Welcome to the study of business finance. The major topic in this module is *Financial Statement Analysis*. And this first presentation will provide an Introduction to Financial Analysis.
Financial Statement Analysis is very important to the management of a company. If you understand what the numbers mean, it is more likely that you will focus your attention on matters that really have an impact on the performance of a company.

To begin our introduction, let’s compare the different focus between Accounting and Finance, and then review some of the basics about financial statements.
I often am asked about the difference between Accounting and Finance. From a very general perspective, the Accounting viewpoint tends to focus more on profitability. In other words, is the product sold for more than the cost to produce it. This calculation requires a careful analysis of accruals and matched expenses to determine an estimate of the product cost.

In contrast, the Finance viewpoint tends to focus more on solvency and market valuation. In this regard, we are more interested in the actual timing of cash flows so that we can make sure that the company does not run out of cash. The emphasis in Finance is also on the market value of a company rather than the Accounting book value. The market value can be estimated from the present value of future cash flows.

Given this difference in perspective, let’s highlight some of the basics about Financial Statements.
Financial Statements

• Income Statement
• Balance Sheets
• Statement of Cash Flows

Financial Statements include the Income Statement, Balance Sheet, and the Statement of Cash Flows. In our review, we will focus primarily on the Income Statement and Balance Sheet.
A balance sheet is a stock level at one point in time while the income statement is a flow between two balance sheets.

This time line shows the relationship between the Income Statement and the Balance Sheets over time. The Balance Sheet represents a snapshot of the level of the various accounts in the Balance Sheet at one point in time. On this slide, this is shown in the Balance Sheet at the end of last year and the Balance Sheet at the end of this year. In contrast, the Income Statement is an accumulation of the revenues and costs that occurred during the period of the previous year. It is important to remember that a Balance Sheet is a “Stock” level at one point in time while the Income Statement is a “Flow” between two balance sheets.
This slide shows a conceptual view of the Income Statement. On the left we see the sales that drive the whole process. Associated with the sales are the Cost of Goods Sold and Expenses. The Cost of Goods Sold include the cost of raw materials to produce the product and depreciation. Expenses include selling and administrative costs as well as interest and taxes. After accounting for these deductions, the remainder is Net Income, or the profits from the business.
*Depreciation* is a non-cash deduction to simulate the using up of a fixed asset. Even though depreciation is not a cash flow, it does affect the amount of taxes paid, which is a cash flow.

In Finance, we focus more on actual cash flows. Within the Cost of Goods Sold is *Depreciation*, which is not an actual cash flow. Instead it is a non-cash deduction to simulate the gradual using up of a fixed asset as the product is produced over time. Depreciation reduces the amount of current taxes paid, so even though it is not a cash flow in itself, it does affect the total cash flow through the effect on taxes, which is a cash flow.

In Finance, we also focus on the actual timing of cash flows. To do this, we must understand some of the basic Accounting concepts within the calculation of the numbers in the Financial Statements.
Matching Principle

Revenue is *recognized* when the effort to generate the sale is substantially complete and there is a reasonable certainty that payment will be received.

*Then, the cost of goods sold is booked for the sale.*

For example, let’s review the *Matching Principle*. The *Matching Principle* in Accounting is an attempt to collect all costs and expenses associated with each sale (no matter when the cash flows actually occur) in order to compare the selling price to the sum of all the unit costs. In other words, are we selling the product for more than it cost us to make the product. Rather than looking at the timing of actual cash flows, revenue is recognized when the effort to generate the sale is substantially complete, and there is a reasonable certainty that payment will be received. At that point, the sale is recognized and the cost of goods sold is booked for the sale. In Finance, we want to reverse this process and get back to the actual timing of cash flows.
This time line shows the timing of the cash flows related to the point the sale and associated costs are booked. To the far left on the time line, raw materials arrive from our suppliers. After the raw materials are delivered,
a payment is made to the suppliers, which represents a cash outflow from the company. This normally occurs long before the actual sale is booked.
Likewise, payroll checks are issued to the employees before the sale takes place. This again is a cash outflow from the company before the sale actually occurs.
The cost of telephone service and electricity is also a cash outflow from the company, before the product is finished for sale.

Eventually, after all these cash flows, the sale is made. However, if the sale is on credit, a cash inflow still does not occur even though the sale is booked by accounting (as an Accounts Receivable). At this point, the company has spent all this cash, the customer has possession of the finished product, and the company still has not received any cash in return.
Finally, when the accounts receivable is collected, the company receives a cash inflow, which is hopefully larger than the sum of all the cash outflows. This is what makes the business succeed. However, notice that there is a considerable lag from the time that cash flows leave the company until a larger cash flow comes back to the company. This means that a cash investment is required to facilitate the business process of selling the product. This investment is called *Net Working Capital*. The importance of this net working capital investment and how to manage it is sometimes not appreciated enough by small business managers, and they can suffer as a result.

The time line in this slide with the lag in cash outflows before a cash inflow is called the *Cash Conversion Cycle*. Let’s see how this fits into the balance sheet.
This slide shows a conceptual representation of the balance sheet. On the left side are the Assets. These include the Current Assets at the top and the Fixed Assets at the bottom.
The current assets are those assets which have a life of less than one year, and include cash, accounts receivable, and inventory.
The fixed assets include the equipment, machinery, buildings, land, etc. which we recognize as the Plant, Property, and Equipment of the business. The fixed assets can also include intangible assets, such as patents and goodwill. But primarily, the fixed assets are the tangible assets required to produce the product.
On the right side of the balance sheet are the *Liabilities and Shareholders Equity*.
At the top are the *Current Liabilities*, which have a life of less than one year. These include accounts payable and notes payable.
Below that are the long-term liabilities, which primarily includes *Long-Term Debt*. This is the long-term borrowing of a firm, which normally consists of bonds.
Finally, at the bottom of the right side of the balance sheet is the *Owners Equity*. This represents the cumulative amount of capital accounted for the benefit of the owners, including the original capital provided by the owners or shareholders and any internally generated funds plowed back into the business for the benefit of the owners.
The *Cash Conversion Cycle* mentioned earlier is mainly concerned with the current assets and current liabilities of the firm.
The current assets include *Cash, Accounts Receivable*, and *Inventory*. The current liabilities consist primarily of *Accounts Payable*. 
Altogether, these accounts represent the *Net Working Capital* of the firm.
Net Working Capital = CA - CL

The *Net Working Capital* is defined as the current assets minus the current liabilities.
The *Cash Conversion Cycle* represents a continuous shifting among these *Net Working Capital* accounts.
The *Cash Conversion Cycle* begins when suppliers deliver the raw materials required to make the product.
The value of these raw materials is added to the inventory account as raw materials inventory. With double entry accounting, the same dollar value is simultaneously added to the accounts payable as a bill to be paid in the near future.

Back in the inventory account, there are three categories of inventory. With the use of the fixed assets, the raw materials inventory develops into goods in process and finally to finished goods. From there, the product is sold.
If the sale is a credit sale, the finished goods in inventory are shifted to *Accounts Receivable*. Actually, the value increases at this step since the finished goods inventory are valued at the Cost of Goods Sold and the *Accounts Receivables* are valued at the selling price. This increase in value represents the operating profit margin.
The time from the initial delivery of inventory to the sale is called the *Inventory Period*. This part of the lag between cash outflows and cash inflows is a result of the time necessary to manufacture the product.
The *Accounts Receivables* represent the amount customers owe to the firm for the purchase of products on credit.
Suppliers

CASH
A/R
INV

A/P
When the *Accounts Receivables* are collected, funds move into the cash account.
The time from the sale of the product to the receipt of cash from the customers is called the Accounts Receivable Period.
If we add both the Inventory Period and the Accounts Receivable Period together, this equals the *Operating Cycle*. The *Operating Cycle* represents the time lag from the initial receiving of the raw materials and supplies to the final receiving of cash from the sale.
The Cycle is not complete, however, until the suppliers are paid cash for the raw materials and supplies they delivered.
With double entry accounting, when the cash payment is made to suppliers, both the Cash account and the Accounts Payable account are reduced by the amount of the payment.
Since the sale of the product at the selling price is generally larger than the Cost of Goods Sold, there should be cash available from the cash account for the purchase of fixed assets and the payment of dividends and interest.
The movement among the Net Working Capital accounts in this flow diagram represents the *Cash Conversion Cycle*. However, it is important to recognize that each of the accounts in this diagram is continuously changing. That’s the way things actually happen in the business.

Now, the sequence of events in the *Cash Conversion Cycle* can also be shown on a time line. Again, you should realize this is a static picture of a dynamically occurring process. Later on in this segment we will calculate the components of the *Cash Conversion Cycle* from data on the Income Statement and Balance Statement.
This time line again highlights the timing differences of cash flows in the process of defining the *Cash Conversion Cycle*, this time in a more static sense.

Along the top of the line, beginning at the left, the process starts with the physical delivery of the raw materials into inventory. This inventory proceeds from *raw materials* to *goods in process* to *finished goods*. Then the sale occurs, and the customer takes possession of the final product.
The time from initial delivery of the inventory to the sale is called the *Inventory Period*.

If the sale is a credit sale, the customer has a period of time before actual cash payment is made. From the company’s point of view, this is when the receivable is collected.
The time between the sale to the customer and the collection of the receivable is called the *Accounts Receivable Period*. 
The sum of the *Inventory Period* and the *Accounts Receivable Period* is a measure of the *Operating Cycle*. The operating cycle measures the time from the initial receiving of the inventory until cash is finally received from the sale.

On the bottom side of the time line, beginning at the left, when the raw materials and supplies were first received, the suppliers to a company normally allow a period of time before payment for the raw materials is actually made.
This period of time from first receiving the inventory to payment for the raw materials is called the *Accounts Payable Period.*
In the overall process, the time required in the operating cycle minus the accounts payable period is called the Cash Conversion Cycle. The cash conversion cycle represents the period of time from the first cash outflow for the raw materials until the final cash inflow is received from the sale of the finished product. This gives an overall measure of how long cash remains invested in net working capital before the company finally receives cash payment. Clearly, an effective manager will try to shorten both the operating cycle and the cash conversion cycle. As the cash conversion cycle is shortened, less cash is required to be invested in net working capital. Likewise, when the cash conversion cycle is lengthened, it is necessary to invest more cash in net working capital. This illustrates why it is so important to be able to quantify the operating cycle and cash conversion cycle.
This slide shows all of the formulas required to calculate all the component parts of the cash conversion cycle. We will look at each of these calculations in an example problem.
For the example problem, we have the balance sheet for the end of last year and the end of this year, and the income statement for the current year.

This is the left side of the balance sheet.
<table>
<thead>
<tr>
<th>Liabilities and equity</th>
<th>Last Year</th>
<th>This Year</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current liabilities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>$228</td>
<td>$240</td>
</tr>
<tr>
<td>Notes payable</td>
<td>32</td>
<td>24</td>
</tr>
<tr>
<td>• Total</td>
<td>$260</td>
<td>$264</td>
</tr>
<tr>
<td><strong>Long-term debt</strong></td>
<td>238</td>
<td>290</td>
</tr>
<tr>
<td><strong>Stockholders’ equity</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common stock and paid-in surplus</td>
<td>250</td>
<td>250</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>652</td>
<td>796</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$902</td>
<td>$1046</td>
</tr>
<tr>
<td><strong>Total liabilities and equity</strong></td>
<td>$1400</td>
<td>$1600</td>
</tr>
</tbody>
</table>

This slide shows the right side of the balance sheet.
### Income Statement This Year

($ in thousands)

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$1000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>568</td>
</tr>
<tr>
<td>Depreciation</td>
<td>100</td>
</tr>
<tr>
<td>Earnings before interest and taxes</td>
<td>$332</td>
</tr>
<tr>
<td>Interest</td>
<td>32</td>
</tr>
<tr>
<td>Taxable income</td>
<td>300</td>
</tr>
<tr>
<td>Taxes</td>
<td>108</td>
</tr>
<tr>
<td>Net income</td>
<td>$192</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>$144</td>
</tr>
<tr>
<td>Dividends</td>
<td>48</td>
</tr>
</tbody>
</table>

And this slide shows the income statement. We can use these financial statements to calculate the operating cycle and the overall cash conversion cycle. To do this, we need to also calculate the various components, including the inventory period, the accounts receivable period, and the accounts payable period.
Let’s begin with the operating cycle. To find the inventory period, we first need to calculate the inventory turnover, which is equal to the cost of goods sold divided by the average inventory. These items are found on the standard financial statements.
The cost of goods sold is found on the Income Statement after net sales. In this example, the cost of goods sold is 568.
The average inventory can be found on the Balance Sheet. The inventory account is among the current assets. To find the average inventory over the year, just add the value at the end of last year to the value at the end of this year and divide by 2.
In this example, 276+332=608 divided by 2 = 304. This “average” may not be the typical level of inventory during the year if the year end values are not normal. But for our purposes, an average between the end of last year and the end of this year will be adequate.
1. The operating cycle
   a) Finding the inventory period

\[
\text{Inventory turnover} = \frac{\text{COGS}}{\text{Avg inventory}}
\]

\[
\frac{568}{308} = 1.844 \text{ turns}
\]

Dividing the cost of goods sold of 568 by the average inventory level of 308 gives an inventory turnover of 1.844 turns per year. This means that, on average, we go through the entire inventory about 1.8 times every year. This does not mean that we go through every item in inventory 1.8 times per year. Some items in the inventory may stay there longer than other items. But, on average, we go through inventory 1.8 times per year.
1. The operating cycle
   a) Finding the inventory period

   \[
   \text{COGS} \\
   \text{Inventory turnover} = \frac{\text{COGS}}{\text{Avg inventory}} \\
   \frac{568}{308} = 1.844 \text{ turns} \\
   \frac{365}{1.844 \text{ turns}} = 198 \text{ days}
   \]

Perhaps a more intuitive number is the *Average Inventory Period*. The average inventory period is defined as 365 days per year divided by the Inventory turnover. In this example, 365 days divided by 1.844 turns per year gives us an average inventory period of 198 days. This means that “on average” an item stays in inventory about 198 days. Some items may stay in inventory less time, and others may be in inventory longer. This number is more intuitive because an operating manager can conceptually understand what it means for an item to stay in inventory for an average of 198 days. If he knows the business well, he can then make an assessment as to whether this is a reasonable amount of time. If that seems like much too long for an item to be in inventory, the operating manager can then manage the business better by focusing his efforts on reducing the average time in inventory. He first might try to find out what is causing the item to be in inventory that long and then make changes in the way things are done to lower that number.
b) Finding the accounts receivable period

Credit sales

Receivables turnover = \frac{\text{Credit sales}}{\text{Avg receivables}}

The next calculation in the operating cycle is the accounts receivable period. To find the accounts receivable period, we first need to calculate the accounts receivable turnover, which is equal to the credit sales divided by the average accounts receivable. The first item we want to find is the credit sales. Think for a moment, where would you expect to find credit sales?
### Income Statement This Year

($ in thousands)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$1000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>568</td>
</tr>
<tr>
<td>Depreciation</td>
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</tr>
<tr>
<td>Taxes</td>
<td>108</td>
</tr>
<tr>
<td>Net income</td>
<td>$192</td>
</tr>
</tbody>
</table>

Retained earnings: $144  
Dividends: 48

Let’s look at the Income Statement. At the top of the Income Statement is Net Sales. However, that is not necessarily Credit Sales unless all sales are made on credit. If there are some cash sales, then the Net Sales would overstate the Credit Sales. This is one place that you need to ask questions from your friendly accountant to differentiate between credit sales and net sales. For this example, we will make the assumption that all sales are on credit, but that may not necessarily be true in a particular company. So for the example problem, we assume credit sales of 1000.
The average accounts receivable can be found on the balance sheet. As in the case with average inventory, to find the average accounts receivable over the year, just add the value at the end of last year to the value at the end of this year and divide by 2.
### Balance Sheet
as of December 31
($ in thousands)

<table>
<thead>
<tr>
<th>Assets</th>
<th>Last Year</th>
<th>This Year</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$ 44</td>
<td>$ 48</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>240</td>
<td>280</td>
</tr>
<tr>
<td>Inventory</td>
<td>276</td>
<td>332</td>
</tr>
<tr>
<td>• Total</td>
<td>$ 560</td>
<td>$ 660</td>
</tr>
<tr>
<td><strong>Fixed assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net plant and equipment</td>
<td>840</td>
<td>940</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$1400</td>
<td>$1600</td>
</tr>
</tbody>
</table>

In this example, 240+280=520 divided by 2 = 260. This “average” again may not be the typical level of accounts receivable during the year if the year end values are not normal. But for our purposes, an average between the end of last year and the end of this year will be adequate.
### Finding the Accounts Receivable Period

<table>
<thead>
<tr>
<th>Credit Sales</th>
<th>Receivables Turnover</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1000</td>
<td>Avg Receivables</td>
</tr>
<tr>
<td></td>
<td>$260</td>
</tr>
</tbody>
</table>

$$ = \frac{3.846 \text{ turns}}{}$$

Now, to find the accounts receivable turnover, we divide the credit sales of 1000 by the average accounts receivable of 260 to calculate an accounts receivable turnover of 3.846 turns per year. This means that, on average, we go through the accounts receivable 3.846 times per year. Some receivables remain uncollected longer than others, but on average they are collected a little more than 3.8 times per year.
b) Finding the accounts receivable period

Credit sales

Receivables turnover = \[
\frac{\text{Credit sales}}{\text{Avg receivables}}
\]

\[
\frac{\$1000}{\$260} = 3.846 \text{ turns}
\]

Receivables period = \[
\frac{365}{3.846 \text{ turns}} = 95 \text{ days}
\]

A more intuitive number is the *Accounts Receivable Period*. The accounts receivable period is defined as 365 days divided by the accounts receivable turnover. In this example, 365 divided by 3.846 gives us an average accounts receivable period of 95 days. An operating manager can conceptually understand that this means that the accounts receivable are collected in an average of 95 days. If this seems like too long of a period before collecting the receivables, the operating manager may want to review the criteria being used to issue credit to customers.
b) Finding the accounts receivable period

\[
\text{Receivables turnover} = \frac{\text{Credit sales}}{\text{Avg receivables}}
\]

\[
\frac{\$1000}{\$260} = 3.846 \text{ turns}
\]

\[
\text{Receivables period} = \frac{365}{3.846 \text{ turns}} = 95 \text{ days}
\]

\[
\text{Operating cycle} = \text{Inventory period} + \text{Receivables period} = 198 + 95 = 293 \text{ days}
\]

Now that we know the inventory period and the accounts receivable period, we can calculate the operating cycle. The *Operating Cycle* is defined as the sum of the inventory period and the accounts receivable period. In this example, the operating cycle is equal to an inventory period of 198 days plus an accounts receivable period of 95 days, which equals an operating cycle of 293 days. Recalling from the earlier discussion on the operating cycle, this means that the average time from when the raw materials are first delivered until we receive the cash for the sale will be 293 days in this example.
2. The cash conversion cycle
   a) Finding the payables turnover

   \[
   \text{COGS} \\
   \text{Payables turnover} = \frac{\text{COGS}}{\text{Avg payables}}
   \]

Finally, the last item we need to calculate the cash conversion cycle is the accounts payable period. But first, let’s calculate the *Accounts Payable Turnover*. The definition of the accounts payable turnover is the cost of goods sold divided by the average accounts payable.
### Income Statement This Year
(S in thousands)

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount (in thousands)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
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<tr>
<td>Taxes</td>
<td>108</td>
</tr>
<tr>
<td><strong>Net income</strong></td>
<td><strong>$192</strong></td>
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<tr>
<td>Retained earnings</td>
<td>$144</td>
</tr>
<tr>
<td>Dividends</td>
<td>48</td>
</tr>
</tbody>
</table>

The cost of goods sold is again found on the Income Statement after net sales. The cost of goods sold is 568 in this example.
<table>
<thead>
<tr>
<th>Liabilities and equity</th>
<th>Last Year</th>
<th>This Year</th>
</tr>
</thead>
<tbody>
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<td><strong>Current liabilities</strong></td>
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<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>$228</td>
<td>$240</td>
</tr>
<tr>
<td>Notes payable</td>
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</tr>
<tr>
<td>• Total</td>
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<td>$264</td>
</tr>
<tr>
<td>Long-term debt</td>
<td>238</td>
<td>290</td>
</tr>
<tr>
<td><strong>Stockholders’ equity</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common stock and paid-in surplus</td>
<td>250</td>
<td>250</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>652</td>
<td>796</td>
</tr>
<tr>
<td>Total</td>
<td>$902</td>
<td>$1046</td>
</tr>
<tr>
<td><strong>Total liabilities and equity</strong></td>
<td>$1400</td>
<td>$1600</td>
</tr>
</tbody>
</table>

The average accounts payable can be found on the right side of the balance sheet. To find the average accounts payable over the year, just add the value at the end of last year to the value at the end of this year and divide by 2.
In this example, $228 + 240 = 468$ divided by $2 = 234$. Again, the typical level of the accounts payable may be somewhat different. But for our purposes, this average will be adequate.
2. The cash conversion cycle
   a) Finding the payables turnover
   
   Payables turnover = \( \frac{\text{COGS}}{\text{Avg payables}} \)
   
   \[
   \frac{\$568}{\$234} = 2.427 \text{ turns}
   \]

   Now, to find the accounts payable turnover, we divide the cost of goods sold of 568 by the average accounts payable of 234 to calculate an accounts payable turnover of 2.427 turns per year. This means that, on average, we go through the accounts payable 2.427 times per year. Some payables remain unpaid longer than others, but on average they are paid a little more than 2 times per year.
2. The cash conversion cycle
   a) Finding the payables turnover

   \[
   \text{Payables turnover} = \frac{\text{COGS}}{\text{Avg payables}}
   \]

   \[
   \frac{568}{234} = 2.427 \text{ turns}
   \]

   \[
   \text{Payables period} = \frac{365}{2.427 \text{ turns}} = 150 \text{ days}
   \]

A more intuitive number is the *Accounts Payable Period*. The accounts payable period is defined as 365 days divided by the accounts payable turnover. In this example, 365 divided by 2.427 gives us an average accounts payable period of 150 days. An operating manager can conceptually understand that this means that the accounts payable are paid on average in 150 days. If this does not seem like an appropriate amount of time for paying the suppliers, the operating manager may want to review the customary practice in paying the company’s bills.
2. The cash conversion cycle
   a) Finding the payables turnover

\[
\text{Payables turnover} = \frac{\text{COGS}}{\text{Avg payables}}
\]

\[
\frac{\$568}{\$234} = 2.427 \text{ turns}
\]

\[
\text{Payables period} = \frac{365}{2.427 \text{ turns}} = 150 \text{ days}
\]

Cash conversion cycle = Operating cycle - Payables period
\[
\begin{align*}
\text{Cash conversion cycle} &= 293 - 150 \\
&= 143 \text{ days}
\end{align*}
\]

Now that we know the operating cycle and the accounts payable period, we can calculate the Cash Conversion Cycle. The Cash Conversion Cycle is defined as the Operating Cycle minus the Accounts Payable Period. In this example, the operating cycle is equal to 293 days and the accounts payable period is 150 days. The cash conversion cycle is therefore 293 minus 150, or 143 days. This measures the overall time from the first payment of cash until cash is finally received for the sale of the product. A good manager will try to decrease the length of the cash conversion cycle because this will decrease the amount of net working capital. Every time the cash conversion cycle is reduced, cash will be made available for use elsewhere in the firm. And conversely, when the cash conversion cycle is increased, more cash must be invested as net working capital in the firm. Therefore, managing the operating cycle and the cash conversion cycle is very important because that will limit the amount of net working capital necessary to maintain the business activities.
Let’s summarize what we have accomplished in this first section. We first presented a high level, conceptual view of the Income Statement and Balance Sheet.
Summary

- Presented a conceptual view of the Income Statement and Balance Sheet.

- Defined the Operating Cycle and the Cash Conversion Cycle.

We then defined the concept of the operating cycle and the cash conversion cycle. We did this to illustrate how the executives of a firm could manage the level of net working capital by controlling the operating and cash conversion cycles.
Summary

• Presented a conceptual view of the Income Statement and Balance Sheet.

• Defined the Operating Cycle and the Cash Conversion Cycle.

• Completed an example problem.

Finally, we completed a numerical example to demonstrate the use of data from the financial statements in calculating the operating and cash conversion cycles. This completes the introduction to the overall topic of financial statement analysis.