


**Chapter 7, Module 8**

**Slide 1**

*Chapter 7 Module 8*

**AMIS 211**  
**Introduction to Financial Accounting**

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Hi everyone. Welcome back.

Let's wrap up our discussion of Accounts Receivable by talking about a couple of financial statement ratios that relate to the Receivables.

Let's jump right into it.

Please go to the next slide with me.

**Slide 2**

***Chapter 7 Module 8: Accts Receivable Ratios***

**Financial Statement Ratios Relating to Accounts Receivable:**

- 1. Accounts Receivable Turnover**
- 2. Average Collection Period**

And, there are two financial statement ratios relating to Accounts Receivable that I would like to talk about.

Let's talk about what is called: the Accounts Receivable Turnover Ratio and what is called: the Average Collection Period.

Let's go ahead to the next slide.

## Slide 3

**Chapter 7 Module 8: Accts Receivable Turnover**

**Accounts Receivable Turnover**  
**Measures the number of times on average**  
**the company collects its accounts receivable.**

$$\frac{\text{Net Sales Revenue}}{\text{Average Accts Receivable}} = \text{Accounts Receivable Turnover}$$

$$\frac{\text{Accts Receivable at Jan. 1} + \text{Accts Receivable at Dec. 31}}{2} = \text{Average Accts Receivable}$$

And, let's deal with the Accounts Receivable Turnover Ratio.

This ratio measures the number of times—on average—the company is able to collect its Accounts Receivable during the year.

To calculate the Accounts Receivable Turnover Ratio, you take your Net Sales Revenue and divide it (/) by your Average Accounts Receivable balance.

To get the Average Accounts Receivable balance, you simply take the Beginning Accounts Receivable—Accounts Receivable at January 1<sup>st</sup>—plus (+) the Ending Accounts Receivable—or the Accounts Receivable at December 31<sup>st</sup>.

Beginning Receivables plus (+) Ending Receivables divided by (/) 2 to give us an average.

Now, if you would go to the next slide with me.

Slide 4

***Chapter 7 Module 8: Accts Receivable Turnover***

The accounts receivable turnover ratio is an indication of how many times during a year a company is 'turning over' or collecting its receivables.

This ratio is a measure of how many times old receivables are collected and replaced by new receivables.



**Higher is better (the higher the number, the faster we are collecting cash from our customers).**

What the Accounts Receivable Turnover Ratio is telling us—as we said just a few moments ago—how many times during the year a company is able to collect its Accounts Receivable.

Thinking of it another way: How many times can the company turn over its Accounts Receivable?

What this basically means is: How many times can the company take its old Accounts Receivable, collect them, and then replace them with new Accounts Receivable; and then, collect them and replace with new; collect and replace with new?

So, on average, how many times during the year is the company able to do that?

Now with this particular ratio, the deal is: the higher the number, the better.

The higher the Accounts Receivable Turnover Ratio, the better we are doing. The higher the number is, the faster we are collecting our Accounts Receivable.

Now, you do, of course, need to add one caveat to that:

Just because you have what you might think is a high number; that does not necessarily mean it is good.

What makes it good?

We do not know without something to compare it against, such as some industry average.

These ratios by themselves are not very meaningful. What makes them meaningful is being able to compare against some benchmark, such as an industry average.

Compared to an industry average, if we are better than average; that is good!

Then, we are collecting our Accounts Receivable faster than the average company that operates in our industry.

That is very important. You want to make sure you are comfortable with that.

Ratios, themselves, are not very meaningful until you have the benchmark to compare them against.

Please go to the next slide.

## Slide 5

**Chapter 7 Module 8: Average Collection Period**

**Average Collection Period**  
Measures the number of days on average between making a sale on credit and collecting our cash from the customer.

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$$\frac{365}{\text{Accts Receivable Turnover}} = \text{Average Collection Period}$$

↓  
**Lower is better.**

Let's look at the other ratio that we are going to deal with: the Average Collection Period.

The Average Collection Period tells us the number of days—on average—between making the sale and collecting our cash.

So, how many days elapse—again, on average—between selling goods on account and then collecting the cash from those customers.

To calculate your Average Collection Period: simply take 365—the number of days in a year—and divide by (/) the Accounts Receivable Turnover that we just calculated on the previous couple of slides.

Notice with this particular ratio: the lower the number, the better.

The lower the number, the fewer days elapse between making the sale and collecting our cash.

Again, we do not know if that is good or not until we are able to compare it against some industry average.

All right! Please go to the next slide.

**Slide 6**

***Chapter 7 Module 8: Accts Receivable Ratios***

**Assume that XYZ Company has beginning accounts receivable of \$35,000; ending accounts receivable of \$40,000; and net sales revenue of \$150,000 for 2005.**

<b>Accts Receivable Turnover</b>	<b>=</b>	$\frac{\text{Net Sales Revenue}}{\text{Average Accts Receivable}}$
<b>4 times</b>	<b>=</b>	$\frac{\$150,000}{(\$35,000 + \$40,000) \div 2}$

And, let's take a look at an example.

Let's just make up some numbers.

Here is what it says:

“Assume that XYZ Company has Beginning Accounts Receivable of \$35,000, and Ending Receivables of \$40,000, and Net Sales for the year of \$150,000.”

Let's start by calculating our Accounts Receivable Turnover Ratio.

The formula is right there on the screen (Slide 6).

To calculate the Accounts Receivable Turnover:

We take our Net Sales of \$150,000 and divide by (/) the Average Accounts Receivable—which is the Beginning (\$35,000) plus (+) the Ending (\$40,000) divided by (/) 2.

Our Accounts Receivable Turnover is 4.0.

We are able to collect our Accounts Receivable 4 times during the year. On average, we are able to replace old Receivables with new Receivables 4 times.

Is that good?

I don't know.

Without something to compare it against—without some sort of industry average or company standard—some benchmark to make a comparison against.

Please go to the next slide with me.

## Slide 7

***Chapter 7 Module 8: Accts Receivable Ratios***

**Assume that XYZ Company has beginning accounts receivable of \$35,000; ending accounts receivable of \$40,000; and net sales revenue of \$150,000 for 2005.**

$$\text{Average Collection Period} = \frac{365}{\text{Accts Receivable Turnover}}$$

$$91.25 \text{ days} = \frac{365}{4}$$

And, let's work with the same problem but let's do the calculation for the Average Collection Period.

It is 365 divided by (/) the Accounts Receivable Turnover (4.0).

When you press those buttons on the calculator, the Average Collection Period is: 91.25 days.

What this means: 91.25 days elapse between making the sale and then collecting the cash.

Again, we don't know if that is good or not without being able to compare it against some industry standard.