



Financial Analysis and the Effective Operation of Your Company

Many small business owners measure the success of their business by their ability to increase sales. Some entrepreneurs may not understand the implications of rapid sales growth.

The keys to successful sales growth are:

- Growth does not exceed the company's CAPACITY to Grow
- AND
- Growth should sustain or INCREASE profitability.

Part One - CAPACITY

As sales increase, so does the need for increased assets to support these sales. This can include:

- Increases in fixed assets to ramp up production
- Higher levels of account receivable to accommodate more clients and/or larger orders
- Higher levels of inventory

These assets tie up "cash". For example a company cannot pay its' employees with inventory or accounts receivable. So either a company has to have enough internally generated cash flow available to meet their operating expenses (like wages and salaries) until assets (like inventory and accounts receivable) are turned into cash or they need to turn to the owners for investment or creditors for financing.

Increased financing typically means increased financing costs, which in turn impacts expenses and therefore profitability. The company will eventually reach a point where they can no longer service the debt (interest charges, other fees associated with debt) or they will be unable to access further debt.

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Part Two – PROFITABILITY

As sales increase, sometimes this success does not translate into increased profitability, and the company owner could wonder if the increase in sales levels was worth the additional associated assets and expenses.

For instance a decreased selling price may lead to increase sales volume

– BUT –

if profitability does not keep pace with sales (i.e. if the price reduction does not result in an increased volume of sales that keeps pace with the additional costs associated with these sales) then the Company has effectively reduced not only their profitability but also their return on investment due to the increased levels of both assets and debt associated with increased sales.

SUMMARY

When assessing the implication of rapid sales growth, business owners should consider the following:

- What are the implications of the sales growth strategy?
- How will the increased levels of accounts receivable and inventory be financed?
- How will cash flow be affected by sales growth?
- What additional fixed assets will be required to support sales expansion, and how will these be financed? How will additional debts, principal payments and interest charges affect your cash flow?
- How will your overall profitability be affected?
- Will you be able to maintain your margins?