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Assets:
Inventory and
Operations Management

Source: Entrepreneurial Small Business, Katz & Green, 2e
McGraw-Hill/Irwin

Chapter 16

Managing Short-term Assets

- Accounts receivable: money that is owed to your business by your customers
 - Relatively few small businesses today provide credit to customers

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- Pros and cons of offering credit to your customers:
 - Providing credit usually results in higher sales revenue because of increased repeat business
 - Reduces cost of selling
 - Credit delays receipt of cash
 - Must replace the "missing" cash
 - Sooner or later a customer will not pay

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- **Managing accounts receivable:**
 - Must establish and enforce efficient and effective policies and procedures for **extending credit:**
 - Minimize the time that passes between credit sale and when the cash is received
 - Keep number of bad accounts as low as possible

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- **Using accounts receivable as a source of financing:**
 - Use your receivables in two ways to quickly lay your **hands on cash:**
 - Pledge receivables as collateral for a commercial loan
 - You can sell your receivables to a finance company in a process called **factoring**

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Example

Offering Credit to New Customers

- How do I determine if a customer is creditworthy?
- Three things you can do to make sure you don't get burned:
 - Check credit references
 - Learn more from the major credit bureaus
 - Consider products and services from D&B (Dun and Bradstreet)

<http://www.enr.com/resources/directories/offering-credit-to-new-customers.html>

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Managing Inventory

- Determine the appropriate level of inventory:
 - Right amount of inventory is determined by:
 - Cost of processing an order
 - Cost of keeping merchandise in inventory
 - Cost of lost sales if you run out
 - Time it takes to receive inventory after it's ordered

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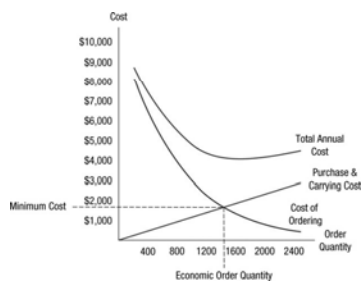
Inventory Costs

Costs of Carrying Inventory	Costs of Ordering Inventory
1. The opportunity cost of the funds invested in inventory	1. The transaction costs of preparing and transmitting the order
2. The cost of keeping inventory secure and in sellable condition	2. Investigating and selecting an appropriate vendor
3. Cost of warehouse or other storage facilities	3. Receiving inventory
a. Utilities	
b. Physically moving inventory into, within, and out of the storage area	
c. Security guards, fencing, access control, etc.	
4. Insurance and taxes on inventory	4. Time required to travel to suppliers to pick up inventory
5. Inventory shrinkage, i.e., loss from waste, spoilage, and theft	5. Inspecting shipments
6. The transaction costs for counting and record keeping	6. Record keeping

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Economic Order Quantity



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- **Scheduling ordering and receipt of inventory:**
 - Need to know when to place each order
 - Deciding when to place an order:
 - Rate of sales
 - Time required to receive new stock
- **Just-in-time inventory systems:**
 - Cost of owning and holding inventory is far greater than the cost of ordering inventory
 - Most businesses try to acquire and keep on hand the minimum amount of inventory possible

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- **Just-in-time inventory:** attempts to reduce inventory levels to absolute minimum
 - Accepting inventory only as it is sold
 - Assembling product in the absolute minimum time possible
 - Shipping product to customer immediately upon completion

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- **Other approaches to inventory control:**
 - **Periodic inventory:** process of physically counting business assets on a set schedule
 - **Perpetual inventory:** recording the receipt and sale of each item as it occurs
 - Provide you with instant access to accurate inventory
 - **Bar coding:** used to reduce cost of perpetual inv.
 - UPC: registered and controlled privately; unique to each product

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- **Other approaches to inventory control:**
 - **Point-of-sale systems:** recently become inexpensive enough to be used by small businesses
 - May acquire complete systems, including a cash drawer, credit card scanner, computer, monitor, and software for less than \$2,000

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Value of Assets in Your Business

- Value of assets in your business far exceeds the value that you might realize if you were to sell them
- **Determining the value of your operating assets:**
 - Value of operating assets is a function of utility
 - **Utility:** net cash inflows the asset will produce

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- **Four accounting methods to value capital assets: cont.**
 - **Book value:** accounting residual that is the difference between the original acquisition cost of capital assets and the amount of depreciation expense that has been recognized for them
 - Depreciation is not any measure of the consumption through use of an asset's value

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- Four accounting methods to value capital assets: cont.
 - Book value:
 - Depreciation is based on three assumptions:
 - Asset has a fixed, determinable period of utility
 - Asset has a fixed, determinable value that will exist when the depreciation process is complete
 - The value of the asset will decline in a continuous and predictable manner

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- Four accounting methods to value capital assets: cont.
 - Disposal value: method of estimating asset value by calculating the net amount that you would realize were you to sell the asset in an "arm's-length" transaction

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- Four accounting methods to value capital assets: cont.
 - Replacement value: value of a currently owned capital asset by determining the cost that would be incurred to replace it with an identical asset
 - Fair market value: an attempt to determine the price that the asset would bring, in its current location and condition

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- **Determining the value of inventory:**
 - Value that you assign to inventory sold:
 - Amount of profit that you recognize
 - Value of your business
 - Begins with knowing how much of what you are holding
 - Assign a high value to inventory:
 - Increase amount deducted for COGS, which results in decreased sale margin

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Property, Plant, and Equipment

- Property, plant, and equipment are likely of relatively minor importance to your success
- Capital assets cause you to incur costs over time:
 - **Cost of acquiring the asset:** includes interest on funds borrowed and the opportunity costs of funds invested to acquire it; include insurance on the asset, property taxes, and value of the space

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- **Capital assets cause you to incur costs over time: cont.**
 - **Costs of owning an asset:** interest on funds borrowed and the opportunity costs of funds invested to acquire it
 - **Costs of operating the asset:** energy the asset consumes, maintenance, and loss of economic value resulting from wear and obsolescence
 - **Costs of disposition:** value of activities necessary to get rid of the asset; include meeting environmental regulations, disassembly, advertising, commissions, shipping, insurance, and fees

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Capital Budgeting Decision

- Small businesses begin to make investment choices:
 - **Capital budgeting:** process of deciding among various investment opportunities to create a specific spending plan
 - Two most commonly used **financial ratios:**
 - Payback period
 - Return on investment (ROI)

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- **Payback period:** statement of how much time must pass before your business receives back the same number of dollars in cash flow as you must pay out to obtain a capital asset

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- **Payback period:**
 - Two decision rules are applied:
 - Accept only those alternatives for which the time required to recoup the original investment is equal to or less than a maximum allowable time determined by management
 - Accept the alternative with the shortest payback period among those that meet the first criterion

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- **Payback period:**
 - **Primary disadvantages:**
 - It disregards the time value of money
 - It disregards all cash flows that occur after the payback period
 - Often result in managers making suboptimal investment decisions

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- **Rate of return on investment (ROI):** measure of the relationship between the initial investment and the profits that are expected to be received from making the investment

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- **Rate on return of investment:**
 - **Two decision rules are applied:**
 - Accept only those alternatives for which the return on investment is equal to or greater than the business's weighted average cost of capital
 - Accept the alternative with higher ROI among those that meet the first criterion

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- **Rate on return of investment:**
 - **Two advantages:**
 - Easy to calculate
 - It relies on accounting information with which business owners, lenders, and investors are comfortable
 - **Two disadvantages:**
 - Profits are not the same as cash
 - Method ignores time value of money

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Rent or Buy

- **Renting:**
 - **Provides two advantages:**
 - Exact amount and timing of cash outflows is specified
 - **Outflows:** funds being paid to others by the firm
 - Renting provides a fall-back position

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- **Renting: cont.**
 - **Provides three disadvantages:**
 - You do not have an ownership position
 - Rental requires that you make regular, timely payments
 - Number of dollars paid in rent usually exceeds the number of dollars you would spend to own the asset

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- **Financing with leases: two basic types**
 - **Operating leases:** similar to renting; ownership of the asset never passes to the lessee
 - **Capital leases:** essentially the same as buying the asset
 - Primary disadvantage is that **leasing costs more** than would purchasing
 - Leased assets are usually subject to numerous restrictions

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- **Fractional ownership and other forms of joint ventures**
 - Little used method of reducing the costs is **joint venturing:**
 - Simply a formalized partnership
 - Makes economic sense when each party has limited use of an expensive asset
 - Relatively common among small businesses in **ownership of airplanes**

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Summary

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