

Cash is King
Business Performance Review
for
XYZ Pty Ltd



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Summary

Introduction

XYZ Pty Ltd has experienced some significant growth in the 2010 financial year. The purchase of a new machine has increased capacity and reduced the costs of manufacturing their products. These two factors have increased the gross profit by 20%. Management has also been able to maintain a tight control of expenses during this growth period through the better use of resources and improved procedures. The new machine was purchased with cash and a large amount of short and long term debt was reduced. The management has a high risk aversion to debt. This decision may have contributed to the reduced cash at the end of the period.

Summary

- Increase in sales and decrease in Cost of Goods Sold (COGS) has led to \$105,000 (20%) increase in gross profit.
- Purchase of new machine has led to increase in GP% from 33.5% to 36.8%.
- The large increase in cash flow from operations has not seen an increase in the cash at bank because of two reasons:
 - The purchase of the new machine was from cash.
 - Large reduction (\$85,000) in short and long term debt which has caused a delay in payments to the creditors which has increased by \$28,500.
- Inventory is slowly rising and needs to be monitored to ensure problems of stock control don't arise in the future.
- There has been better control of accounts receivable.
- Management has maintained tight control of both fixed and variable expenses.
- Liquidity hasn't improved due to loan reduction and assets bought with cash.

Suggestions

- Review the accounts payables and check that all creditors are paid on time as per credit agreements to ensure continuing good relations with suppliers. This may require external funding.
- Review policy of reducing debt and buying assets with cash to the detriment of liquidity.
- Review inventory control system and implement new controls, if necessary and continue to monitor the inventory levels.
- Continue to monitor and control expenses.

Cash Flow

Year	2007	2008	2009	2010
Cash At Bank	\$27,000	\$31,000	\$33,000	\$18,000
Cash after operations		\$45,600	\$56,000	\$200,300
Net Cash flow		\$4,000	\$2,000	(\$15,000)

The main drivers of cash flow are:

- Sales, gross profit margin and expenses – How much you sell, what you pay for your product and how you manage your expenses. These three factors make up your net profit.
- Working Capital Cycle – How you manage your accounts receivable, inventory and accounts payable.
- Assets – The purchase and disposal of your assets.
- Financing – The borrowing and repayment of loans.
- Equity – Funding and drawings from owners.

“**Cash at Bank**” represents the total amount of cash in all bank accounts.

The Cash at Bank has remained relatively stable over the past four years with a slight decrease in 2010.

“**Cash after operations**” is represents the first two main drivers. It is one of the most critical measures because it is generally totally under the control of management. If it is negative then funding to keep the business running must come from another source such as loans or equity funding.

The Cash after Operations has increased significantly in 2010. A combination of positive factors has caused this improvement. These factors include increased sales, reduced COGS%, and stable expenses. However, the increase in accounts payable may be an area for concern.

“**Net Cash Flow**” is the sum of all inflows and outflows through the business during the period.

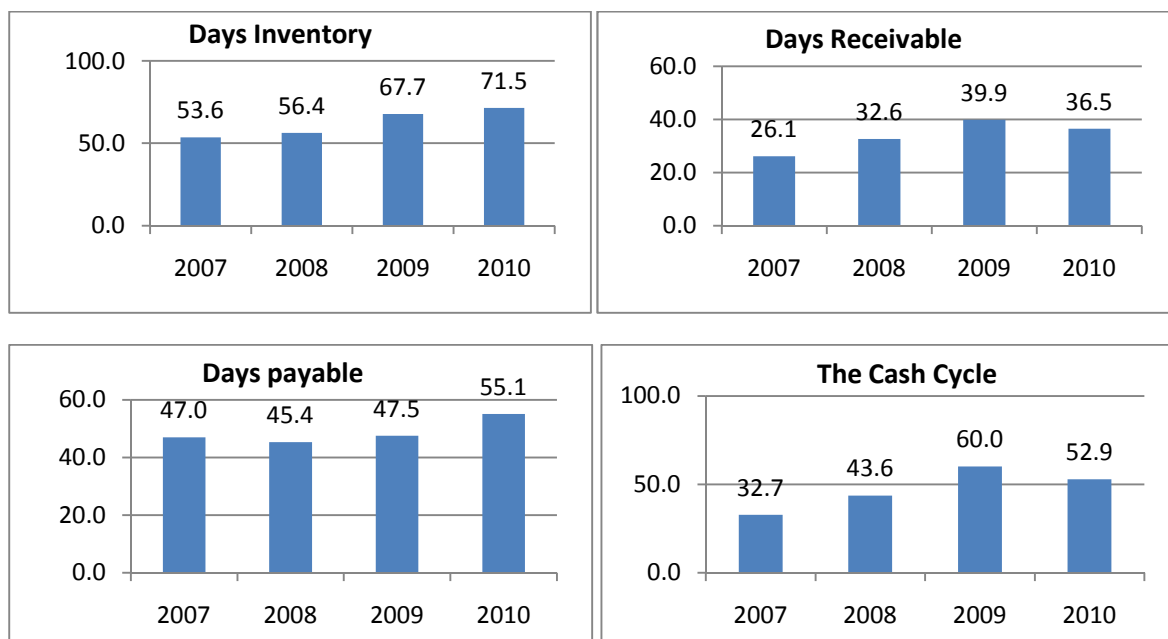
Net Cash Flow has actually decreased although there has been a significant increase in cash after operations. The contributing factors include increased tax, purchase of equipment and large reduction in short and long term debt. The increase in interest rates after the fixed loan period finished was a factor that influenced management to reduce their loans. Management may need to reconsider this strategy due to the effect it had on liquidity.

Working Capital Cycle

The cheapest and best source of cash for a business is the efficient management of the cash conversion cycle (or simply the cash cycle). The cash cycle is the length of time it takes from purchasing your stock till you receive payment from your customer. We can measure this cycle with the following performance indicators:

- Days Inventory – the average number of days your stock is held before being sold.
- Days Receivable – the average number of days to collect cash from your customers.
- Days Payable – the average number of days to pay your suppliers.
- The Cash Cycle = Days Inventory + Days Receivable – Days Payable.

Generally, the shorter the number of days the better the cash flow. However, it is not recommended that you hold off paying suppliers to reduce your cash cycle. The cash cycle can also be compared to industry norms as well as being reviewed for efficiency.



The Cash Cycle has improved by 7 days. However, this improvement is largely due to the increase in Days Payable as the reduction in Days Receivable is offset by the increase in Inventory Days. This is not a suitable strategy to increase cash flow. Inventory control needs to be monitored to ensure problems don't arise in the future.

The Working Capital % measures how much is invested in working capital compared to sales. The Working Capital % needs to be less than the Gross Profit %. If the Working Capital % is higher than other funding will be required.

Working Capital %	8.2%	11.6%	16.0%	15.4%
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Profit to Cash Report

The Profit to Cash report presents the cash flow statement in a different way. It can highlight some key measures of business performance. The key measures are the Cash After Operations which shows the cash flow generated from operations of the business and the Net Cash Income which indicates the ability of the business to repay its loan repayments and purchase fixed assets.

	Year	2008	2009	2010
Gross Cash Profits				
Profit		\$1,500,000	\$1,550,000	\$1,700,000
Change in Receivables		(\$34,000)	(\$35,400)	(\$600)
Cash from Sales		\$1,466,000	\$1,514,600	\$1,699,400
Cost of Sales		(\$1,000,000)	(\$1,030,000)	(\$1,075,000)
Change in Inventories		(\$19,400)	(\$36,600)	(\$19,600)
Change in Payables		\$6,000	\$10,000	\$28,500
Cash Production Costs		(\$1,013,400)	(\$1,056,600)	(\$1,066,100)
GROSS CASH PROFITS		\$452,600	\$458,000	\$633,300
Cash after Operations				
GROSS CASH PROFITS		\$452,600	\$458,000	\$633,300
Operating Expense		(\$405,000)	(\$420,000)	(\$432,000)
Miscellaneous Transactions				
Other Income and Expenses		\$0	\$0	\$0
Change in Other Current Assets		(\$2,000)	\$16,000	(\$2,000)
Change in Deposits		\$0	\$0	\$0
Change in Tax Payable		\$0	\$0	\$0
Change in Accrued Expenses		\$0	\$2,000	\$1,000
Change in Other Current Liabilities		\$0	\$0	\$0
Change in Other Long term Liabilities		\$0	\$0	\$0
Total Miscellaneous Transactions		(\$2,000)	\$18,000	(\$1,000)
Cash Operating Expense		(\$407,000)	(\$402,000)	(\$433,000)
CASH AFTER OPERATIONS		\$45,600	\$56,000	\$200,300
Net Cash Income				
CASH AFTER OPERATIONS		\$45,600	\$56,000	\$200,300
Income Taxes Paid		(\$18,600)	(\$18,000)	(\$45,300)
NET CASH AFTER OPERATIONS		\$27,000	\$38,000	\$155,000
Interest Paid		(\$23,000)	(\$29,000)	(\$30,000)
Dividends Paid		\$0	\$0	\$0
Financing Costs		(\$23,000)	(\$29,000)	(\$30,000)
NET CASH INCOME		\$4,000	\$9,000	\$125,000

<i>Year</i>	2008	2009	2010
NET CASH INCOME	\$4,000	\$9,000	\$125,000
Change in Fixed Assets	\$0	(\$15,000)	(\$55,000)
Change in Intangible Assets	\$0	\$0	\$0
Change in Other Assets	\$0	\$0	\$0
Investments in Non Current Assets	\$0	(\$15,000)	(\$55,000)
Net cash Income After Assets	\$4,000	(\$6,000)	\$70,000
Change in Directors Loans	\$0	\$0	\$0
Net Cash Income After Equity Funds	\$4,000	(\$6,000)	\$70,000
Change in Long Term Debt	(\$10,000)	(\$2,000)	(\$25,000)
Change in Short Term Debt	\$10,000	\$10,000	(\$60,000)
Net cash from financing	\$0	\$8,000	(\$85,000)
CHANGE IN CASH AT BANK	\$4,000	\$2,000	(\$15,000)

Cash at beginning of period

Cash at the end of period

	\$27,000	\$31,000	\$33,000
	\$27,000	\$31,000	\$18,000

Dollar Analysis

Dollar Analysis presents the Profit to Cash Report in a format that shows how each dollar received from sales is used. For example, the COGS may use 60cents and 5 cents is used to fund the accounts receivable.

Dollar Analysis				
	Year	Year	Year	Year
	2007	2008	2009	2010
Revenue	100.00	100.00	100.00	100.00
COGS	65.71	66.67	66.45	63.24
Gross Profit	34.29	33.33	33.55	36.76
Accounts Receivable Variation	7.14	2.27	2.28	0.04
Inventory Variation	9.64	1.29	2.36	1.15
Accounts Payable Variation	(8.57)	(0.40)	(0.65)	(1.68)
Working Capital	8.21	3.16	4.00	(0.49)
Marginal Cash Flow	26.07	30.17	29.55	37.25
Fixed Costs	10.36	9.67	9.68	9.24
Variable Costs	17.86	17.33	17.42	16.18
Overheads	28.21	27.00	27.10	25.41
Net Variable Cash Flow	(2.14)	3.17	2.45	11.84

In 2007 other sources of funding were required to keep the business liquid. However, in 2010 cash flow from operations is very healthy. The lack of liquidity is due to other factors such as financing which need to be controlled.

Efficiency Report

The Efficiency Report shows how the business has managed its operations compared to revenue growth. The revenue growth from the previous period is compared to the growth in expenses, COGS, accounts receivable, accounts payable and inventory. For example, if revenue has grown 5% over the past year and accounts receivable has grown by 12% then this will have a negative effect on the cash flow and should be examined.

Efficiency Report				
		Year	Year	Year
		2008	2009	2010
Revenue Growth		7.1%	3.3%	9.7%
Accounts Receivable	\$ Growth on previous period	\$34,000	\$35,400	\$600
	Growth at Revenue Growth %	\$7,143	\$4,467	\$16,394
	Impact on Cash Flow	(\$26,857)	(\$30,933)	\$15,794
Fixed Expenses	\$ Growth on previous period	\$0	\$5,000	\$7,000
	Growth at Revenue Growth %	\$10,357	\$4,833	\$14,516
	Impact on Cash Flow	\$10,357	(\$167)	\$7,516
Variable Expenses	\$ Growth on previous period	\$10,000	\$10,000	\$5,000
	Growth at Revenue Growth %	\$17,857	\$8,667	\$26,129
	Impact on Cash Flow	\$7,857	(\$1,333)	\$21,129
Cost of Sales	\$ Growth on previous period	\$80,000	\$30,000	\$45,000
	Growth at Revenue Growth %	\$65,714	\$33,333	\$99,677
	Impact on Cash Flow	(\$14,286)	\$3,333	\$54,677
Cost of Sales Growth		8.7%	3.0%	4.4%
Inventory	\$ Growth on previous period	\$19,400	\$36,600	\$19,600
	Growth at Cost of Sales %	\$11,739	\$4,632	\$8,345
	Impact on Cash Flow	(\$7,661)	(\$31,968)	(\$11,255)
Accounts Payable	\$ Growth on previous period	\$6,000	\$10,000	\$28,500
	Growth at Cost of Sales %	\$10,435	\$3,780	\$5,942
	Impact on Cash Flow	(\$4,435)	\$6,220	\$22,558
Total Impact on Cash Flow		(\$35,024)	(\$54,848)	\$110,419

The efficiency report confirms the need to monitor inventory and accounts payable. The report also highlights the impact of the new machine (\$54,677) and maintaining tight control on costs (\$28645).

Ratio Analysis

Liquidity Ratios

Current Ratio	1.05	1.18	1.27	1.40
Quick Ratio	0.64	0.72	0.74	0.77

Income and Profitability Ratios

Revenue	\$1,400,000	\$1,500,000	\$1,550,000	\$1,700,000
Gross Profit %	34.3%	33.3%	33.5%	36.8%
Net Profit %	5.4%	5.7%	5.7%	10.6%

Liquidity ratios measure the capacity of the business to meet short term financial commitments as they become due.

The **current ratio** is a measure of the liquidity of your business. It tells you whether your business has enough current assets to meet its short term financial obligations as they become due. The higher the ratio, the better the business is able to meet its short term financial commitments. A current ratio of 2:1 is regarded as desirable for a healthy business. However, every industry or business is different. As a general rule, try to achieve a current ratio above 1:1 and as close to 2:1 as possible.

The current ratio has improved with the reduction of the short term debt. However, the increase of accounts payable and reduction of cash has slowed its recovery. These two factors need to be addressed to see the ratio move towards the healthy 2:1 ratio.

The **quick ratio** is another measure of the liquidity of your business. It measures the current assets that can be quickly convertible into cash that can be used to meet short term liabilities. The quick ratio provides a more conservative measure than the current ratio because it excludes inventory. The optimal quick ratio is regarded 1:1 or higher, which means that current liabilities can be met from current assets without the need to sell inventory.

The quick ratio hasn't improved as needed due to the same reasons mentioned above.