Managing the Firm’s Assets

PART 5
Managing Growth in the Small Business
The Working-Capital Cycle

**Working-Capital Management**
- The management of current assets and current liabilities

**Net Working Capital**
- current assets
  - (cash, account receivable, and inventories)
- minus
- current liabilities
  - (short-term notes, accounts payable, and accruals)

**Why is this important?**
The Working Capital Cycle

1. Buy inventory for sale, increasing accounts payable.

2. Sell inventory for cash; sell inventory on credit (accounts receivable).

3. Pay the accounts payable (decreases cash and accounts payable).

4. Collect the accounts receivable (decreases accounts payable and increases cash).

5. Begin cycle again.
**Cash conversion period—**
AFTER we pay our payables UNTIL we receive our receivables

**Day a.** Inventory is ordered in anticipation of future sales.
**Day b.** Inventory is received.
**Day c.** Inventory is sold on credit.
**Day d.** Accounts payable come due and are paid.
**Day e.** Accounts receivable are collected.

Cash conversion period—
the time required to convert paid-for inventories and accounts receivable into cash.
Dell has a **negative 44 days CCC**, which means that their sales are converted into hard cash 44 days before Dell needs to pay for purchase invoices to vendors.

Could you imagine the cash flow they have . . .
Your Working-Capital Cycle

• Purchase or produce inventory for sale,
  ➢ Increases accounts payable
  ➢ How many days do you hold inventory before sale?
• Sell inventory
  ➢ For cash (receivables = 0 days)
  ➢ For credit (accounts receivable days).
• If Payables >= 1day - Pay the accounts payable
  ➢ Decreases cash and accounts payable
  ➢ How many days to pay your vendors (trade credit)?
• If Receivables >= 1day - Collect the accounts receivable
  ➢ Decreases accounts payable and increases cash
• Complete the cycle

SIMPLIFIED

INVENTORY: + # DAYS (how long you hold before sale)
RECEIVABLES + # DAYS (how long buyers take to pay you)
# DAYS
PAYABLES - # DAYS (how long before you pay suppliers)
Cash Conversion Period = # DAYS (inventory paid -> receipt of AR)
Managing Cash Flows

The Growth Trap – a cash shortage (cash crunch)

- **Cause:**
  - rapid growth and
  - long cash conversion period
- Can have rapid sales growth yet go bankrupt

How Fast/Big do we need to grow?

- Film - [Do we have to grow BIG?](#) Film (5 min)
Exhibit 22.4 Flow of Cash through a Business

- Owner's Investment
- Borrowed Funds
- Sale of Fixed Assets
- Cash Sales
- Purchase of Fixed Assets
- Collection of Accounts Receivable
- Payment of Expenses
- Payment of Dividends
- Payment for Inventory
Managing Accounts Receivable

Accounts Receivable Financing

- **Pledged accounts receivable**
  - Accounts receivable used as collateral for a loan.

- **Factoring** – [Short Video]
  - Obtaining cash by selling accounts receivable at a discount to another firm.

**Advantage**
- Immediate cash flow

**Disadvantages**
- High interest costs for loans funds and discounts for factored receivables
- Loss of receivables as collateral in borrowing
Managing Inventories

Inventory is a “necessary evil.”

- Product supply and consumer demand don’t always match up.

Reducing Inventory to Free Cash

- Monitoring current inventory
  - Determine age and suitability for sale.
- Controlling stockpiles
  - Match on-hand inventory with demand.
  - Avoid personalizing the business-customer relationship.
  - Avoid forward purchasing of inventory; carrying cost for excess inventory may exceed any savings.
Managing Accounts Payable

- **Negotiation**
  - Asks creditors for adjustments or additional time.

- **Timing**
  - Creditors’ funds can supply short-term cash needs until payment is demanded.
  - Accounts with cash discounts for early payment should be examined for their savings potential.
  - “Buy now, pay later”—pay early enough to get cash discounts and timely enough to avoid late-payment fees.
  - Additional frequent shipments
  - Blanket P.O. and scheduled payments
Capital Budgeting

Capital Budgeting Analysis

- Decisions about **long-term investments**:
  - Developing new products
  - Replacing equipment
  - Constructing new facilities
  - Expanding sales territories

- Seeks to **answer the question**:
  - “Do future benefits from the investment exceed the cost of making the investment?”

- Good decisions can add value;
  - Bad decisions can put you out of business.
Three Rules of Capital Budgeting

- Investors judging the attractiveness of an investment prefer:
  - More cash rather than less cash.
  - Cash sooner rather than later.
  - Less risk rather than more risk.

Short Video on Calculating ROI
Last Issues to Consider

5 Skills that entrepreneurs need

Video (8 min)

Answer this question while watching:

1. What are the 5 skills? Describe each with some detail (at least two or three sentences)
Managing Risk in the Small Business

PART 5
Managing Growth in the Small Business
What is Risk?

- **Risk**
  - The possibility of suffering harm or loss.

- **Business Risk**
  - The possibility of losses associated with the assets and the earnings potential of a firm.

- **Market Risk**
  - The uncertainty (gain or loss) associated with an investment decision.

- **Pure Risk**
  - The uncertainty associated with a situation where only loss or no loss can occur—there is no potential for gain (only downside).
  - Only form of risk that is insurable.
Torts

Wrongful acts or omissions for which an injured can take legal action against the wrongdoer for monetary damages.
Outsourcing

1. As requested, I put together a list of functions we should outsource.

2. I limited my list to things we don't do well.


4. That leaves us with our core competence...

5. ...sitting around a brown table.
Outsource Risk – Buy Business Insurance

**Business Owner’s Policy (BOP)** A package bundling property and liability insurance together - meant to appeal to small businesses with 100 or fewer employees

- **General Liability** includes accidents, products, operations, and contracts
- **Property Insurance** includes burglary and Plate Glass
- **Workers' Compensation** includes medical care to employees’ on-the-job injuries
- **Professional Liability/ Errors & Omissions (E&O)** error or oversight - from failing to issue a policy.
- **Directors & Officers (D&O)** Errors in judgment, breaches of duty, and wrongful acts
- **Business Automobile** Vehicles - private passenger cars, pickups, light vans . . .
- **Marine** Ocean shipping
- **Umbrella (Supplemental)** High limit coverage in excess of policy limits
- **Business Interruption** Temporary shutdown - fire or other insured peril
- **Key Person Life** Disability or death of an employee in a significant position.
- **Travel** Traveling on business, away from the usual place of business
## Insurance - Life Table (2002 - http://www.cdc.gov)

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<th>Probability of Dying</th>
<th>Expectation of Life</th>
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Are Sales Growing Slowly or Rapidly?

How About Now?

Sales Growth

Zoom Graph

Figures for above charts

<table>
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## Average Pay

Let's take a look at the average starting pay for Mt. SAC graduates:

<table>
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<th>Salary</th>
<th>How would you determine the average salary of a Mt. SAC graduate?</th>
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<tbody>
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<td>$23,000</td>
<td>The <strong>average salary is $23,000.00</strong> (based on <strong>mode</strong> - highest frequency)</td>
</tr>
<tr>
<td>23,000</td>
<td></td>
</tr>
<tr>
<td>25,000</td>
<td>The <strong>average salary is $30,000.00</strong> (based on <strong>median</strong> - numbers above and 4 numbers below - The Census Bureau uses this method)</td>
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<tr>
<td>28,000</td>
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<tr>
<td>30,000</td>
<td>The <strong>average salary is $42,333.33</strong> (based on <strong>mean</strong> - arithmetic average)</td>
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<td>32,000</td>
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<td>57,000</td>
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<td>$125,000</td>
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</table>
Before 1940 there were over 200,000 cases of malaria a year, whereas now there are only handful of cases. What happened?
Join the Navy and live longer?

During the Spanish-American war the death rate in the Navy was 9 per 1,000. For civilians in New York, during the same period, it was 16 per 1,000. Navy recruiters used these figures to show that it was safer to be in the Navy than out of it. These figures are accurate - what makes them meaningless?
The people from the New Hebrides believe that body lice produce good health. Observations over centuries had taught them that people in good health usually had lice and sick people very often did not. The observations were accurate, but what's wrong?
When you confuse the significance of dimensions or compare two objects of different dimensions, it can give a wrong impression of size. A foot has 12 inches but a square foot has 144 square inches.

The world population (3 different ways):

If every person in the world was lined up end to end, we would stretch four times longer than the orbit of the Moon around the Earth.

If we all lived in a city with the population density of New York City, that city would cover the state of Texas.

If every person was given a 20'x20'x20' apartment, the total volume would only fill the Grand Canyon half way.
A visitor at the Natural History Museum asks a guard how old the dinosaur skeleton is. The guard responds that the skeleton is 90,000,006 years old.

He explains, "They told me it was 90,000,000 years old when I started working here, and that was six years ago."
There are four key questions that may allow us to "see beyond" the hype of statistics:

1. **Who says so?**
   Look for the possibility for bias. Look for conscious bias - what facts have been deliberately left out? Look for unconscious bias - what facts that are relevant may be missing? - who funded the study or research?

2. **How does he/she know?**
   A questionnaire is sent to 120 companies, with a 15% response rate. 66% percent of the respondents said they lowered prices. Should we lower prices as well - What does this tell us?
   Only 12 companies said they lowered prices, whereas 6 said they didn't and 102 did not respond. **These statistics mean very little.** Valid studies normally require a 65% response rate.
3. **What's missing?**
Watch out for small sample size, which average (mean, median, mode) is being used, or for the lack of comparisons or other data to collaborate the findings.

4. **Did somebody change the subject?**
Watch out for a switch between the raw figures and a conclusion. One thing is all too often reported as another. As an example, more reported cases of a disease is NOT the same thing as more disease. There is often a difference between what people/companies say in surveys and what they actually do. (halo effect)
How Fast?

A Race track is one mile long, if a driver goes around once at 30 miles per hour, how fast must he drive in the second lap to average sixty miles per hour for both laps?