



# Cash Flow Early Warning Calculator

If your customers all paid “cash on the barrelhead” when your service was provided or your product was delivered, then you’d never have a cash flow problem because no one would ever owe you anything, i.e., your accounts receivable would be zero!

However, most businesses operate with an accounts receivable, so a sale doesn’t necessarily mean you have received cash in the bank. You don’t have income to pay your bills until the cash is received from the sale you made. How long does it typically take you to collect?

Here’s a quick way to take a snapshot of the number of days it takes you to collect from your customers; use the Day Sales Outstanding, or DSO, formula:

$$\frac{\text{Current Value of Accounts Receivable}}{\text{Total Sales From Previous 12 Months}} \times 365 = \text{NumberOfDaysToCollect}$$

where Current Value of Accounts Receivable is taken from your current balance sheet and Total Sales From Previous 12 Months is taken from your income statement(s).

For a simple example, take a business with \$1,000,000 in sales over the last 12 months with an accounts receivable value of \$100,000. Plugging these figures into our formula we have:

$$\frac{\$100,000}{\$1,000,000} \times 365 = 36.5 \text{ days it typically takes you to collect}$$

Obviously your goal is to keep the number of days to collect number as small as possible and it’s smart business practice to keep the age of your accounts receivable to 30 days or less.

This snapshot formula works best in a business model with a large number of routine sales. If you operate a model with high dollar sales on an infrequent basis, then the picture the formula paints is not as accurate.

The other half of the story is your Days Payable Outstanding or DPO, which is the same formula applied to your accounts payable.

$$\frac{\text{Current Value of Accounts Payable}}{\text{Total Sales From Previous 12 Months}} \times 365 = \text{NumberOfDaysToPay}$$

where Current Value of Accounts Payable is taken from your current balance sheet and Total Sales From Previous 12 Months is the same value used previously, taken from your income statement(s).

(Continued on reverse →)

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## Your Early Warning System

Your DPO must be greater than or equal to your DSO in order to have a healthy cash flow!

If you can float your bills longer than your customers do, where your  $DPO > DSO$ , then cash will begin accumulating in your business. However, if your customers are dragging their feet, where your  $DPO < DSO$ , then your cash is going out the door faster than it is coming in. And the bigger the difference, the faster your business is being drained of cash!

It's obvious that you need to frequently monitor these numbers and the  $\frac{DPO}{DSO}$  ratio to watch for early signs of trouble if your business model has accounts receivable.

If you use a spreadsheet to monitor your business expenses, you can easily create a ratio of the value of  $\frac{DPO}{DSO}$ , where anytime the ratio has a value of  $\geq 1$  you would know your business is cash flow positive for the period. Any value of  $< 1$  would mean indicate a cash flow negative situation and would be cause for investigation if the condition persists.