Analysis of small enterprise: jones electrical distribution

Mr. Jones is having business in a large, fragmented and highly competitive environment. Profitability of his business depends heavily on sales volumes and costs.

The sales are growing at around 18% per annum. However, the profit margin is not maintained at a constant level in terms of sales growth. Exhibit I shows that even though the sales growth was achieved in FY 2005-2006, the firm could not have higher operating profits. The sales revenue was nullified by huge rise in operating expenses.

A close look at the profit and loss account reveals that the operating expenses are mainly consists of salaries and wages. It seems that in order to keep the fixed costs in control, the compensation of sales executives is quite high because of link to sales volumes. The sales growth has helped the employees to earn more than to the organization.

Secondly, Mr. Jones is working with more than 100 suppliers. For such a small volume of business, 100 suppliers are in excess. This huge number of suppliers may create problems in tracking on accounts payable. The company is also having average days payable at 22. 8 days in FY 2006, as compared to 9. 8 days in FY 2005. During the last two years, Mr. Jones has not been able to take advantage of trade discounts.

Mr. Jones is also making payments of $ 2000 per month to Mr. Verden, along with interest payment of 8% per annum. The face amount ($250000) can be considered as a long term loan for Mr. Jones. However, it is not evident from the P & L account, that the interest paid on the loan taken from Mr. Verden is accounted for income statement.

Mr. Jones is also building up fixed assets over a period of time; however, these assets were financed through his short term financing. It can be assumed that the short term finance was available readily for the operations, has been diverted to create long term assets and liquidating long term debts.

These facts and assumptions imply the Mr. Jones is having a relatively aggressive approach in working capital financing of the firm.

Main issue for Mr. Jones is to find a financing option for the firm. As the market is very dynamic and there is economy downturn, he is not able to forecast demand for his products for more than one year. Although, the following year looks quite promising and a good sale is forecasted, Mr. Jones is facing issue of liquidity.

Mr. Jones is of opinion that the liquidity problem is causing the irregular cash flows and hence he need to borrow more money for daily operations. However the forecasted cash flow (Exhibit III) can show that there is no severe cash flow problem. A focused approach to accounts payable and accounts receivables will help Mr. Jones to overcome the liquidity problems.

Around the main issue of arranging finance for the business, Mr. Jones has the additional issues of growing sales, reducing tension between the firm and suppliers, moderating salary for the sales staff and creating a strong relationship with the bankers.

Looking at the financial statements (Exhibit I, II, III) we can say that the financial condition of Jones Electrical Distribution are satisfactory.

The company is having steady growth in sales. The operating margins are also kept at optimal levels. However the company is facing problems managing their cash operations. A feel of cash crunch is guiding the firm to store more inventories, and as a result of that, the inventory levels have increased. The firm is also investing in fixed assets on regular basis. The firm is able to maintain the cost of goods sold to an optimal level since last few years. This has been the result of maintaining cordial relations with the suppliers.

The firm is maintaining healthy liquidity ratios and growth ratios. However, the increase in days payable and inventory turnover is a bit of concern. Even if the cash conversion cycle is reducing, we can observe that days payable has exceeded the limit of 30 days. It means that if the relationship between the firm and supplier is not maintained, the firm can face the interest expenses for not managing their current assets. The firm is working on very thin operating margin. The increase in TIE (Times interest earned) over the years measurers that the operation income is declining and soon the firm will not be able to meet their annual interest costs. suggest of increasing sales volume on immediate basis to maintain profitability. The firm is also able to maintain retention rate of 100% after providing for the proprietor׳s salary. This made sure that the firm will take minimal finances from outside sources.

The major problem for Jones Electric Distribution Company is to manage cash for the new financial year 2007. And this problem looks like a temporary problem. The firm is having stored huge inventories in expectation of sales growth for the New Year. The forecasted analysis shows that a onetime credit enhancement from bank will help the firm to manage their finances better. A higher credit will help the firm procure inventory and use them in business. With improved collections and cash at hand, the firm can now manage for trade discounts and save money. Secondly, the firm will be able to retain a huge sum of $201, 000 at the end of FY 2007. These funds can be used to retire their personal loan with Mr. Varden. Retirement of this loan will help the firm to improve on its profitability and the bank finance will be easier.

It is also observed that additional finance from bank is helping the firm to avail trade discounts. The nominal cost of not taking the discount when credit terms are 2/10, net 30 is 37. 24 % [(2/98)*(365/30-10)], which is much higher than the 8% interest charged by the bank. Hence, it is advisable for Mr. Jones to go for a bank finance and use the money for availing trade discounts.

Even if Mr. Jones adopt a slow growth strategy (to grow at the rate of 8-10%), and can manage with the existing facility of USD 250000/-, he can avail trade discounts and increase his earnings. However, one time use of bank finance will make sure that in coming years, Mr. Jones can be debt free and his firm′s financial performance will improve.

Looking at the market growth and the risk appetite for Mr. Jones, we can advice him for taking an aggressive route and avail higher finances from Southern Bank and Trust.

The financial projections are given below for various options.

Following are the options available to Mr. Jones.

Take Trade Discount and avail USD 350000/-

Take Trade Discount and avail USD 250000/-

Forgo Trade Discount and avail USD 350000/-

Forgo Trade Discount and No Additional Financing

We already seen that forgoing trade discount is a costly affair for the firm and hence cannot be used. So first two options are available for making a profitable decision. As Mr. Jones is forecasting the market as growing, he can use this opportunity to avail bank finance at USD 350000/-. This facility can be availed in two parts, Long Term and Short Term. Long term funds of USD 100000/- can be used with the cash received from business to retire the personal loan. Remaining USD 250000/- can be used for normal business transactions and avail trade discounts. These operations will make sure that Mr. Jones is having stable business operations in under one year.

While going for financial restructuring, Mr. Jones can also look forward to change the salary structure of Sales Personnel.

FRICTO Analysis.

Flexibility : An additional finance of US $ 100000/- will help Mr. Jones to manage his future cash flows. Mr. Jones is already maintaining a healthy RR of 100%. This helps the firm to keep the Debt/Equity ratio in control. The continuous operations will make sure that Mr. Jones can avail more finance as and when required.

Risk : Mr. Jones required reducing his number of suppliers and focusing on few major ones. With reduction of suppliers, it will be easier for him to manage accounts payable and he can demand better credit terms.

Income : Cost reduction will be the focus area for Mr. Jones, in an attempt to increase profits for the firm. As the firm is working on very thin margins, any excess spending will hamper the profitability of the firm. Mr. Jones needs to give closer look on operating expenses, which are increasing ahead of sales growth.

Control : Mr. Jones can decide on which option to choose for the betterment of the firm in long term.

Timing : As the business is in growing stage, Mr. Jones is able to take risks, depending on his relations with supplier and buyers. It is also beneficial to avail additional finance when business is growing.

Others : The risk appetite of Mr. Jones, his relation with the suppliers and an in depth knowledge of the industry is the key success factor for the firm. The success of the firm depends heavily on Mr. Jones′ insights.

Exhibit I

Exhibit II

Exhibit III

Exhibit IV