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Panning For Your Business Gold Mine . . . Asset Management!

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Basically, there are two types of assets: current assets and fixed assets. Current assets or "liquid assets" include such things as cash, accounts receivable, inventory, prepaid expenses, etc. They are called current assets because of their ability to be liquidated into cash within a relatively short period of time -- usually less than one year. Conversely, fixed assets are those assets which usually cannot be liquidated into cash in a short period of time. Fixed assets include such things as land, buildings, equipment, furniture and fixtures, etc.

Just as we found when we analyzed the income statement, the successful search for the gold mine in our assets requires us to look "underneath" the numbers. To see how this works, I would like to share with you how to find the gold mine in one type of current assets: accounts receivable.

Accounts Receivable

Accounts receivable occur whenever you sell your product or service on terms (e.g. net 30 days). The key in managing your accounts receivable comes from your ability to balance your need for liquidity against profitability. Lenient credit terms could jeopardize a firm's ability to pay its own bills because its customers cannot pay them. However, lenient credit also makes it easier to sell your product and services to more customers and, hopefully, increase your profits.

From a financial perspective, two commonly used measures of accounts receivable are: Days Sales Outstanding (DSO) and an aging schedule. DSO looks at the relationship of your accounts receivable balance to your average daily sales. A company with an accounts receivable balance of $100,000 and an average daily sales balance of $5,000 has a DSO of 20 days. Aging looks at how much of your accounts receivable balance is within invoice terms and how much exceeds those terms by 30, 60, 90 days, etc. By aging the same $100,000 accounts receivable balance, you might find that 80% of this balance is current, 5% is 30 days past due and 15% is 90 plus days past due.

Basically, there are two types of assets: current assets and fixed assets. Current assets can be converted into cash within a relatively short period of time. Fixed assets cannot.

Now that you understand the basics, let's look at an example. Assume the following for company XYZ:

Sales for the year average $128,000 per month.
Sales for the last three months average $100,000.

Accounts receivable balance:	
12/31/89	$170,000
12/31/90	$225,000
Days sales outstanding (DSO):	
12/31/89	40
03/31/90	43
06/30/90	48
09/30/90	50
12/31/90	53
Aging of accounts receivable:	
Current (1-30days)	30%
30 days past due	25%
31-60 days past due	10%
61-90 days past due	5%
over 90 days past due	30%
TOTAL	100%

What is this information telling us?

1. They are doing a poor job of analyzing and managing their accounts receivable. The DSO is increasing and a large percentage of invoices are past due (45% are 31 plus days past due). Basically, their poor credit and collection policy has put them in a postion of financing their customers.

2. They are not properly evaluating the credit risk of new customers nor evaluating the credit-worthiness of existing customers. Most companies do an adequate job of screening new customers but fail to have in place an on-going system to review the credit of existing customers. The first time most companies check the credit of an existing customer is when there is trouble. By this time, it may be too late and the result may be more bad debt. To avoid this, every company needs to put a system in place which ensures that each customer's credit (at least each major customer) is reviewed at least once a year. Use whatever sources are available to do this review: Dun and Bradstreet reports, trade associations, chambers of commerce, salesmen, financial statements, etc.

3. They have not clearly defined an effective collection program. Who is responsible for collecting past due invoices? What procedures are being used? What criteria is used to approve credit and assign credit limits?

4. Something that cannot be derived from the data, but should be examined, is an analysis of the accounts. In this case, for example, there are a total of 80 customers. Of this total, 32 or 40% had balances 60 plus days past due and were no longer active accounts. Therefore, accounts receivable increased at a time when both sales and the customer base are decreasing; this is a situation which is going to go from bad to worse very quickly.

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5. They do not have an effective feedback program. If all they care about is collecting money, they will miss a golden opportunity to learn about their business from their customer's perspective. A good collection program should identify if the reason for slowness in payment is due to poor customer service and/or product performance. Are customers slow in paying because salesmen are giving 60 days rather than standard 30 days terms? Are invoices being mailed to wrong addresses? Is the accounting department failing to issue credit memos in a timely fashion for returned merchandise and, as a result, customers are delaying payment?

Use the information you receive to not only measure your liquidity but also to guage the effectiveness of your business. Look underneath the numbers; analyze them; and, adjust your business accordingly.

This is the third of a four-article series. For additional articles, or for additional reprints of this article, contact Terry Soifer, President, Consulting CFO, Inc. ***(407) 628-5534.***