Chapter 15

INTERNAL SOURCES OF CASH

INTRODUCTION

Over time, companies tend to tie up more capital than necessary in assets such as accounts receivable, inventory and plant property and equipment. Excess assets must be funded through either debt or equity. Some estimate that by the time the typical entrepreneur is ready to exit via sale or IPO, his or her ownership has been diluted to 20% of the company, with the other 80% belonging to "the money," that is to the investors. The fewer excess assets a company has, the less equity an entrepreneur will have to give up so asset minimization should be an important capital preservation strategy.

Another issue entrepreneurs have to think about is that growth requires capital, not just for research and development, and not just for plant and equipment, but growth requires capital for accounts receivable and inventory. A rapidly growing company can outrun its capital and be forced to accept funding on highly unfavorable terms. Such unexpected capital shortfalls place entrepreneurs in a weak bargaining position, with little time to consider alternatives.

The demand for capital is not confined to start-up or early stage companies. Mature companies constantly need to re-evaluate their capital structure and assess whether capital is deployed productively. In fact, the longer a company has been in existence, the greater the likelihood that it has a treasure trove of cash buried amongst its assets waiting to be uncovered.

This chapter examines ways to raise capital from better management of accounts receivable, inventory, and plant and equipment. It also examines how to forecast the capital demands of a growing company.

Raising capital from outside sources creates dependence and dependence limits options and weakens a company's bargaining position. On the other hand, finding cash internally, lessens dependence, and strengthens a company's bargaining position.

HOW MUCH CAPITAL IS APPROPRIATE?

In analyzing any problem, it is often useful to proceed from the big picture to the components of that picture. Every dollar of assets has to be financed by some form of capital. So the first question should be whether the company has an appropriate amount of assets. For many companies, this question can be addressed with the Return on Assets ratio. The equation for Return on Assets (ROA) is given as Eq.15.1. This ratio compares income from operations to the assets that produced that income. If the ratio is high, management is doing a good job of producing income from assets. If the ratio is low, it could indicate one of two things: (i) the company has excess non-revenue producing assets or (ii) management isn't efficiently using the assets at its disposal.[1]

$$\text{ROA} = \frac{\text{Net Income} + \text{Interest} \times (1 - \text{Tax Rate})}{\text{Average Assets}} \qquad \text{Eq.15.1}$$

Where:

Net Income - is income after taxes

Interest - is interest expense

Tax Rate - is the company's effective tax rate which can be found by dividing Income Tax by Earnings Before Taxes

Average Assets - are the assets at the end of the current year plus the assets at the end of the prior year divided by two.

Interest is added back to Net Income so that companies with different financing strategies can be compared. The reason we multiply Interest times (1- Tax Rate) is that taxes subsidize the cost of interest. How? If a company pays $100 and is in the 20% bracket it saves $20 in taxes. So the real cost of the $100 of interest is only $80.

Suppose Adams Company has Net Income of $370,000; Interest was $40,000; it is in the 25% tax bracket; assets at the end of the most current