industry and type of business. In 2018, the average DSO number was 40 days among non-financial companies analyzed by the Hackett Group.

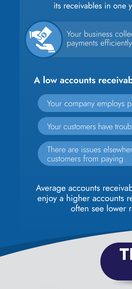


To understand the effectiveness of your accounts receivables process, analyze individual DSO values, and review trends in DSOs over time. DSOs may also vary according to seasonality. Generally, seasonal rises and falls aren't a cause for concern. Instead, forecast your business's cash flow to plan for seasonal changes.

Why would days sales in receivables increase?

An increase in days sales outstanding indicates that it may be taking your business longer to collect outstanding payments.

Reasons why you may see a higher DSO include:

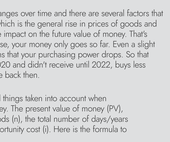


- Customers are taking longer to make payments.
- Customers aren't satisfied with your business or customer service, so they may be reluctant to pay.
- Customers with poor credit are making purchases on credit. So you may need to review your credit terms.
- Your sales team is extending flexible payment terms to help drive sales.

WHAT IS A GOOD DSO RATIO

Tracking a company accounts receivable turnover ratio helps management of the company manage the cash cycle providing a more efficient use of assets. By knowing how much money customers owe the company, provides a better plan for future purchases.

Tracking these numbers and sending out notices after a period of time, usually 30 days help reduce the risk of customer delinquencies. Also, accounts receivable is considered an asset on the company balance sheet, which can help when the company needs to apply for financing.



Calculating The Accounts Receivable Turnover Ratio

To calculate your business's accounts receivable turnover ratio, divide your net credit sales by your average accounts receivable. This formula uses the average accounts receivable figure to smooth out the calculation over the time period you analyze. Higher ratios suggest efficient debt collection, while lower numbers point to less efficient debt collection.

Lets use an example where a company has $750,000 in net credit sales, $50,000 in accounts receivable at the beginning of the year and $60,000 in accounts receivable at the end of the year. Using the receivable turnover ratio:

$750,000 / ([$50,000 + $60,000) / 2] = 13.64

This indicates that the business collects its receivables 13.64 times on average per year.

This higher ratio signals an adequate ability to collect on your debts.

As another example, imagine a company has $30,000 in net credit sales, $5,000 in accounts receivable at the beginning of the year and $3,000 in accounts receivable at year end. By applying the account receivable turnover ratio, you find that:

$30,000 / ([($5,000 + $3,000) / 2) = 7.5



This signifies that the business collects its receivables only 7.5 times on average per year. This lower ratio indicates the business should probably change its policies and practices to manage cash flow more effectively.

If your small business lets customers set up credit accounts, good tracking habits and accounts receivable management help you keep your accounts receivable turnover ratio high and your cash flow stable.

Interpreting Your Accounts Receivable Turnover Ratio

The accounts receivable turnover ratio indicates how many times, on average, a business collects on its receivables in one year. A high accounts receivable is more desirable and could imply that:

- Your business collects payments efficiently
- You have quality customers who pay their bills timely
- Your company's credit policy is restrictive

A low accounts receivable ratio may indicate that:

- Your company employs poor collection processes
- Your customers have trouble meeting payment due dates
- There are issues elsewhere in the business that prevent customers from paying

Average accounts receivable turnover ratios often vary by industry. While retail businesses typically enjoy a higher accounts receivable turnover ratio, companies in the oil and gas extraction industry often see lower ratios, waiting longer to receive payments from their customers.

TIME VALUE OF MONEY TURNOVER RATIO

The time value of money (TVM) is the concept that a sum of money is worth more now than the same sum will beat a future date due. TVM is also referred to as the present discounted value.

Opportunity cost is key to the concept of TVM. Money reinvested in a company over time earns a positive return. Money that is not reinvested loses value over time. Therefore, again, a sum of money that is expected to be paid in the future, no matter how confidently it is expects, is losing value in the meantime.

The value of money changes over time and there are several factors that can affect it. Inflation, which is the general rise in prices of goods and services, has a negative impact on the future value of money. That's because when prices rise, your money only goes so far. Even a slight increase in prices means that your purchasing power drops. So that dollar you earned in 2020 and didn't receive until 2022, buys less today than it would have back then.

To calculate TVM, there are several things taken into account when calculating the future value of money. The present value of money (PV), the number of compounding periods (n), the total number of days/years (t), and the interest rate or lost opportunity cost (i). Here is the formula to calculate TVE:

FV = PV x [1 + (i / n)] (n x t)

The overall accounts receivables process for any company has a huge impact on the financial soundness and profitability of the company. Analyzing a company's accounts receivables and it's respective processes, taking into account the Days Sales Outstanding, Accounts Receivable Turnover Ratio and the impact of the Time Value of Money will significantly improve the financial position of the company and ensure long term success.