

Small Business Management ^{19e}

LAUNCHING AND GROWING ENTREPRENEURIAL VENTURES

Longenecker · Petty · Palich · Hoy



CHAPTER 22

Managing the
Firm's Assets

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?

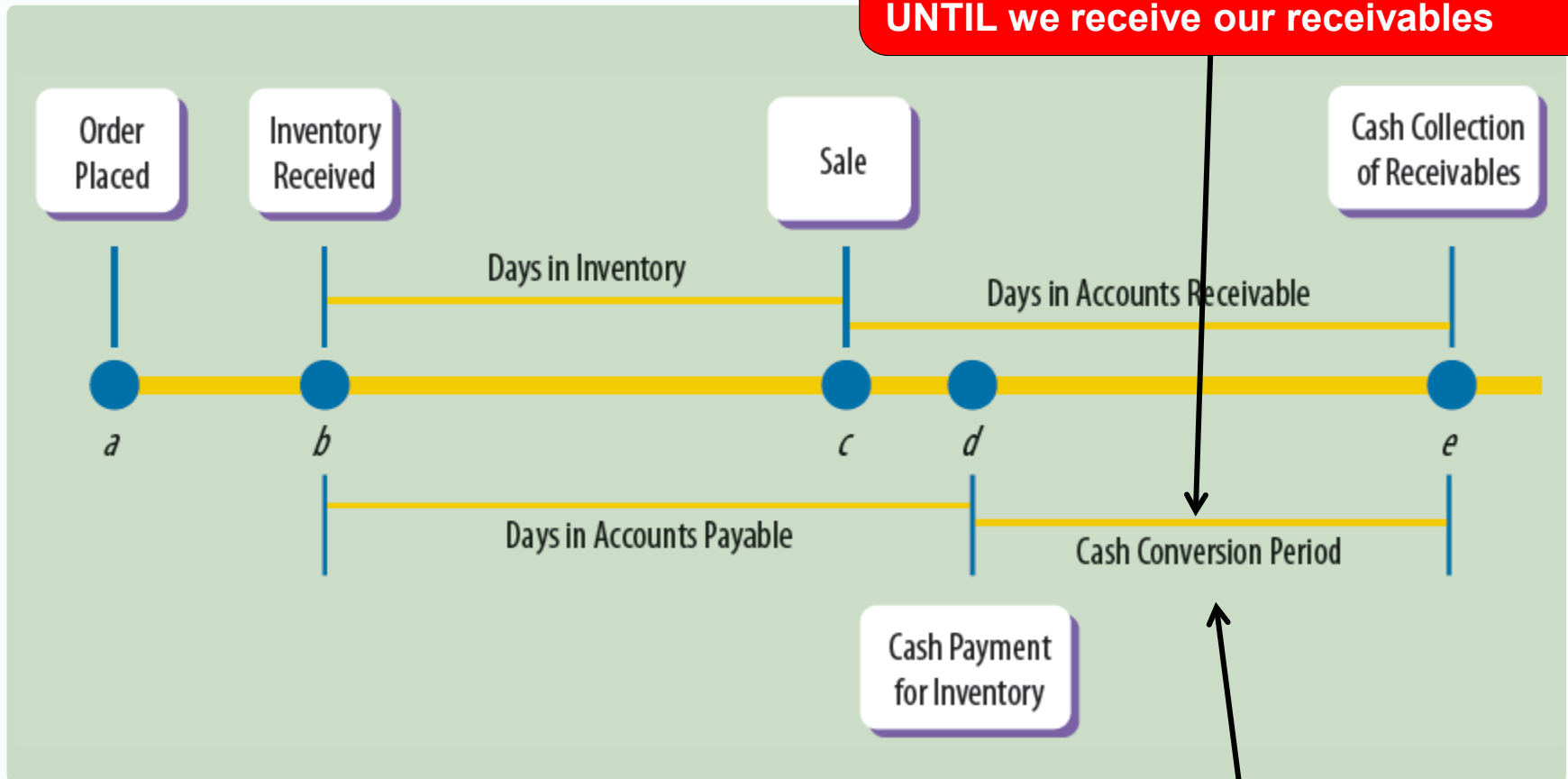
The Working Capital Cycle

- ① → Purchase or produce inventory for sale, which increases accounts payable.
- ② → Sell inventory for cash; sell inventory for 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.

22.2

Working Capital Timeline

**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.

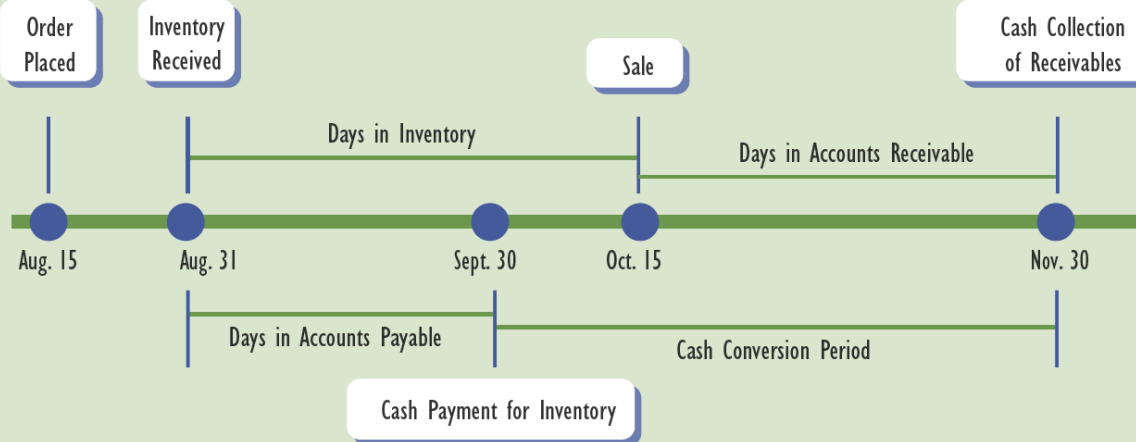
Day d. Accounts payable come due and are paid.

Day e. Accounts receivable are collected.

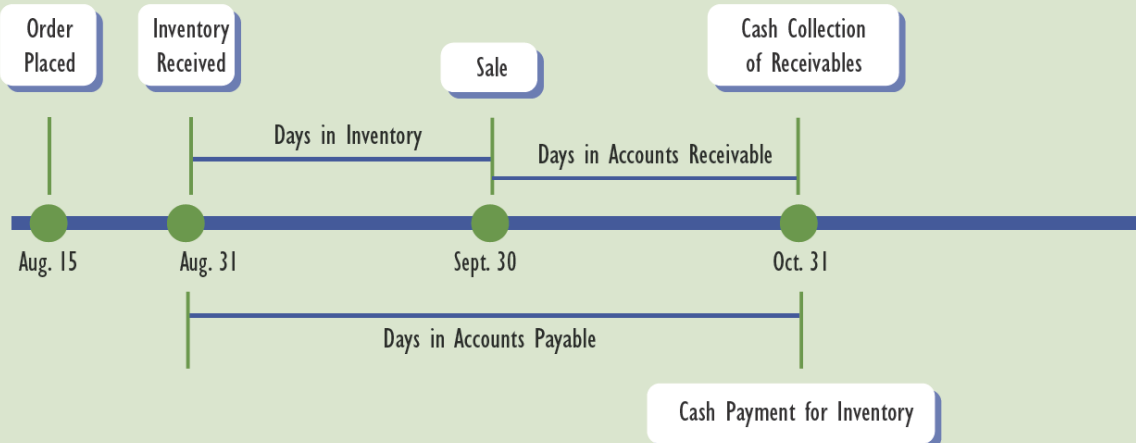
**Cash conversion period—
the time required to convert
paid-for inventories and
accounts receivable into cash.**

Exhibit 22.2 - Working-Capital Timelines for Pokey, Inc., and Quick Turn Company

Pokey, Inc.



Quick Turn Company



Dell has a **negative 44 days CCC**, which means that their sales are converted in 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

Here is a great tutorial on how to calculate your Cash Conversion Period (and an example calculation):

<http://www.investopedia.com/articles/06/cashconversioncycle.asp>

Cash Conversion Period = DIO + DSO - DPO

Step 1

Days of Inventory Outstanding (DIO)

DIO is how many days it takes to sell the entire inventory. The smaller the number, the better. To calculate it, you first need to determine:

Average Inventory:

$((\text{Beginning Inventory} + \text{Ending Inventory}) / 2)$

Then, use it to calculate DIO:

$(\text{Average Inventory} / \text{Cost of Goods Sold})$

Your Working-Capital Cycle

Step 2

Days of Sales Outstanding (DSO)

DSO is days sales outstanding, or the number of days a company takes to collect on sales. First, calculate:

Average Accounts Receivable (AR):

(Average accounts receivable \div 2)

Then, calculate the DSO:

((Accounts Receivable / Annual Revenue) x Number of Days in Period)

Step 3

Days of Payables Outstanding (DPO)

DPO is days payable outstanding. This reflects the company's payment of its own bills or accounts payable (AP). If this can be maximized, the company holds onto cash longer, maximizing its investment potential. Therefore, a longer DPO is better.

Calculate:

(Ending Accounts Payable / (Cost of Sales / Number of Days))

Your Working-Capital Cycle

Here is a great tutorial on how to calculate your Cash Conversion Period (and an example calculation):

<http://www.investopedia.com/articles/06/cashconversioncycle.asp>

SIMPLIFIED

$$\begin{array}{lcl} \text{INVENTORY (DIO)} & + & \# \text{ DAYS (how long you hold before sale)} \\ \text{RECEIVABLES (DSO)} & + & \# \text{ DAYS (how long buyers take to pay you)} \\ \text{PAYABLES (DPO)} & - & \# \text{ DAYS (how long before you pay suppliers)} \\ \hline \text{Cash Conversion} & & \\ \text{Period} & = & \# \text{ DAYS (inventory paid -> receipt of AR)} \end{array}$$

Managing Cash Flows

The Growth Trap – a cash shortage (cash crunch)

➤ Cause:

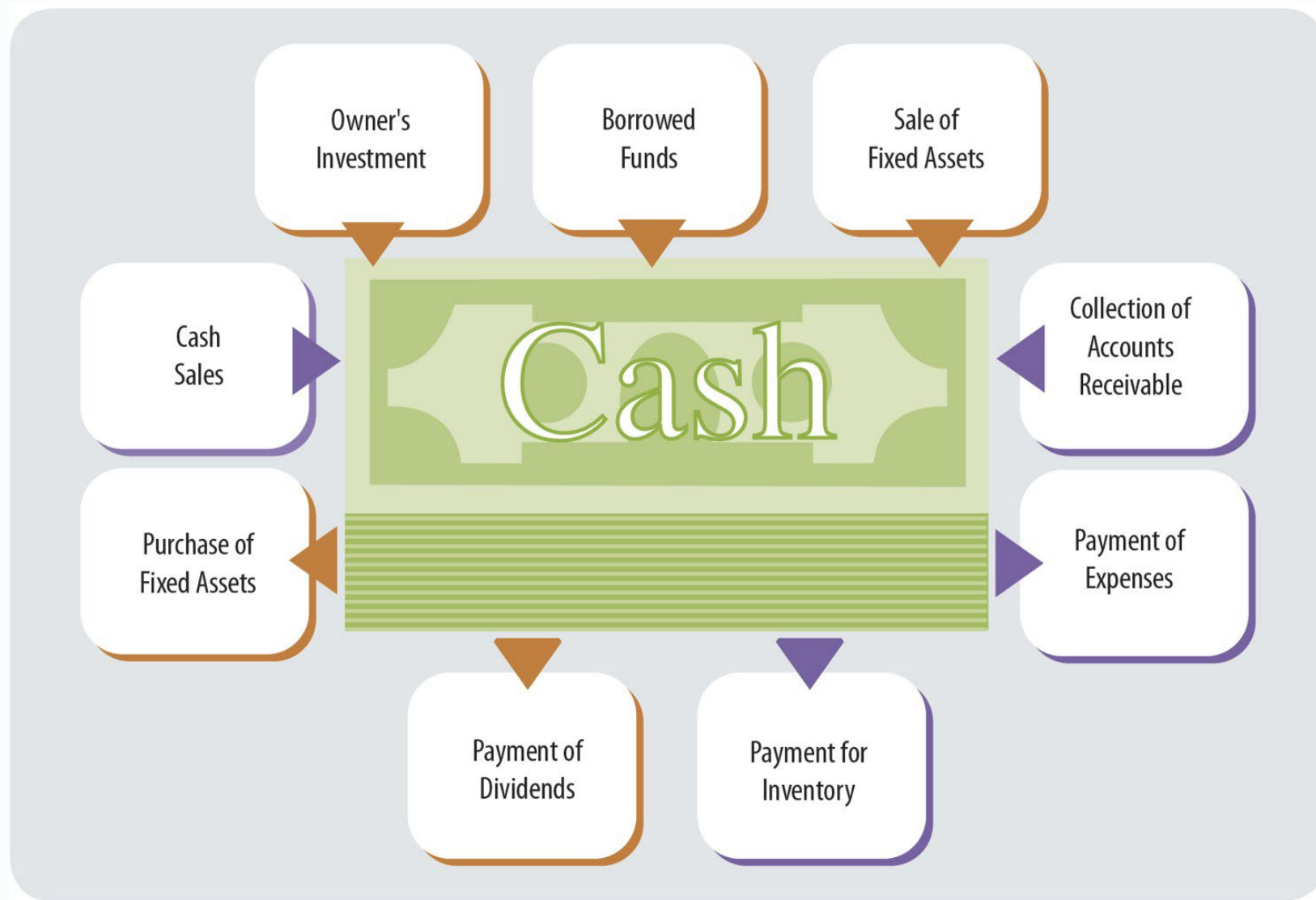
- ❖ rapid growth and
- ❖ long cash conversion period

➤ 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)
- Film – Growth Comes with Challenges (5 min)

22.4 Flow of Cash Through a Business



Ways to Improve Cash Flow

Video

1. Collect Outstanding Receivables
2. Reduce Costs (goods, labor, expenses)
3. Improve Internal Controls
4. Increase Sales (Gross Revenue)
5. Increase Prices
6. Owner Financing
7. Leverage a Line of Credit
8. Secure a Loan
9. Enlist Equity Partners
10. Liquidate Assets
11. Reduce/Control Inventory
12. Build up an Operating Reserve
13. Shorten Due Dates (Receivables)
14. Set up Monthly Reoccurring Contracts
15. Factoring (Selling Receivables)

Managing Inventory

Inventory is a “necessary evil.”

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

Monitoring Inventory

- Determine **age and suitability for sale.**
- Controlling stockpiles
 - **Match** on-hand inventory with demand.
 - **Avoid personalizing** the business-customer relationship.
 - **Monthly Reoccurring Contracts** – Blanket Purchase Orders
 - **Avoid forward purchasing** of inventory; carrying cost for excess inventory may exceed any savings.

Managing Accounts Payable

- Negotiation
 - Ask 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.

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:

1. More cash rather than less cash.
2. Cash sooner rather than later.
3. Less risk rather than more risk.

Short Video on [Calculating ROI](#)



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CHAPTER

23

Managing Risk

What is Business 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.
- Need Insurance [VIDEO](#)

**Sources of
Tort Liability**

```
graph LR; A([Sources of Tort Liability]) --- B[Premises Liability]; A --- C[Operations Liability]; A --- D[Professional Liability]; A --- E[Employers' Liability]; A --- F[Automobile Liability]; A --- G[Product Liability]; A --- H[Completed Operations Liability]; A --- I[Directors and Officers Liability]
```

Premises Liability

Operations Liability

Professional Liability

Employers' Liability

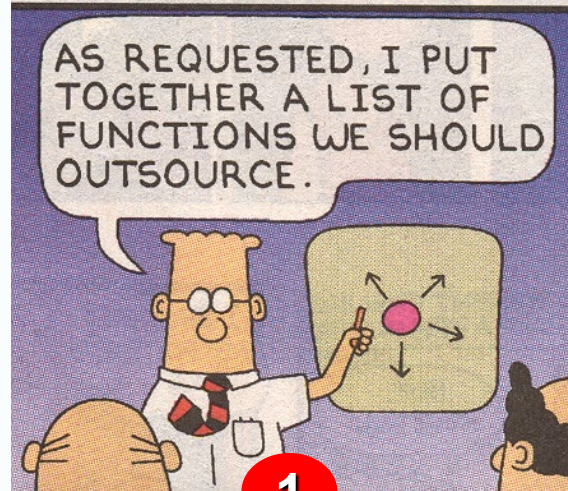
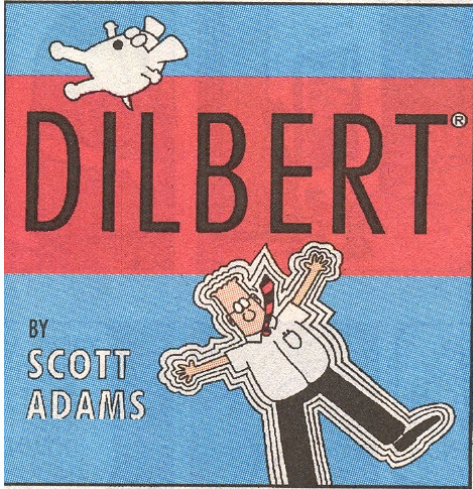
Automobile Liability

Product Liability

**Completed
Operations Liability**

**Directors and
Officers Liability**

Outsourcing



1



2



3



4



5

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

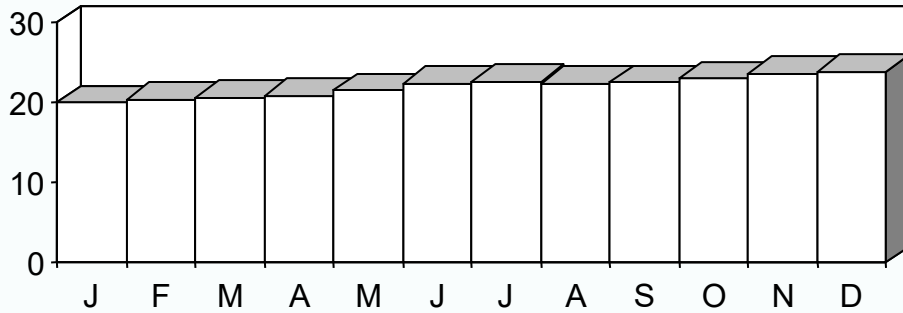
- **General Liability** includes accidents, products, operations, and contracts
- **Property Insurance** includes burglary and Plate Glass
- **Workers' Compensation** includes medical care to employees' on-the-job injuries
- **Professional Liability/ Errors & Omissions (E&O)** error or oversight - from 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 (2016)

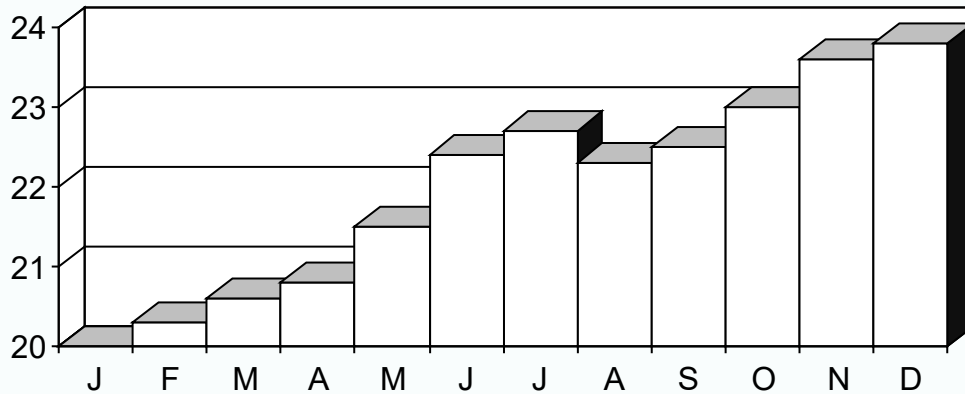
	MALE	FEMALE
Age	Life Expectancy	Life Expectancy
0	75.97	80.96
10	66.57	71.50
20	56.85	61.63
30	47.65	51.97
40	38.56	42.47
50	29.67	33.23
60	21.58	24.56
70	14.39	16.54
80	8.28	9.68
90	4.05	4.78
100	2.12	2.42
101	2.01	2.28
102	1.90	2.14
103	1.80	2.01
104	1.70	1.88
105	1.60	1.76
106	1.51	1.65
107	1.42	1.54
108	1.34	1.44
109	1.26	1.34
110	1.18	1.24
111	1.10	1.15
112	1.03	1.06
113	0.96	0.98
114	0.90	0.91
115	0.84	0.84
116	0.78	0.78
117	0.72	0.72
118	0.66	0.66
119	0.61	0.61

Source: <https://www.ssa.gov/oact/STATS/table4c6.html> - 2016

Are Sales Growing Slowly or Rapidly?

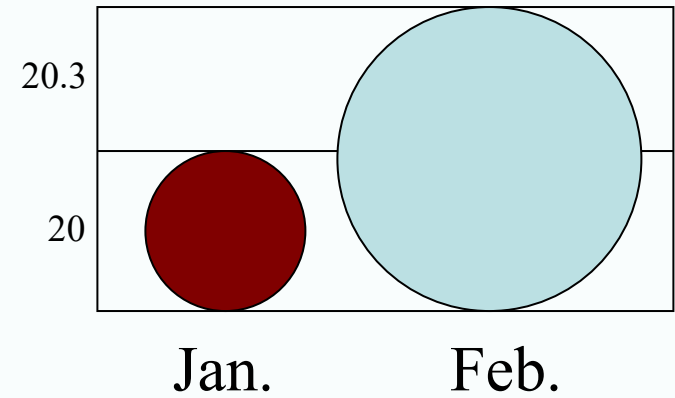


How About Now?



Sales Growth

Zoom Graph



Figures for above charts

J	F	M	A	M	J	J	A	S	O	N	D
20	20.3	20.6	20.8	21.5	22.4	22.7	22.3	22.5	23	23.6	23.8

Average Pay

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

- \$ 23,000** How would you determine the average salary of a Mt. SAC graduate?
- 23,000**
- 25,000** **The average salary is \$23,000.00**
(based on mode - highest frequency)
- 28,000**
- 30,000** **The average salary is \$30,000.00**
(based on median - numbers above and 4 numbers below -
The Census Bureau uses this method)
- 32,000**
- 38,000**
- 57,000** **The average salary is \$42,333.33** (based on mean -
arithmetic average)
- \$ 125,000**

Malaria in the American South has been curbed

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?

Lice are healthy!

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?

Dimensional Dementia

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.

Last Dramadigit

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."

How to Talk Back to Statistics

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.

How to Talk Back to Statistics

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 corroborate 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?