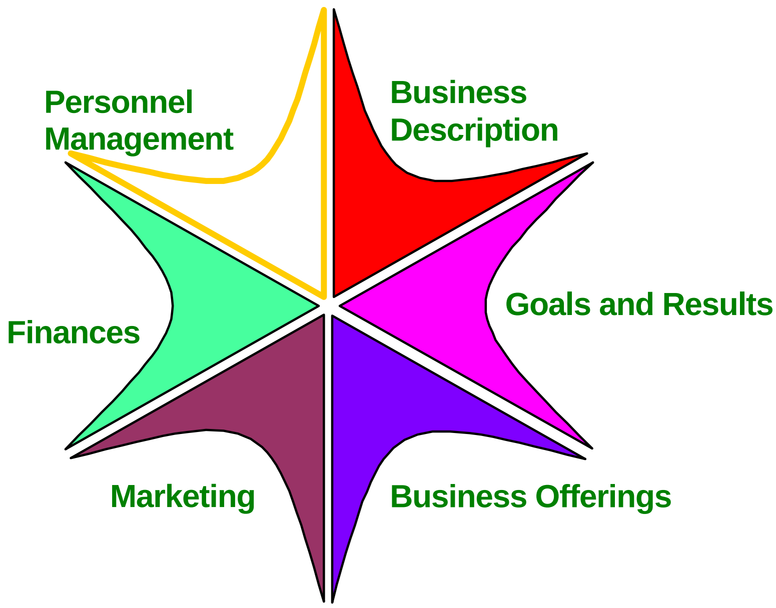
Operational Financial Management



CorNu
Enterprises

A CorNu Enterprise Educational Product

BIZBITE CONSULTING GROUP

Operational Financial Management

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Credit Page

The founders of BizBite Consulting Group and developers of CorNu Enterprises dynamic approach to education are

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How is this module organized?

The Operational Financial Management module has one major topic:

1. Operational financial management

Within the module, the material is divided into these headings:

Introduction
How to use this section
(Module content)
Uses
Summary
Celebrate

Celebrate!

It is important that you recognize your achievements and celebrate each small step. Phone some friends and celebrate it. We will offer you opportunities to celebrate at the end of each part of the module. Have fun with them. We had fun creating them for you.

Suggestions on how to use this module

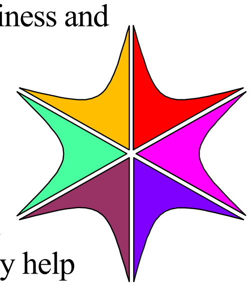
This module is organized so that you decide:

- In what order you want to access the various titles
- What you want to ignore
- How many times you want to revisit the material

Just return to the Table of Contents and click on what you want to read or review again.

The six-pointed star

We have depicted business and a business plan as a six-pointed star. Each part of the star represents a major aspect of your business and an important element of a business plan. Together, they form a complete view of your business and your business plan.



We have carried this star throughout all the BizBite Consulting Group products and all the modules.

As each new section is begun or completed, the appropriate part of the star is colored and the rest of the star is colorless. This may help you to see how a specific topic relates to the whole business and to remind you that it is part of the whole.

Acknowledgement

All of the Universal Laws quoted at the end of each module come from

Brain Tracy (1992). The Universal Laws of Success and Achievement. Chicago: Nightingale-Conant Corporation.
They are from the supplement to the eight-audiocassette program

Operational Financial Management

Introduction

In **Operational Financial Management**, the focus will be on the following three topics:

1. Inventory management
2. Accounts receivable and credit policy
3. Preparing pro-forma cash flow statements

Operational Financial Management is particularly concerned with managing the flow of cash in and out of the business. It is also concerned with how to utilize the cash by the business to provide the best ***return on investment (ROI).***

As you move through this section, think of how you presently manage your business in relation to these three subject segments. A brief outline of these segments follows:

Inventory management

In **Inventory Management**, you will learn the different ways in which inventory is evaluated. Samples will provide you with examples that will help you in properly evaluating the inventory in your business.

Managing the product mix in a business can be a complex issue. **Inventory Management** will present ideas on how to manage the product mix to obtain the best return.

As well, you will learn the importance of maximizing inventory turnover. You will see ideas and examples that you can apply to your business.

Accounts receivable and credit policy

In this segment, you will learn the importance of designing a credit policy that will best serve the needs of the business and market it serves. You will learn that creative use of credit policy can be an important part of both:

- The sales and marketing management of a company
- The financial management of a company

We will discuss the effect on the business of effective credit policy and management.

You will learn about the typical ***accounts receivable (A/R)*** reporting tools and their use.

You will also learn methods of managing credit sales and the resulting accounts receivable (A/R).

Preparing pro-forma cash flow statements

In **Preparing Pro-forma Cash Flow Statements**, we will present in detail the elements of a cash flow statement and its preparation. You will learn, step by step, how to prepare a cash flow statement and will be able to apply this directly to your business.

We will discuss the importance of using the pro-forma cash flow statement to:

- Forecast the expected revenue and expense for the fiscal year
- Plan for potential shortfalls in business revenue
- Communicate financing needs to a lender

At the end of this material, we provide sample spreadsheets to assist you in preparing a cash flow statement for your business.

When you have finished, think carefully about the ideas presented. Consider how you operate now and what ideas would improve your business now or in the future.

The Laws of Business—of obsolescence

Whatever is, is already becoming obsolete.
Change prevails—–it's unavoidable.
A successful business adapts quickly; even better,
it helps create change.

Inventory Management

Introduction

For any company that handles inventory, the inventory represents a major investment for the company. For many companies, the value of the inventory is the value of the company. It may be the largest asset of the company. Therefore, inventory deserves careful attention and proper management in order for it to yield the maximum ***return on investment (ROI)*** to the company.

The purpose of **Inventory Management** is to generate more awareness of common approaches to managing inventory. We will discuss some inventory management ideas in *income statement analysis* in relation to the ***cost of goods sold (CGS)—***ideas such as inventory turnover and the evaluation of inventory.

Now, we will build on those ideas and discuss other ideas related to good inventory management.

We will focus on four important areas:

1. Inventory evaluation
2. Managing the product mix in inventory
3. Inventory investment
4. Inventory turnover

How to use this information

As you read this material, you should think about:

- How you presently manage the inventory in your business
- What you presently do to manage the amount of money invested in each product category
- What do you now do to manage and control the quality of your inventory
- What do you do now to promote inventory turnover

a. Inventory evaluation

Evaluation of the inventory can vary with the industry and the type of business.

Natural resources, manufacturing, distribution, and retail—all of these industries may evaluate inventory differently.

Within these industries, evaluate some groups of products differently because of the nature of the product and the handling of it.

If your industry or business has special inventory evaluation concerns, you should consult your accountant for direction.

For the purpose of discussion in this segment, we will only be concerned with presenting the main approaches to inventory evaluation.

There are three methods of inventory evaluation:

a. First in first out (FIFO)
b. Last in first out (LIFO)
c. Weighted average

From an accounting point of view, it usually doesn't matter the choice of method as long as its use is consistent. However, each method can affect cost of goods sold (CGS) differently. In addition, the rate of inventory turnover and tax considerations may influence the choice of method.

For the purpose of illustration of these three methods, in the next three segments we will use the following example:

Acme Mercantile inventory records show the following information.					
Beginning Inventory	Units	1000	@	$1.00 ea.	= $1,000
Purchase #1	Units	2000	@	$1.12 ea.	= $2,240
Purchase #2	Units	2000	@	$1.22 ea	= $2,440
Total Units	**5000**		**Total value**		**$5,680**
Ending Inventory	Units	2000			
Units Sold		3000			

This example indicates only two purchases; however, in practice, there may be many purchases.

(1) First In first out (FIFO)

The FIFO method of inventory evaluation assumes that:

The first items (purchase for inventory) are the first items sold.

Therefore, using the assumed figures for Acme Mercantile, the following scenario illustrates how the FIFO method works.

If 3000 units are sold:				
Units Sold 1st	Units sold	1000	@	\$1.00 ea. = \$1,000
2nd units sold	2000 @	\$1.12 ea.		= \$2,240
Cost of Units sold				\$3,240
Cost of units remaining in inventory		\$2,000 x \$1.22 ea. = \$2,440		

(2) Last in first out (LIFO)

The LIFO method of inventory evaluation assumes that:

The last items purchased for inventory are the first items sold.

Therefore, using the assumed figures for Acme Mercantile, the following scenario illustrates how the LIFO method works.

If 3000 units are sold:				
1st units sold	2,000	@	\$1.22 ea.	= \$2,440
2nd units sold	1,000	@	\$1.12 ea.	= \$1,120
Cost of units sold				**\$3,560**
Cost of units remaining in inventory	1,000 x \$1.22 ea			= \$1,120
1,000 x \$1.00 ea				= \$1,000
Total cost of remaining units in inventory				= **\$2,120**

(3) Weighted average

The weighted average method of inventory evaluation assumes that:

Unit cost of inventory is the total cost of inventory divided by the number of units.

Therefore, using the assumed figures for Acme Mercantile, the following scenario illustrates how the weighted average method works.

If 3000 units are sold:		
Weighted average cost is	$5,680/5,000 units	= $1.136/unit
Therefore, cost of units sold is	3,000 x $1.136	= $3,408
Total cost of units remaining in inventory is	2,000 x $1.136	= $2,272

In the three methods of inventory evaluation, you can see that:

- The cost of units sold is different
- The cost of the units remaining in inventory is different

The reason is that the evaluation assumption is different. None of the three methods are wrong, but the method chosen will affect the ***cost of goods sold (CGS)*** calculation and hence the profit calculation for the period.

1. The **FIFO method** is the most widely used. It produces values closer to current market values since it includes costs that are more current.

   You could say that this method encourages the turnover of inventory because the better the turnover rate, the closer the inventory valuation will be to current market costs.

   However, it still slightly underestimates current market value because it does include earlier costs.

2. The **LIFO method** generally results in undervalued inventory.

   If you use this method, you are not allowing for the replacement cost of your inventory.

   LIFO may not be acceptable by governments in some jurisdictions because, by undervaluing inventory, the CGS is overstated and this has the effect of lowering the taxable income of the company.

3. The **weighted average method** tends to produce values that are similar to FIFO because it blends the cost of all the items in inventory. However, this does depend on the type of business and the turnover rate.

(4) Periodic and perpetual inventories

The inventory calculation examples (shown above) assume that on a periodic basis, the inventory is counted and evaluated. It is a legal requirement in most jurisdictions that at least once a year or in a 12-month period, there should be a complete physical inventory

In practice today, many businesses use a perpetual inventory system where the cost of blending existing inventory constantly with the cost of new items acquired for inventory.

> Electronic inventory management systems and accounting software handles perpetual inventory systems with ease.
>
> Many such systems will allow inventory calculations using the different methods of evaluation.
>
> Sometimes, within a particular business, evaluating product categories differently can present a more accurate picture for tax purposes.

Managing the product mix in inventory

The ***product mix*** is a term that refers to the product selection that a company stocks and the amount of those products that are stocked. The product mix in the inventory of a company is very important. If you don't have the right amount of each product at the right time, it can have a significant effect on the profitability of the company.

Managing the product mix involves:

Selecting main product lines that will complement each other in terms of quality range and price range

Selecting the right accessory and related products to go with the main products

Accurately projecting the required stock quantities at all times and determining the amount of additional stock required in peak or seasonal periods. Establishing minimum and maximum inventory levels for all items for each period of the fiscal year

Accurately determining the inventory value of each part of the product mix

Ensuring that units of product in all segments of the product mix are in saleable condition

Promoting the turnover of inventory to ensure that the majority of product units are fresh and as recently purchased as possible

Consciously and aggressively moving overage, damaged or poor quality inventory

b. Inventory investment

Being constantly aware of the amount of money necessary to maintain established inventory levels is a key factor in managing inventory. Without awareness and exercising spending control, a business could easily spend profits or even the proceeds from gross sales on items other than inventory.

In this event, the problems resulting could be:

- Lack of funds to reinvest in inventory
- Borrow money to reinvest in inventory. This increases expense and, therefore, can lower profits
- Less inventory to sell of important product lines and, therefore, lower sales
- Inability of the business to react to customer demand for new products
- Loss of customer confidence in the business as a supplier
- Loss of market share

These points illustrate how important it is to maintain inventory levels at acceptable levels in all segments of the product mix.

Maintaining inventory levels of key products is vital to the success of your business.

To ensure that your business maintains inventory at required levels, you should prepare detailed inventory reports.

> The frequency of preparing the reports may vary with some businesses. Businesses with higher turnover rates need to prepare the reports monthly, but many businesses would likely find that quarterly inventory reports are sufficient.
>
> These reports should show the inventory value of each item in inventory as well as the total value for the product segment of which it is a part. The report should show comparative figures to the previous period so identify changes in value.
>
> These reports will be labour intensive to produce by hand, but many accounting software programs or business managerial software programs will easily produce detailed inventory reports at the push-of-a-button. Consult your certified accountant on the accounting needs for your business.

Based on the inventory reports, you need to budget money for monthly maintenance of the inventory investment in each product.

A portion of this money really represents a portion of the cost of goods sold (CGS).

To maintain inventory investment, replace the CGS each month.

Therefore, allocate that portion of your sales revenue represented by the CGS each month to replace the inventory investment.

It is a good idea to compare the % to sales of CGS from one period to another on the income statement.

In **Income Statement Analysis**, we will discuss the inventory section of the income statement. Revisit or visit that section and review the discussion about inventory, CGS, and the statement of inventory value.

c. Inventory turnover

The question of monitoring and controlling ***inventory turnover*** has come up a number of times in our discussions about inventory management. Inventory turnover affects all the items we have discussed so far—evaluation, product mix, and investment.

In reference to the examples above, we have referred to inventory turnover effecting the calculations and they will widely differ.

You will find little difference in the calculation methods in businesses with:

Higher turnover rates and low inventory values

You will find bigger differences in the calculation methods in businesses with:

Lower turnover rates and higher inventory values

In either case, it is evident that inventory turnover rates are a key factor in business profitability. To facilitate inventory turnover, every business should:

a. Use inventory identification methods—*Inventory identification*
b. Assign a length of time an item may be in inventory—*Length of time in inventory*
c. Produce inventory movement reports each month—*Inventory*
d. Produce monthly overage inventory reports—*Overage inventory report*

We will now discuss these four items:

(1) Inventory identification

Identify every item in inventory needs as to:

- An inventory ID number
- When the item was brought into inventory
- The cost price of the item

In addition to the product ID number, use a product code of some sort to mark the purchasing information on a tag attached to the item or use a stamp to stamp it on the package.

For example:

Product codes may be alpha numeric and the variety of systems is unlimited. A typical example of using a code in a retail store is as follows.

Assign a number to each month of the year—#1 for Jan. #2 for Feb.—until each month of the year has a number.

Choose a word with 10 letters or perhaps two words that total 10 letters and assign each letter a number in sequence from 1–9 + a letter for 0 as follows:

B	L	A	C	K	H	O	R	S	E
1	2	3	4	5	6	7	8	9	0

Purchasing an item of inventory at a purchase price of $24.90 the store would code the information as follows: #2–LCSE–99

Many stores use this simple method so that without the aid of electronic scanners a clerk in the store can see at a glance how long the product has been on the shelf and the cost price. The clerk would use this information to:

- Sell first the items that have been in inventory the longest.

Even if several items on a shelf are identical, it is important to have the most fresh, recently purchased inventory *on hand*.

- To make on-the-spot price adjustments, if necessary, while still maintaining a minimum GM.

  Knowing exactly how much profit there is in an item is an advantage when dealing with a customer.

Clerks using a product code like this become very proficient at reading the code without any hesitation. It becomes second nature to them as they are working with it all the time.

Usually incorporated into the barcode is exactly the same kind of information you see on price tags in stores and on most packaging today

A barcode is a strip of lines of various widths that represent all the product and pricing information for that inventory item.

When the barcode is scanned (with a barcode scanner at the ***point of sale (POS)*** or read by a clerk), all of the product and price information on the code is retrieved.

Here is an example of a barcode:

Example:

Another device that is useful in identifying Inventory at the point of sale (POS) is colour coding. Colour codes can help a sales clerk to identify the oldest inventory and its purchase date.

If clothing stores did not promote high turnover of inventory, the overage inventory would soon choke it. This is why you frequently see inventory-on-sale at clothing stores.

For example:

Tracking the age of inventory in the retail clothing business can make a big difference in inventory turnover and the salability of inventory. Clothing inventory becomes obsolete very quickly because of:

- Seasonal demand
- Changing styles in fashion

Producing inventory movement reports at the *push of a button* on your computer works well in getting a *global* picture of the inventory in the store. However, at the POS, a clerk serving a customer in front of a rack of similar jackets will benefit from a quick visual method of determining the age of inventory.

A simply device that is used by some retailers is to colour code the tags on the inventory. Coloured price tags are readily available from store fixture and supply wholesalers.

Assign each month of the year a colour. You might decide upon:

Red	January
Green	February
Light yellow	March
Blue	April

A clerk looking at a rack filled with similar jackets would know at a glance that the jacket with a light yellow tag had been in inventory the longest. The clerk would then try to promote the sale of those items.

There are many ways to identify inventory. The system used will depend on the type of business and the inventory stocked. Be creative in your business. You should think of ways that you can do a better job of identifying your inventory in order to promote turnover.

(2) Length of time in Inventory

Assign each product group in inventory a maximum time in inventory. Assign a shorter or longer time for some items within a product group.

> Even items that you think are very durable or won't become obsolete in a short time should be assigned a maximum time that you will keep them in stock.

Sitting on a shelf or hanging on a rack inventory will:

Become ingrained with a certain amount of dust

Become soiled from handling by customers

Acquire nicks or chips from jostling against other products

Not look fresh and new to customers

It is important to maintain inventory in as good condition and appearance as possible as well as to promote inventory turnover.

Once you have assigned a time limit to the inventory, use a visual method similar to that previous discussed to identify it.

In assigning a time limit to products, consider the following points:

- Look at inventory movement standards for the product in your industry
- Consider that it is your money that is invested in and tied up in the product as long as it sits in inventory
- Consider how perishable the product is. Will it deteriorate in value over a short time such as vegetables?
- Consider the seasonality of the product. That means to consider if it is an item that mainly sells in spring, summer, and fall or winter season
- How soon will the product become obsolete? Is it likely to become out of fashion in 3–6 months?
- Many industries consider that if a product has not sold for a year, the business has lost at least 30% of the value of the product by not turning over the money invested and reinvesting the money in new products.

For example:

A hardware store has hammers that were purchased for $15.00 and sell at a 33⅓% GM at $22.50 each.

If these hammers do not sell for a year, the store has:

Not made the expected GP of $7.50 each on these hammers

Not been able to apply this GP against operating expense

Not been able to reinvest the store's own money in other products

Although a hammer would not be considered a perishable item or subject to changes in fashion, the store must turn the money invested in inventory in a timely fashion in order to be profitable.

In this business, the time assigned for the hammers should not be longer than six months.

For example:

A clothing store has purchased dresses for summer sale. The dresses arrived in stock in March. The purchase price was $35.00 each and, at a 50% GM, the regular retail price is $70.00 each

If these dresses do not sell within 30-60 days at regular price the store:

Has not made the expected GP of $35.00 each on these dresses

May miss the narrow window of opportunity when most customers will buy summer clothing

Must consider the prospect that the dresses may be out of season and out of fashion within a couple of months

Must start an aggressive on sale strategy to make sure within another 30—60 days, the dresses are sold.

Seasonality and fashion dictate stock considerations in the clothing industry. It is why regular selling prices yield 50% GM. The business needs to have enough GM at the regular price to be able to offer 15%, 20%, and 35% discounts off the regular price and still make some GP.

In this example, the clothing business would likely assign a time in inventory of no more than two months.

We urge you to use these two very different examples to think about your business and what time limits you would assign to items in your inventory.

As you can see, the time limits can be very different and for different reasons. However, whether your product is a bar of steel, wire mesh, clothing, or perishable grocery items, you need to think it through carefully and assign inventory time limits that meet the needs of your business.

(3) Inventory movement reports

Inventory movement reports are very helpful in closely monitoring inventory. These days they are easy to access because any accounting software program should have the ability to produce these reports.

As well, many available business managerial programs will do a better job than an accounting software program in managing daily operations.

An inventory movement report should categorize inventory in product groups.

Within the main product, show the groups and products in sub-categories separately.

This is because when you view the report, you can focus your analysis on one group at a time and not get lost in a mass of unconnected information.

An inventory movement report should show on a per item basis:

- Beginning inventory number units and value
- The minimum and maximum inventory level for each item
- The pack size for each item—That is, how the item comes packaged for shipment—is it supplied in cases of 6, 12 or 24 items per package
- Number of inventory units sold of each item each month of the fiscal year-to-date and the value
- Number of inventory units on hand of each item and the value

After each inventory category or product group, it is useful to know the total value in inventory of that group of products.

Produce different versions of an ***inventory movement report*** for various users of the information in the business. The following three examples will illustrate this:

Example 1:

In this first example, a manager only wishes to view the movement history of an item. Therefore, the only information shown is the item description, ID# and the movement history. The movement history shows the manager the seasonal fluctuation in the movement of the item. A rat-tail file is an item of merchandise commonly found in hardware stores.

Inventory Movement Report													
Product Group/Class				**Date:**									
Item description	Prod ID#	Jan	Feb	March	April	May	June	July	August	Sept	Oct	Nov	Dec
8″ rat-tail file	1234567	6	15	24	30	20	26	15	12	18	30	22	10

Example 2:

In this second example, the manager wishes to see the value of the inventory items in stock, the preset stock level information, and the established ordering point along with the inventory movement history. One reason for this might be that changes in demand are cause for considering adjustments to stock levels and ordering figures.

Inventory Movement Report																		
Product Group/Class:									**Date:**									
Item Description	Prod ID#	Pack size	Min Inv	Max Inv	Order Pt	On Hand	Jan	Feb	Mar	Apri	May	June	July	Aug	Sept	Oct	Nov	Dec
8″ rat-tail file	1234567																	

Example 3:

In this third example, the manager wants most of the detail on the previous two example forms, but what's more, wants to produce a form that can be used to record ordering information.

Note that on the extreme right of the form that the last four columns are to record the quantity ordered, ordered when, who did the ordering and the requisition reference number.

In some businesses, there may be only one department doing all purchasing. In that case, only one PO# or purchase order number is used.

Some businesses have several departments that are preparing orders for submission to the purchasing department.

In this case, these departments prepare requisitions for the purchasing department.

The purchasing department consolidates the requisitions on PO's before forwarding the orders to the suppliers.

Inventory Movement Report																						
Product Group/Class:											**Date:**											
Item Desc.	Prod ID#	Pac Size	Min Inv	Max Inv	Ord Pt	On hand	Jan	Feb	Mar	Apr	Mar	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Qty Ord	Date	Req #	Emp #
8″ rat-tail file	1234567	12	24	36	18	16	6	15	24	30	20	26	15	12	18	30	22	10	12	17/2/00	123 456	23

Using the information on this last example note the following:

Mar-June movement is 100 items divided by 4 months = 25 items/month average

Sept-Dec movement is 80 items divided by 4 months = 20 items/month average

Total items moved per year is 228 items divided by 12 months = 19 items average

Therefore, because the pack size is 12, the order point has been set at 18 in order to accommodate the minimum and maximum inventory movement. Another factor that will influence ordering is the length of time it typically takes to receive an order from a supplier.

Before choosing a business managerial software program, seek advice from your accountant as to what features and information would best serve the needs of your business.

Using the inventory movement report information

You should study the data presented on the inventory movement report and answer the following questions about each item:

Does the item move at a consistent rate each month?

Does the demand for the item vary in some months of the year?

Is the inventory investment too high or too low in relation to the inventory movement?

Could inventory turnover be improved by adjusting the inventory investment in certain periods of the fiscal year?

Based on sales and the time it takes to replace inventory, what is the minimum number of units that should be stocked, and how many more units (the maximum) is it necessary to stock at certain times of the year?

Overage inventory reports

An ***overage inventory report*** is another report that the business managerial software and most accounting programs will produce.

Based on the length of time in inventory you have assigned to the item, the software will produce a report showing how many of each item you have in stock in excess of the assigned length of time in inventory.

This report will typically include the following information:

- A listing of all overage items by product category
- The number of units and the value of each overage item
- The total value of the overage inventory by product category
- The grand total value of all the overage inventory

As well, some overage inventory reports state information such as:

The earliest purchase date and quantity remaining of the original purchase.

The reports do vary in level of detail. Some software programs may be configured to provide additional information you may need.

What to do with the overage inventory report information

If your business has never regularly monitored overage inventory, you may be surprised at how much inventory is slow moving and could be classified as overage.

If you are able to produce an overage inventory report easily every month, you can scrutinize every listed item and make decisions as to:

- Is the item necessary to have in inventory? Must you have it satisfy customers?
- Do customers expect your business to have the item?
- Is it the right product or is there a similar product that would sell better?
- Was the item displayed or promoted properly?
- Are the inventory level quantities realistic in relation to the product movement?

If, after considering the answers to all of these questions, your decision is to remove the product from inventory, then do so as quickly as possible.

You are better off to sell overage inventory at a loss and re-invest the money in inventory that will yield good turnover rates

Cull slow-moving or overage inventory from inventory constantly. Display this stock and its discounted price prominently to whatever degree necessary to move it.

Summary

In **Inventory Management**, we have discussed ideas and methods related to the management of inventory. You have learned how to:

- Evaluate inventory
- Manage the product mix
- Manage the inventory investment
- Manage and promote inventory turnover

Compare the ideas and methods presented here to the ways in which you manage inventory in your business now.

Ask yourself these questions:

What ideas and methods would likely have the most positive effect on your business?

What do you project that the financial effect could be?

What ideas and methods can be implemented now?

What ideas and methods will need to be phased in?

What ideas and methods will require assistance from your accountant?

Laws of Money—of saving

Financial freedom comes to those who save 10 percent of more of their income all their lives.
The way to do this is to pay yourself first.

Celebrate!!

Join your friends for dinner

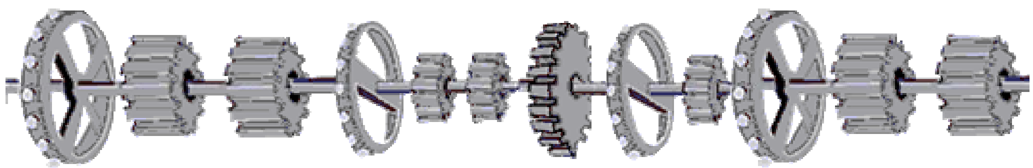
Accounts Receivable (AR) and Credit Policy

Introduction

Managing how ***accounts receivable (A/R)*** and ***credit policy*** in a company can have a major impact on the business. Here, we will discuss these important aspects of the financial management of the business. We will present common procedures and ideas in managing A/R and credit policy.

How to use this information

As you read this material, consider carefully the elements of the credit policy in your business. Think about how your present credit policy and the effect it has on your business. As well, think about how much of your business is charge sales and how important those accounts receivable (A/R) are to the business.



Ask yourself these questions:

How do the ideas presented on A/R management compare to the A/R in your business?

Could a redesigned credit policy better serve the financial needs of the business?

Could some of the ideas and procedures present help you design a better credit policy?

Would implementing some of the ideas presented improve the profitability of your business?

We have divided the material into two major parts:

A. Accounts receivable (A/R)

B. Credit policy

a. Accounts receivable (A/R)

Analyzing your ***accounts receivable (A/R)*** is an important part of monthly financial performance review and analysis.

Reports often refer to Accounts Receivable by the abbreviation, A/R.

Accounts receivables (A/R) are accounts with customers that the business has sold goods or services to on credit terms.

The amount of money represented by accounts receivable (A/R) can have a significant effect on the cash flow of the business because as long as those accounts remain unpaid, the money:

Is unavailable for use by the business

Cannot be reinvested in inventory

Cannot be used to pay the monthly expenses of the business

Cannot be used to acquire capital equipment needed

Cannot be used to implement marketing programs

Until accounts receivable (A/R) is paid, the money is not part of the cash flow of the business.

Unpaid accounts receivable (A/R) can increase the need for the business to borrow money to finance operations.

The cost of borrowing this operating capital is an added expense to the business.

Essentially, financing the accounts receivable (A/R)

A manager must justify this expense by balancing the expense against the other possible benefits to the business of borrowing money to finance the shortfall in revenue created by accounts receivable (A/R).

These benefits may be:

Increased turnover of inventory

Moving larger amounts of inventory may allow the business to buy products in larger volumes at lower prices

Buying at lower prices may result in a competitive advantage, which can result in increased sales

Balancing these factors to arrive at a decision is not always easy. In addition to the cost of borrowing, there can be other possible expenses involved with moving larger volumes of product by increasing accounts receivable (A/R).

Consequently, a manager must weigh all the costs versus the benefits to having accounts receivable (A/R) and increasing accounts receivable.

Some of these costs may be:

Increased staffing expense

Increased shipping and handling expense

Increased advertising and promotion expense

Increased warehousing and storage expense

This is an important factor in developing a ***credit policy*** for the company.

A company credit policy is a statement of the terms and conditions under which a company will allow customers to buy on credit. We will discuss credit policy later.

It is very important that a business be constantly aware of dollar value of unpaid accounts or accounts receivable (A/R). Controlling the amount of accounts receivable (A/R) and improving upon the rate of payment by customers can have a major effect on the cash flow and profitability of the business.

To facilitate analyzing accounts receivable (A/R) it is useful to produce an ***Aged Accounts Receivable Report.***

Named an Aged Accounts Receivable Report because it presents a history of purchases by a customer and how much remains unpaid.

An Aged Accounts Receivable Report is usually a spreadsheet with columns for each month of the year.

It includes the name of the account and the amount that remains unpaid each month. **Delinquent accounts** are customers who have not paid their accounts within the terms of the company's credit policy.

In a column on the far right does a space for the total amount of the money owe by the customer.

Aged Accounts Receivable (A/R) Report #1

Date										
Account Name	**CR. Limit**	**Terms App.**	**Total Owing**	**Amt. +/- CR.**	**Current Month**	**30 days**	**60 days**	**90 days**	**120 days**	**Prior Month**
Acme Supply	$5,000	60 days	$8,700	+$3,700	$500	$700	$1,200	$1,800	$2,000	$2,500
Superior Service	$500	30 days	$600	+$300	$200		$100		$300	
Quality Contractors	$500	60 days	$900	+$400	$300	$500	$100			
A-1 Builders	$15,000	60 days	$27,300	+$12,300	$8,000	$6,500	$5,800		$4,000	$3,000
Totals			**$37,500**	**+$16,700**	**$9,000**	**$7,700**	**$7,200**	**$1,800**	**$6,300**	**$5,500**

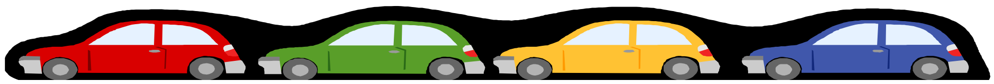
Aged Accounts Receivable (A/R) Report #2

This example shows some of the same information as the report above but presents only the balances owing for each period and a total amount owing. Some companies may provide a report that only shows this amount of detail to employees that deal with customers.

Name	Current	30 Days	60 Days	90 Days	120 Days	Prior Month	Total Owing
Acme Supply	$500	$700	$1,200	$1,800	$2,000	$2,500	$8,700
Superior Services	$200		$100		$300		$600
Quality Contractors	$300	$500	$100				$900
A-1 Builders	$8,000	$6,500	$5,800		$4,000	$3,000	$27,300
Totals	**$9,000**	**$7,700**	**$7,200**	**$1,800**	**$6,300**	**$5,500**	**$37,500**

The viewer of a report like this would want to acquire more knowledge about the accounts and the reasons for their purchasing and payment history.

If this were an example of the aged accounts receivable (A/R) report for your business, here are the following observations concerning the accounts.



Acme Supply—This delinquent account is getting further in debt to your company every month.

It is clear that only partial payment was received for each month's purchases.

The reason for this should be determined immediately.

If the customer has kept the account more current in the past and is a valued account, you may wish to negotiate a regular payment schedule to retire the past months owing.

You may even wish to continue selling to the customer as long as they adhere to the payment schedule.

If the circumstances don't warrant a negotiated repayment schedule, then the customer's account should be suspended until the account is brought into line with the credit terms policy of your company.

If no effort was made to repay the amounts owing, it may be necessary to either sue the customer for the money or send the account to a collection agency.

Superior Services—This delinquent account is not buying large amounts and in some months, there are no purchases.

This account may like to shop around for the *best deal.*

The amount 60 days past due is not large and likely not to be concerned about.

However, the $300 that is 120 days past due should be of concern.

As much as the $300 is important, it is important to know the reason why a relatively small amount was not paid.

When this situation exists, there is usually a story. The customer may be unhappy with the product or service that they bought. They may have expressed their dissatisfaction to someone in your business and they still are not satisfied.

Long before this account reaches the stage of being 120 days past due, a vigilant manager should be contacting the customer to determine their reasons for non-payment of the account.

Quickly identifying the reasons for a credit problem and resolving it maintain good customer relations and build the reputation of your business.

Quality Contractors—This delinquent account is a small builder that does small repairperson projects and renovations.

This account typically pays the account off regularly but is always waiting for payment after a job is completed.

A job could take 30–60 days to complete so most of the time payment is made in about 60 days.

The account is loyal to your business so there should be little concern that payment is always 60 days after purchase.

A-1 Builders—This delinquent account is similar to Quality Contractors, only the business is larger.

Most of their business is sub-contracting to larger general contractors.

A little extra communication and attention may be necessary with this type of account.

You need to know the reason for the non-payment of the amounts that are 120 days and prior months past due. It could be that there is some dissatisfaction with a product or service.

However, it may be that the general contractor has not paid them for some reason and so they are not paying you.

If the reason for non-payment is not directly related to product or services supplied by your company, then it must be made clear to A-1 Builders that you are not in the business of financing them and they must pay the account or risk suspension of credit privileges.

As part of assessing the value of this account to the business and deciding on a course of action, the manager would want to look also at the accounts purchasing history.

The following is an example of a Customer Purchase History Report.

A Customer Purchase History Report

Customer Purchase History Report								**Date**							
Account Name	Acct #	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec	YTD	PYTD
A-1 Builders	42351	$6,000	$7,000		$5,800	$6,500	$8,000							$33,300	$29,000

These examples are just a few of the typical situations that a manager and a credit manager deal with every day. You can see that doing a good job of managing accounts receivable (A/R) requires:

Constant attention

Current knowledge of customers' business and their changing needs

Being able to analyze and determine underlying reasons for the way customers pay their accounts

Application of good people skills and questioning techniques

Good decision-making skills

In **Testing the Financial Strength of Your Business,** there is a discussion of common business management ratios.

Two useful ratios for monitoring accounts receivable (A/R) are the ***accounts receivable turnover*** formula and the ***average collection period*** formula.

Completing a detailed analysis of accounts receivable (A/R) on a monthly basis is important.

As part of the analysis, it is a good idea to test the effect on your business if accounts receivable (A/R) increased or decreased or if the average collection period was greater or less.

Such an analysis may indicate that it is worth the expense of hiring a full-time person to manage accounts receivable (A/R) and collect delinquent accounts.

Good management of accounts receivable can have a major impact on:

The cash flow of a business

The amount of financing needed by the business

The cost of borrowing operating capital

Other ratios of interest relative to accounts receivable (A/R) are the current ratio, the acid test, and the debt to asset ratio are found in **Testing the Financial Strength of Your Business**.

In using these ratios, the **quality** of the accounts receivable (A/R) is important.

The term quality means how collectable is the money from the receivables or how quickly the receivables are converted into cash.

If overage accounts receivable represent a significant amount of money, then inclusion of those accounts in calculating the ratio may not give a true picture of the financial position of the business.

Summary of accounts receivable (A/R)

In **Accounts Receivable**, we have discussed how selling offerings on credit and creating accounts receivable can benefit a business. We have discussed some of the problems that can be involved with accounts receivable and some common tests for monitoring them.

Effect management of accounts receivables is a balancing act for many businesses. In designing a ***credit policy***, a manager is always striking a balance between:

- Allowing enough purchase on credit to stimulate sales and promote inventory turnover
- Maintaining positive cash flow and liquidity in the business

b. Credit policy

A company's ***credit policy*** is a statement of the terms and conditions under which a company will allow customers to buy on credit.

The credit policy of a company influences many aspects of the business.

The credit policy can have the effect of stimulating or inhibiting sales.

It can result in increasing or decreasing inventory turnover.

It can have an effect on the cash flow of the company.

Indirectly, it can have an effect on the amount of borrowed operating capital a company requires. In other words, it influences the:

- Sales and marketing of the business
- The financial management of the business

Tailor the credit policy of the company to the needs of the company and the market it serves. Key considerations when designing a credit policy are:

- Industry norms for the market served by the business
- Competitive credit policies of businesses in your market
- Your business's specific financial needs

Determine your business's specific financial needs by the results of your break-even analysis and estimates of what the business requires in order to achieve an acceptable level of profit and ROI.

Three ways to use credit policy

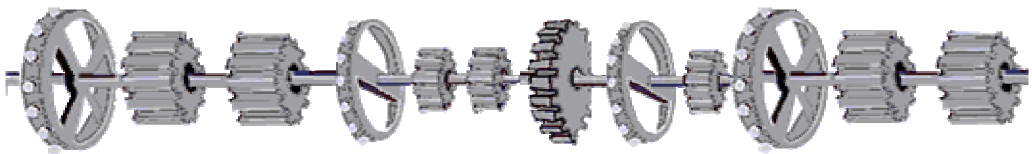
Most small businesses have a very simple credit policy.

Often there hasn't been a lot of thought put into formulating the policy.

A small company could derive its credit policy from:

- What others in the industry seem to be doing
- Adapt another company's policy

The basic reason to have a credit policy is to have some measure of control over the granting of credit.



Example of common credit terms:

It is very common for a company to have credit terms on consumer credit sales as follows:

Normal credit terms require that full payment in 30 days.

Making a payment within 15 days after purchase may provide a discount of 1% or 2%

Interest on past due accounts is 1½% per month on the past due balance.

A written credit policy (as stated in the previous three points) is common on company statements as: Credit terms are 1%–15 days. Net 30 days; 1½% month interest on past due accounts

The type of credit terms may vary slightly in the time period and percentage of interest due, but the terms usually relate to the cost of borrowing money.

This type of credit policy affords a measure of control. However, we will discuss using credit policy more creatively in the next three segments:

1. Credit policy used as a sales tool
2. Credit policy as a cash flow management tool
3. Credit policy as a profit generating tool

(1) Credit policy used as a sales tool

Credit policy can be a powerful sales tool. A company may want to do this in order to:

- Stimulate sales during slow seasonal periods
- Increase sales of high-priced items
- Keep a manufacturing plant operating in the off season
- Buy market share by offering better credit terms than the competition

Examples of businesses that do this are:

Companies that will take *booking orders* in the Fall for shipment the following Spring usually do so because they want to keep their manufacturing plant operating in the winter months.

If the company doesn't manufacture products, it may want to qualify for discounts from the manufacturer and may be willing to pass on some of that discount to their customers.

Companies selling high-priced items such as furniture, jewelry, automobiles, or major appliances may advertise that no payment is necessary for six months or even a year. Larger volumes of merchandise are sold under these terms.

(2) Credit policy as a cash flow management tool

The strictness or flexibility of the credit policy has a direct impact on the cash flow of the company. Relating the strictness of the credit policy to:

- The gross margin (GM) generated by the products sold by the business
- The cash needed by the business to meet its monthly obligations
- The length of time that the capital invested in accounts receivable (A/R) remains unpaid

Examples of businesses that do this are:

A ***business*** that makes a low GM on its products may not allow purchases on credit or the time before payment is due is very short. The time allowed before payment is due may be as little as 5–10 days.

A major reason for this is that if large amounts of sold merchandise on credit, the business would have to borrow money to meet its monthly obligations.

If the company is making a low GM, it can't afford to pay the interest charges on the borrowed operating capital for more than a very short period of time.

Businesses that make a large GM on their products can afford to extend credit for longer periods of time.

The reason for this is that the amount of borrowed money that may be necessary to meet monthly obligations is less.

In addition, a larger GM will allow the company to use a lesser portion of that GM to pay the interest charges on the borrowed capital and have enough left to meet the monthly obligations of the business.

(3) Credit policy as a profit generating tool

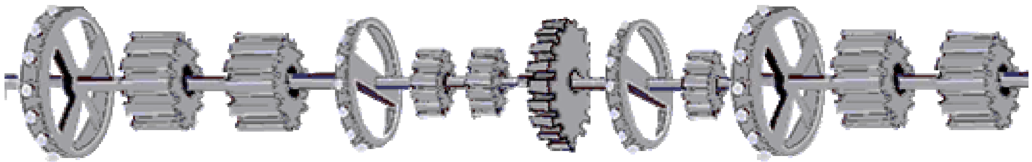
In certain instances, a profit-generation tool uses a credit policy.

This may be particularly so where the difference between bank interest and consumer credit rates are greater than normal.

In this case, a company may decide that it is worthwhile to maintain the total value of accounts receivable (A/R) at a certain level so as to:

- Stimulate sales volume
- Improve buying power of the company
- Improve inventory turnover
- Generate enough monthly interest income to offset a substantial portion of the operating costs of the credit department.

Therefore, the credit policy of a company can have the effect of offsetting a good portion of the operating expense of the credit department.



For example:

The value of accounts receivable (A/R) to which interest may be applied is $300,000.

The credit policy states that the interest applied to past due accounts is 1½% per month

Therefore, the gross amount of interest income generated from A/R is: $300,000 x .015 = $4,500

In a small company, this amount of money may very well pay two people to administer the credit policy of the company. In paying for itself, this cost of operating the credit department directly reflects the bottom line profit of the company.

Note: In this example, 300 customers who owe $1,000 or 1,000 customers who owe $300 may represent the $300,000 in A/R.

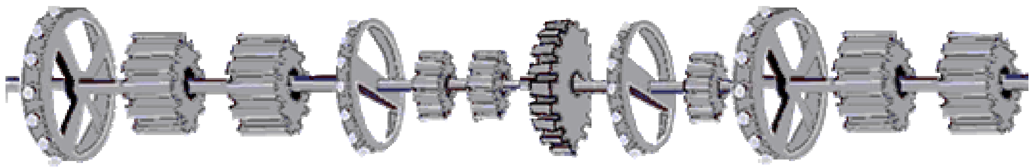
Therefore, the amount of work involved for the credit department to manage $300,000 of A/R will depend upon the number of customers owing the money.

Each business needs to assess the most profitable ratio between total A/R, past due A/R, and the operating cost of the credit department.

Six key elements to consider in granting credit

Deciding what customers are allowed to buy on credit and under what terms is a key part of developing a credit policy for your company.

> You may decide to have one policy for all customers or you may decide to have different policies for certain groups of customers.



Whatever your decision, consider the following key factors:

1. Qualification
2. Credit limit
3. Time frame for which credit is granted
4. Repayment incentives
5. Default and delinquent penalties
6. Payment instruments

We will now discuss each of these six factors:

(1) Qualifications

All customers must be required to qualify for the privilege of buying on credit.

> This means that they must prove that they have the ability to pay for their purchases within the terms of the credit policy of the company.
>
> They also must show that other companies have granted them credit in the past and that they have honoured their commitments to those companies.

To qualify for purchasing on credit, a customer is required to fill out an application form.

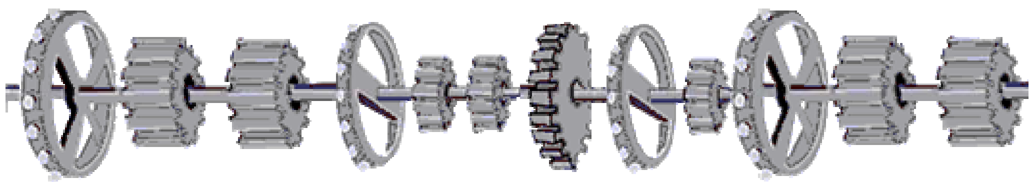
> This form will gather information about the customer and their credit history that the manager or credit manager will verify.
>
> Carefully check the references given.
>
> As well, you should check the applicant's history with a credit-reporting agency in your area.

Carefully screening credit applicants is very worthwhile.

In spite of the most careful investigation, some accounts will default on their accounts and you will either sue for the money or send the account to an agency for collection.

In either case, it is costly to the business.

What's more, deducting the net amount collected after collection fees or legal fees will sometimes be a fraction of the owed money.



Businesses usually use four types of forms for their customers:

a. The Personal Credit Application

b. The Commercial Credit Application

c. The Personal Guarantee

d. Joint Payment Agreement

In all cases when the applicant fills out the application, there is a statement at the bottom of the application form, which:

- Details the terms under which credit will be granted
- Requests signed authorization by the applicant for the vendor to make any necessary investigations with references or credit granting agencies.

Applicants are required to acknowledge and sign that they understand the terms and conditions outlined in the statement.

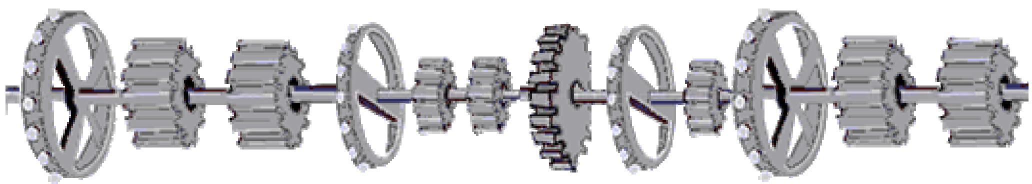
(2) Personal credit application

Typically, use the ***personal credit application*** for individuals applying for credit rather than a company applying for credit.

However, if the individual is making an application for their company to buy on credit and their business is less than two years old, it is common practice for them to be required to fill out both a Commercial Credit Application and a Personal Credit Application.

The reason for this is that their business does not have enough credit history.

Personal credit applications may vary in the information required, but most include information such as:



Place of residence, past and present	Employment history
Personal income	Personal asset value
Bank reference	Spousal relationship
Credit accounts with other companies	

The following are examples of:

- A Personal Credit Application
- A Business Credit Application
- A Personal Guarantee

A Personal Credit Application

[COMPANY]

Personal Credit Application

Last name:____________________First name:__________________ SIN. No.______

Address:____ Tel. No.______

City:__________________ Postal code:_________________ How long:___________

Previous address:____________________________________ Postal code:__________

Marital status:__________ Spouse's name _____________________________

Date of birth:___________ Monthly income:_____________ No. Dependants:______

Employer:____________________________Address:____________________________

How Long:____

Current Obligations

Creditor Original Amt. Balance Due Monthly Payment

____

____

____

Home: _______Leased-Monthly Rent $_______

________Rented-Monthly Rent $ ______________ Mortgage Amt._______

________Owned-Market Value $_______ Held By______________

Automobile(s): Year Make Amt. Owing Value _

. ____ $ ___________

. ____ $ ___________

Bank:_______________________________Address:____________________________

References where Charge Accounts operated:

1.____Address:____________________

2.____Address:____________________

3.____Address:____________________

The above data is for the purpose of obtaining credit and is warranted to be true

I request credit from you to a maximum of $___________ at any one time for goods and/or services to be furnished by you, and I agree if credit is given, payment shall be made by the 15th of the month following the month in which credit is given. If payment is not made within one month of the month in which credit is given, the amount unpaid shall bear compound interest at the rate of eighteen percent (18%) per annum (1½% per month), effective the first day of the month following the month in which credit is given until paid. Either party may terminate this arrangement forthwith upon notice, whereupon all balances including interest shall become immediately due and payable.

I hereby authorize _____________________ (Company Name) to obtain such credit reports or other information as may be deemed necessary in connection with the establishment and maintenance of a credit account or for any other direct business requirement.

This consent is given pursuant to Section 12 of the Personal Information Reporting Act.

Signature of Applicant: ______________________________

Date: ________________

Schedule

Interest of (cost of borrowing) will be added to your account each month in accordance with your outstanding balance and calculated at eighteen percent (18%) per annum (1½% per month).

Balance is will be	Mo. Cost	Balance is will be	Month Cost

(You may insert a table showing cost of borrowing, as some jurisdictions require.)

For office use only

Credit Department Department Manager's Approval

____ Approved Credit Limit ________| _________________________________

Charge Card #______________________|Signature _________________________

Charge Card Expiry Date:_____________|

Notes:____
____
____
____

(3) Commercial credit application

Use the ***commercial credit application*** for a company that is applying to purchase on credit.

The information required is similar to the personal credit application in some respects, but requires more detail on:

- The type of company—proprietorship, partnership, corporation
- The ownership structure of the company
- Past history and experience of the owners
- Bank references
- Average bank balance on the deposit
- Overdrafts or loans owing
- Trade references—other companies the business buys from on credit.

The following is an example of a Commercial Credit Application.

A Business Credit Application

[COMPANY]

Business Credit Application

Name Acct.:____| ____ Proprietorship

Address:____| ____ Partnership

City:_______________________________ Postal Code:__________| ____ Corporation

Mailing Address: ____| GST # _

Postal Code: ____________| PST # _________

Type of Business: ________________________ Phone No. ________ _______________

Time in Bus.____

Names: ____________________________ Address:_____________________________

Owners: ____________________________ Address:_____________________________

Shareholders: _______________________ Address: _____________________________

Premises

____ Leased - Monthly $____________

____ Owned - Market Value $ ___________ Mortgage $ ____________________

Mortgage held by:____

Name of Bank:____

Address:____

References __________________________Address:______________________________

___________________________________Address:______________________________

Trade ___________________________Address:______________________________

Names ___________________________Address:______________________________

Are Financial Statements Available To Us? ____ Yes ____ No

If No, Give Reason ____

Number of invoices required ______Purchase orders required ___ Yes ___ No

We request credit from you to a maximum of $ __________ at any one time for goods and/or services to be furnished by you, and we agree if credit is given, payment shall be made by the 15th of the month following the month in which credit is given. If payment is not made within one month of the month in which credit is given, the amount unpaid shall bear compound interest at the rate of eighteen percent (18%) per annum (1½% per month), effective the first day of the month following the month in which credit is given until paid. Either party may terminate this arrangement forthwith upon notice, whereupon all balances including interest shall become immediately due and payable.

Credit Dept. Copy ___________________Authorized Signature _____________________

For Office Use Only

Application Completed At Dept. No. ________ By: _________________________________
Print Name

Sales Dept. Recommendations, Present Jobs, Potential, etc.

Credit Department **Dept. Manager's Approval**

____ Approved Credit Limit: _____________

____ Declined (See Below)_______________ _________________________________
Signature

(4) Personal guarantee

A vendor (a company granting credit) in some instances requires a personal guarantee where:

- The customer has exceeded their credit limit by a significant amount
- The customer is expected to exceed their credit limit by a significant amount
- The customer is not able to adhere to the credit terms for a period of time because they are waiting for funds from sources such as project progress payments, liquidation of assets, or additional investment capital.
- The vendor is concerned that factors in the personal or business life of the customer may jeopardize the ability of the customer to pay their account.

The personal guarantee is a legal document that secures the interest of the vendor. It makes the customer personally responsible for the debt of their business no matter what type of business it is—Corporation, Limited Company, Partnership, or Proprietorship. It commits the customer to paying off the debt of their business from their personal assets.

The following is an example of a personal guarantee. The requirements of such a legal form may vary in the jurisdiction. Consult a lawyer as to the use of the proper form in your jurisdiction.

A Personal Guarantee

TO: [**Vendor**] (hereinafter referred to as _________________)

I/WE, the undersigned (hereinafter called "the Guarantors") in consideration of your supplying _______________________________________ (hereinafter called "the Company) a body corporate, ________(Address)______________________, with such goods as _______(Vendor)____________ may be willing to sell the Company from time to time, upon such terms of credit or for cash, as ______(Vendor)________ shall think fit, or in consideration of ______(Vendor)________________ not immediately requiring payment of such indebtedness as may be owed by the Company to ______(Vendor)________, **JOINTLY AND SEVERALLY GUARANTEE** payment to ______(Vendor)__________ of such present indebtedness as is owed by the Company to __________________(Vendor)_______ and payment to ________(Vendor)__________ of all future indebtedness of the Company for all goods that __________(Vendor)___________ may supply to the Company in the future.

AND I/WE AGREE that ________(Vendor)_________ shall be at liberty to accept the note or acceptances of the Company for the price of such goods, or any part thereof, to compromise the Company's liability to _______(Vendor)_________, to exercise or relinquish other securities as ___________(Vendor)___________ may think proper and to give the Company such extensions of time for payment for the said goods without notice to or communication with me/us and without prejudicing the rights of _______(Vendor)__________against me/us under this guarantee.

AND I/WE AGREE that _________(Vendor)_________ need not give me/us notice of default by the Company, nor shall _______(Vendor)___________ be bound to exhaust its recourse against the Company or any other persons or against any securities ________(Vendor)_________ may hold, before requiring payment from me/us.

ALL debts and liabilities, present and future, of the Company to me/us are hereby assigned to __________(Vendor)____________ and postponed to the liability of the Company to ______(Vendor)_______, and all securities received from the Company or held for the Company by me/us from this date shall be held or received in trust for ______(Vendor)__________.

AND I/WE AGREE that ________(Vendor)_________ shall have the right at any time to refuse further credit to the Company without notice to me/us, and without discharging or affecting my/our liability hereunder.

AND I/WE DECLARE AND AGREE that this Guarantee shall be a continuing Guarantee and shall extend to and be security for any sum or sums of money which shall or may at any time be due from the Company to ________ (Vendor) __________ and shall remain in force and cover all liabilities of the Company to _________ (Vendor) _________, inclusive of those liabilities incurred or arising down to the expiration of three (3) months after notice in writing of discontinuance of this Guarantee shall have been given by double registered mail, postage prepaid, addressed to _______ (Vendor) ______ at its registered office and notwithstanding the discontinuance of this Guarantee as to one or more of the undersigned, I/WE agree that this Guarantee shall remain continuing as to the other or others of the undersigned.

THERE are no representations, collateral agreements, or conditions with respect to this Guarantee, affecting the liability hereunder of me/us to ________(Vendor)__________ except as are contained in writing in this Guarantee.

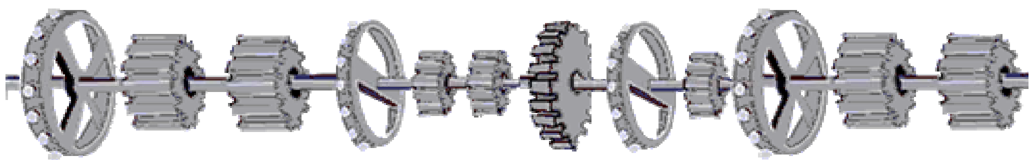
Dated at__________, British Columbia, this _______ day of ____, 200 _

Signed: **__________________________ Guarantor**:_____________________________

in the presence of __________________ Guarantor:_____________________________

(5) Joint payment agreement

There are certain cases where a ***joint payment agreement*** may be necessary as additional security that the customer will pay their account.



Situations where such an agreement is used are:

The customer is relying on the payment they will receive from a contract or a project to pay their account

The customer has a history of being delinquent in payment of their account

There is a concern that the customer may use the payment they receive from the contract to pay other debts before paying what they owe to your business

In a case like this, the customer may still sign a personal guarantee. However, a personal guarantee or a promissory note still does not ensure prompt payment of the account. To collect an account using notes and guarantees can still involve a lengthy legal process.

The person or company that your customer is contracted for signs a joint payment agreement.

> The joint payment agreement states that the signer of the agreement will only issue cheques *jointly* to your company and your customer in payment for the work performed by your customer.
>
> The payee on the cheque will read 'Pay to the order of Your Company and Your Customer's Company'. When this is completed, your customer may not cash the cheque. Both you and your customer would go to the bank, endorse the cheque and the bank would then cash the cheque in your presence.
>
> ***Joint Payment Agreement:***

The following is an example of a joint payment agreement. The form may vary in some jurisdictions. You should consult a lawyer in your area to ensure that it conforms to the legal requirements in your area.

A Joint Payment Agreement

Date: _____________

In consideration of the advance of materials and/or money necessary for the completion of the job known as ____,

located at____,

which the undersigned Contractor has contracted to do for me, I hereby agree that all payments for said job will be remitted jointly to [company name] and the undersigned Contractor until total indebtedness due said [company name] from the undersigned Contractor relating to said job or contract is paid in full.

It is further agreed that in the event the undersigned should abandon said job or contract or transfer or make an assignment of it or any rights thereunder before said sum has been paid, said payments still due or unpaid or due the successor of the undersigned thereon, or the transferee or assignee of said contract or rights thereunder, shall be made payable to such successor, transferee or assignee and [company name] as aforesaid, until said sum or the balance thereof shall have been paid.

____

Owner or General Contractor

By______________________________________

____

Address _________________________________

Accepted and agreed to this _____ day of ____________ 200 ______________________

Contracted by ____

Address: ____

(2) Credit limit

The customer applying for credit will state on the credit application form how much they expect to be purchasing on a monthly basis. After reviewing the credit application and checking the references given, the business makes a decision on the ability of the customer to adhere to the credit policy of the company.

Example:

A customer may state on the credit application that the amount of their account will be approximately $800/month. Therefore, they are asking for a credit limit of $1,000/month.

After reviewing the application and checking the references, the manager of the company granting credit may find that the customer does not have a credit limit over $500 with those references and has occasionally fallen behind in the payment of their account with those companies.

In this case, the decision of the manager might be that credit approval would be given, but only for a $500 credit limit because the customer's history indicates that amount is as much as can be handled.

Make exceptions if the vendor is willing to accept additional security for the amount of the account in the form of a personal guarantee, a note payable, or an assignment of assets as security.

After opening an account and charging a customer's limit if they demonstrate that:

- They establish a history of paying their account on time
- Communicate future purchasing needs and work closely with the credit department
- If they expect to temporarily exceed their credit limit, they inform the credit department in advance and get approval

A business should value customers that view credit as a privilege and communicate their needs.

(3) Time frame for which credit is granted

Granted the period for which credit depends on:

- The GM the company makes on its products
- The cash flow situation in the company
- Whether or not using credit policy as a sales tool, a financial management tool, or a profit-making tool.

We have already dealt with various aspects of these points in the context of previous segments.

(4) Repayment incentives

At the outset of this section, we outlined a basic credit policy, which included an incentive for repaying the A/R owing earlier than the required time limit.

Some companies use repayment incentives more creatively than just offering
1-2% for repayment within 15 days.

Of course, as mentioned previously, the amount of incentive that can be offered will depend on the GM the company makes on its products.

Some illustrations of the use of repayment incentives are providing a graduated scale of progressive discounts.

For example: Offer a discount of:

3% discount if payment is made within 15 days

2% discount if payment is made within 16–30 days

1% discount if payment is made within 31–45 days

Some companies take booking orders. A ***booking order*** is a term that means an order taken well in advance of the shipping date) for shipment several months later may offer a similar progressive repayment incentive.

For example:

If a company is taking Fall booking orders in October to be shipped March 1st the following year, they may offer a discount of:

15% discount if the order is prepaid

10% discount if payment is made upon receipt of the order

5% discount if payment is made within 15 days

3% discount if payment is made within 16–30 days

2% discount if payment is made within 30–45 days

Gross amount is due in 60 days from date of shipment

There are two major reasons for a credit policy like this on a special booking order. If bank interest rates on loans were 1% per month, a company may be quite willing to give a 15% discount for prepayment of the order because a company is:

1. Using the customer's money to finance their business

   If the company were borrowing the money to buy or manufacture the products for the booking order, it would cost the company 4% for interest charges for the four months from November 1st to March 1st the following year.

2. Earning interest on the customer's money prior to paying the factory for the order

   Let us assume that interest on deposits at the bank is at least 6% per annum. In the four months before shipping the booking order, the company earns approximately ½% per month if the customer's prepayment is only put on deposit in the bank, because in four months the company earns 4 x ½ = 2% on the customer's money.

   On the other hand, higher rates of return are often available in other investment instruments.

   In both of the above examples, there are very good reasons why some customers would find the repayment choices attractive.

   The rate of inventory turnover of the products bought

   How much of the products are bought

Ideally, the customer buying the product should only buy sufficient quantities as will be sold within the period before payment is due the supplier.

In this event, customers are using the supplier's money to finance their business.

If customers buy too much product, they may be paying the supplier out of the profits of future business rather than current business.

(5) Default or delinquency penalties

If a customer's account is past due, their account is termed a delinquent account. You may refer this account as being in *default*. The amount that is past due is assessed interest charges.

This is done because:

The unpaid money is unavailable for use by the business

The business would have to pay interest charges on the money if it were borrowed money

By not paying the money owed, the customer is using the money of the business. The customer should pay a fair charge for the use of the money the same as they would if the borrowed money came from a bank.

In view of the above, companies will usually charge at least the same rate of interest as the bank.

However, it is more common that companies will charge a higher rate than the bank because the company could have made more money if they had the money to reinvest in the business.

Therefore, businesses will often charge 1½–2% per month on the past due portion of A/R.

This would translate to an annual interest rate of 18–24% per annum.

(6) Payment instruments

In conducting daily transactions, most businesses have a choice of accepting the following payment instruments:

- Cash
- Cheque
- Money order/bank drafts
- Debit card
- Credit card

Other forms of payment that are emerging and becoming popular are:

- Smart cards—a type of debit card that is *preloaded* electronically from your computer with small amounts of cash. Typically, it is used for small purchases.
- Electronic transfer of funds using a computer

Cash or cheques incur little handling cost to the business.

However, accepting cheques does carry the risk. A few of those cheques are returned as NSF (Not Sufficient Funds).

In addition to the loss of the amount of the cheque, there is a charge to the business for the processing of bad cheques. This fee may be $10–$15 or more. If customers have an account, then place charges on the account.

There is a cost to the business of handling electronic transactions that needs recovering from the profit of the business. Typical charges are:

- A monthly bank charge for the use of the electronic terminal and printer
- A transaction fee that will vary with the volume of transactions

However, the transaction fee for most business will be at least 2% of the net value of the transaction before any added taxes.

If the business accepts payment by credit card, it is not receiving the same amount of money as it would from customers paying cash.

For this reason, some businesses will charge a customer the amount of the credit card transaction fee.

However, in practice in daily transactions, most businesses will not charge for a transaction fee because:

- Accepting credit cards tends to stimulate sales
- Credit card purchases are not carried as A/R by the business
- The amount of the purchase is guaranteed by the credit card company

However, many companies will take a different attitude towards customers paying A/R with a credit card. Some companies will not accept credit cards in payment of A/R for the following reasons:

- By accepting the credit card, the business is actually accepting a discount of at least 2% on the sales
- By not paying the A/R for a month or two, the customer has already used the company's money for that period and that has probably cost the business at least 1–2%.

Summary

In the latter part of **Accounts Receivable and Credit Policy**, we have discussed the elements of a credit policy and using a credit policy in a business.

We have discussed in some detail how to screen applicants for credit and ways to protect your business against non-payment of accounts.

As you studied this material, you should have compared the ideas and examples to the way you manage credit policy in your business now.

You should ask yourself:

What ideas and methods are you using now?

What present methods and procedures can be improved?

What new ideas and methods would be useful to your business?

The Laws of Money—of conservation

It's not how much you make but how much you keep that counts. Successful people save lots in prosperous times to have a financial cushion for bad times.

Celebrate!!

Take time for a snack.
You deserve it.

Preparing Pro-forma Cash Flow Statements

Introduction

A ***pro-forma cash flow statement*** is sometimes called a cash flow projection or simply a cash flow statement. We will use the term pro-forma cash flow statement here.

Effective cash flow management is essential to the continued health and survival of any business.

Good cash flow management assists in:

- **Financial planning**
- **Inventory purchases**
- **Formulating credit and collection policies**
- **Renewing business lines of credit**
- **Making an effective presentation to your lender**
- **Keeping on top of operating capital needs**
- **Providing early indications of when expenses are getting out of line**

Function of pro-forma cash flow statements

A pro-forma cash flow statement compares projected income and expenses with actual income and expenses on a monthly basis throughout the fiscal year.

It is one of the most effective tools an owner or manager has to control their business.

When asked how they manage their cash flow, many small business people will admit that they really don't have a formalized plan.

They will often say that they *sort of know* or *they have a feel* for the seasonal changes in their business and cut back or make adjustments accordingly.

Comparing the actual cash flow of the business to a 12–month cash flow projection can reveal any sudden changes that have occurred in your expenses and the effect that may have on your current and future cash position.

Good cash flow management can take a lot of pressure off the business.

The cash flow projection is simply a budgeting tool that, if used properly, can smooth out the highs and lows in your business because of cyclical or seasonal changes.

It is not a cure-all, but it does help to give a sense of direction and, along with a written business plan, clears the mind for more productive and creative thinking.

How to use this information

The pro-forma cash flow statement is just as important for the existing business. However, the existing business has the benefit of business history and, therefore, the projected figures should be a more accurate estimate of the expected business performance.

The business will use the pro-forma cash flow statement to forecast the effect on the business of:

Adding products or services to the business

Addition of personnel **A change of location**

Increases in taxes

Consult the pro-forma cash flow statement every month to monitor and compare actual and projected results. This is an essential part of good business management and planning.

Preparing a pro-forma cash flow statement

We will take you step-by-step through the process of preparing a pro-forma cash flow statement. You will be using the following three spreadsheet forms in this process:

1. Projected cash and accounts receivable (A/R)
2. Projected accounts payable
3. Pro-forma cash flow statement

All the forms are worksheets and intended to be used primarily internally. However, review periodically these forms with a lender.

To simplify the illustration, the example used will be the format used for a fee-for-service business. That is a business where revenue is not derived from the sale of products but rather generated from fees for work performed.

Examples of people in this type of business are:

Lawyers	Accountants
Health professionals	
Security services	Consultants
Personnel services	
Real Estate	Delivery service

In these businesses, derive the total sales revenue from the services provided to the customers/clients.

In a business selling products, deduct the cost of the product and all the directly related expenses from the selling price in order to determine the net revenue or income derived from sales.

> In other words, in a business selling products ***net sales revenue*** is the selling price less the ***cost of goods sold (CGS)***. See the details of doing this calculation on the income statement of the business. We will not be dealing with the income statement in this section.

A pro-forma cash flow statement (cash flow statement) is only concerned with the net cash receipts and expenditures of the business.

Steps in preparing a pro-forma cash flow statement

There are ten steps in the pro-forma cash flow statement process. They are:

1. Estimate sales and fees-for-service.
2. Estimate your revenue received from accounts receivable.
3. Decide how much of your business will be for cash or thirty day terms.
4. Repeat the same process as 1–3 only for expense items.
5. Closing relating accounts payable planning to expected revenues.
6. Enter the estimated total cash received and estimated total expenses on the Cash Flow Worksheet.
7. Fill in all other estimated income and expense items on the Cash Flow Worksheet.
8. Calculate the total cash in, cash out for each month, and enter the surplus or deficit on the worksheet.
9. Enter the opening cash balance in the first month and carry this forward in each months calculation to arrive at the 'actual surplus or deficit'
10. Enter the amount of your business opening cash balance in the first month of your fiscal year and carry this forward through your calculations to arrive at the 'actual' projected surplus or deficit each month.

You may find it necessary to print either the set of directions and/or the three spreadsheet forms (*See below*) hence, you can relate the instructions to the worksheet.

Note:

The reference on the Projected Cash and Accounts Receivable Worksheet to 'Enter on line 1'

'Enter on line 2' refers to specific lines on the following Pro-Forma Cash Flow Statement where you enter the summary information.

Also, the reference on the Projected Accounts Payable Worksheet to 'Enter on line 22' refers to the specific line on the following Pro-Forma Cash Flow Statement where the summary information is entered

4. First, estimate the sales or fees-for-service for each month of the fiscal year by factoring in those seasonal variations, or changes that you expect in the business cycle.

   The previous year's results can be a forecasting guide but you may want to apply other standards.

   For example:

   Use conservative forecasts if you are in, or expect to be entering, a recession period.

   On the other hand, use an optimistic forecast if you are in a growth period or, expect to be entering a growth period.

   However, the best approach (most of the time) is the middle-of-the-road. Enter these figures on a spreadsheet

   (See example below–Projected Cash and Accounts Receivable)

5. Next, estimate your revenue received from the accounts receivable (A/R) for each month of the fiscal year.

   To do this, include:

   What you would usually expect to receive from the previous month's sales/fees?

   What you would expect to receive from 60-day accounts?

   What you expect to receive from all sales/fees prior to 60 days?

   Total these figures and enter them on the Projected Cash and Accounts Receivable Spreadsheet.

6. Decide how much of your business will be for cash or thirty day terms, and how much will be carried for longer terms.

   > ***For example:***
   >
   > If, your business has been 10% cash/30 days and 90% longer credit terms it likely will remain the same if you don't plan to make changes to your credit policies.
   >
   > If, however, this is obviously putting a strain on the business and you don't wish to increase your operating loan, you may well want to review your credit policies.
   >
   > You have to decide whether the cost of carrying the additional business on account is worth it.

7. Now, you do the same exercise for your expenses and prepare a spreadsheet if your business involves the purchase and resale of products. (See example below–Projected Accounts Payable)

   > ***For example:***
   >
   > First, estimate the purchases you plan to make each month and enter the figures.
   >
   > Then estimate the payments normally made on purchases made on the current month's purchases, the payments normally made on the previous month's purchases, the payments normally made on 60-day purchases and, finally, the payments usually made on purchases over 60 days.
   >
   > Total the accounts payable and enter this on the spreadsheet.

8. Complete the accounts payable planning in close relationship to the revenues expected from sales/fees.

> ***For example:***
>
> Very favourable payment terms at very low or no interest can ease the burden on the business and the expense of each month's payment is reflected in the month that it will be paid.
>
> If, however, a large purchase is made at a special price but must be paid for now, it may not be a good deal if the goods will not be used up for several months.
>
> A very rough *rule-of-thumb* would be, don't buy more than you need for the next 60 days unless you are getting an additional 5% discount for each additional month you will carry the product.
>
> For example, if you were not going to use the product up for 6 months, you would need at least a 20% discount to make the same net profit.

9. Now that you have, your total cash received and cash payments estimated, go to your pro-forma cash flow statement, (See example below) and enter your totals.
10. Your next step is to fill in all the other items related to income and expense.

Under Income is:	Under Expenses is:	Other Operating Expenses:
Loan proceeds–this is the monthly amount received from the operating loan and will be filled in last Sale of fixed assets Other cash received	Rent Management salaries Other salaries and wages Legal and audit fees Utilities (heat, light, water) Telephone Repairs and maintenance Licences and municipal taxes Various insurances	Payments on purchases of fixed assets Interest paid on loans (short-term loans, lines of credit, overdrafts) Payments on mortgages/term loans Income tax payments Cash dividends paid Payments on accounts payable Other cash expenses

11. Enter all of this data and then you should calculate your **total cash in** and the **total cash out** for each month throughout the fiscal year and determine in which months there may be a cash surplus or deficit.
12. Enter the amount of your business opening cash balance in the first month of your fiscal year and carry this forward through your calculations to arrive at the 'actual' projected surplus or deficit each month.

    This figure is, therefore, an estimate of the least amount you will require as an operating loan to run your business. For now, enter this amount under Loan Proceeds in the Cash In section in order to balance the statement.

Once this is completed, you are prepared (along with your financial statements and your business plan) to meet with your lender.

Each month, you will enter the actual figures for the items listed on your worksheet. The items will vary somewhat with the business and this is only an example.

Communicate closely with your Lender and make them aware of any significant changes, particularly if it may affect your need for operating capital.

A well-informed Lender can be a powerful resource. However, frequently you hear small businesses complaining about the support of their Lender.

Usually, the real story is that business owners do not do their homework and provide their Lender with the needed detailed information.

Pro-forma cash flow statement

Now you have a projected pro-forma cash flow statement.

> The pro-forma cash flow statement has columns to show the projected income and expense for each month of the fiscal year and blank columns beside each month's projection to record the **actual figures**.
>
> The projected figures are your one-year operating budget. Careful analysis of any deviations from this budget can help to minimize expenses and maximize profits—referred to as doing a budget deviation analysis.
>
> It only takes a few hours each month to review and it should be a regular part of your business management activity.
>
> It is easy to forget to do some of these business planning and direction activities when times are good and the business is flying high. Nevertheless, budget deviation analysis is an essential part of effective business management.

Perform a budget deviation analysis on a monthly basis to be meaningful and useful. If a business has several projects *on the go* at one time, it may be a good idea to devise separate budgets for each project.

This is one of the best sources of current operating information for your business and, if the budgets have been prepared carefully and thoughtfully, the budget deviation analysis will tell you at a glance, which parts of your business, are getting out of control. Experience will teach you

- Which deviations are significant
- What magnitude of variance is important

Carefully examine any change, whether positive or negative, and the reasons for it determined.

If the change is negative, then implement a corrective plan of action. If the change is positive, then you should ask yourself:

What did I do right?

With a little digging, you may discover something that, if controlled and directed, could have a major impact on the future profitability of the company.

While doing your pro-forma cash flow statement for the month, it is important to cast also your eye back upon previous months to identify any trends or offsets. A review and analysis of any monthly fluctuations will often reveal:

- The negative deviation in one month is offset by a positive deviation in the following month
- Seasonal fluctuations or business cycle factors that are, perhaps, because of the variable timing of projects

With experience, your budgeting and your analysis will become more exact and you will have greater control over the profitability of your business. All financial control documents should be adapted to the needs of your business in terms of the items included and the degree of detail, but the format should adhere to generally accepted accounting principles.

> Your accountant will help you in this area but, you must be the one to decide what information is most useful to you in running the business, and what information reflected by the budget deviation analysis is most significant.

Sample spreadsheets

Below are three samples of:

1. Projected Cash Sales and Accounts Receivable
2. Projected Accounts Payable
3. Pro-forma Cash flow Statement (worksheet)

		Projected Cash and Accounts Payable										
Month	**Jan.**	**Feb.**	**Mar.**	**Apr.**	**May**	**June**	**July**	**Aug.**	**Sept.**	**Oct.**	**Nov.**	**Dec.**
Projected Sales	$10,000											
Cash Sales (line 1)	$9,500											
Coll. Of Sales 1 mo. Prior	$5,000											
Coll. Of Sales 2 mo. Prior	$2,000											
Coll. Of Sales Over 2 mo.	$500											
Total Accts. Rec. (line 2)	$27,000	0	0	0	0	0	0	0	0	0	0	0
		Projected Accounts Receivable										
Month	**Jan.**	**Feb.**	**Mar.**	**Apr.**	**May**	**June**	**July**	**Aug.**	**Sept.**	**Oct.**	**Nov.**	**Dec.**
Planned Purchases	$2,000											
Pay On Current Mo. Purch.	$1,000											
Pay On Purch. 1 Mo. Prior	$200											
Pay On Purch. 2 Mo. Prior	$200											
Pay On Purch. Over 2 Mo.	$100											
Total Accts. Payable(line 22)	$3,500	0	0	0	0	0	0	0	0	0	0	0

	Pro-Forma Cash Flow Statement									
Income (Cash Only)										
Month	**January**	**January**	**February**	**February**	**March**	**March**	**April**	**April**	**May**	**May**
	Planned	***Actual***	***Planned***	***Actual***	***Planned***	***Actual***	***Planned***	***Actual***	***Planned***	***Actual***
1.Cash										
2.Collection from Accounts Receivable										
3.Loan Proceeds										
4.Sale of Fixed Assets										
5.Other Cash Received										
6.**Total Cash In**	0	0	0	0	0	0	0	0	0	0
7.Rent (for premises, equipment, etc.)										
8.Management Salaries										
9.Other Salaries and Wages										
10.Legal and Audit Fees										
11.Utilities (heat, light, water)										
12.Telephone										
13.Repairs and Maintenance										
14.Licences and Municipal Taxes										
15.Insurance										
16.Other Operating Expenses										
17.Payments on Purchases of Fixed Assets										
18.Interest Paid on Loans										
(short-term loans, lines of credit, overdrafts)										
19.Payments on Mortgages/Term Loans										
20.Income Tax Payments										
21.Cash Dividends Paid										
22.Payments on Accounts Payable										
23.Other Cash Expenses										
24.Total Cash Out	0	0	0	0	0	0	0	0	0	0
25.Surplus or Deficit	0	0	0	0	0	0	0	0	0	0
(subtract cash in minus cash out)										
26.Opening Cash Balance										
27.Closing Cash Balance	0	0	0	0	0	0	0	0	0	0

Summary

In **Preparing Pro-forma Cash Flow Statements**, we have discussed what it is and how it is used. We have presented in detail how the pro-forma cash flow statement is prepared.

You have studied how that the pro-forma cash flow statement provides the business owner with a quick barometer of the financial health of a business. It gives the business owner a snapshot every month of the businesses:

- Ability to meet current financial commitments
- Changes and trends that are developing in business cash flow

These can give early warning signs that will trigger an in depth investigation into the reasons for the results. The business manager can then take remedial action.

You should have considered the importance of communicating with your banker. Keeping your lender informed about the performance of the business and its cash flow will help you to obtained needed financing.

The Laws of Money—Parkinson's Law

Expenses always rise to meet income. It happens to most people.
It's why most people aren't rich. To be rich, you must flout this law.

Celebrate!!

Other products and modules for sale

Other modules available on this site deal specifically with aspects of business planning research and analysis. For a complete in depth treatment of operational financial management, the BizBite Consulting Group product **Financial Management** is also available. For detailed information on the content of these products, please go to '**Product**' on the menu bar on the web site.

All of the business testing formulae presented in this module are available in Interactive form in our product 'Interactive Excel Workbooks'. In the workbooks, you can insert your own figures in the various formulae and the calculations are automatically completed for you. You simply follow the directions on the title page of the Workbooks.

Glossary of Terms

Accounts receivable (A/R)—Accounts receivables (A/R) are accounts with customers that the business has sold goods or services to on credit terms.

Accounts Receivable Turnover Formula—total net credit sales/average accounts receivable

Average account collection period formula—days in the period x, average accounts receivable/total net credit sales

Average days payable formula—days in the period x accounts payable/total credit purchase

Cost of goods sold *(CGS)*—is an item that appears on the Operating Statement, sometimes called either the Income Statement or the Profit and Loss Statement. Adding inventory purchases during the accounting period to the beginning inventory, then subtracting the ending inventory for the period derives the **CGS.**

Credit policy—is a statement of the terms and conditions under which a company will allow customers to buy on credit

Delinquent accounts—are customers who have not paid their accounts within the terms of the company's credit policy.

Income statement (also called the profit & loss statement or the operating statement)—statement of the changes that have occurred from one financial measurement period (fiscal measurement period as in a *fiscal year*) to another

The *income statement* provides a summary of the transactions made and the income generated from those transactions. It also summarizes the changes in Inventory value and the expenditures made by the business for that fiscal period. Finally, the *income statement* presents the *profit* or *loss* made by the business for the fiscal period.

Inventory turnover—the rate at which the initial or beginning inventory investment is sold. If the beginning inventory investment is replaced three times during the fiscal year, the inventory turnover is said to be three or sometimes expressed as *three turns per year*.

Inventory turnover formula—cost of goods sold (CGS)/average inventory

Point of sale (POP)—to describe anything that occurs at the point where goods are displayed or a transaction is made.

Pro-forma cash flow statement—is sometimes called a cash flow projection or simply a cash flow statement. We will use the term pro-forma cash flow statement here

Pro-forma—is a term meaning a projection or estimate of what may result in the future from actions in the present. A pro-forma financial statement is one that shows how the actual operations of the business will turn out if certain assumptions are realized.

PY—abbreviation meaning Prior Year

Return on investment (ROI)—is how much profit is generated by the business in relation to the investment in the business. (See Profitability Ratios)

Return on sales ratio formula—net profit after taxes/net sales

Return on shareholders equity formula—net income/shareholders equity

Return on total assets formula—net income (from operations)/average total assets

YTD—abbreviation meaning Year To Date

The end