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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.entrepreneur.com/mcgraw-hill/entrepreneur/offerings/credit/16-5.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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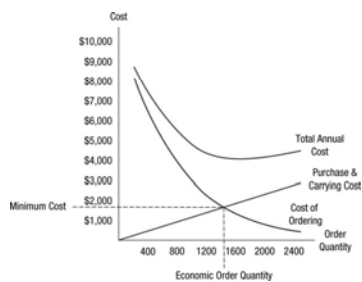
Inventory Costs

| 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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