AML White Paper

How to Kill a Small Business

Small businesses account for more than 50% of the employment in the U.S., and "employer businesses", those businesses with at least one employee other than the owner, have a surprisingly good survival rate through the first few years. But only about half make it to year 5 and only a third make it to year 10. What happens? What's the leading cause of death among small businesses? Bad marketing? Bad location? Bad service? Bad product? Maybe any or all of these. But chances are if the business is infected with any of these, they wouldn't even make it out of their first year. How can a company be successful through the first year or two, then start struggling? Bad management? Maybe… but bad management of what? People? How about assets? Specifically, cash. That's right. Money in the bank. Every year, thousands of companies close their doors, not because they weren't profitable on their income statement, but because they ran out of cash. Most of these didn't close their doors but they had their doors closed for them…by creditors. But how is this possible? If a company isn't losing money, then it must be making money, and if it's making money, then it must have cash. Right? Wrong! People who think this are confusing their Income Statement, or P&L, with their Balance Sheet. Cash is the life blood of the company. Without cash payrolls are not met, bills are not paid, and doors don't stay open.

Let's take a look at a simple business that's turning a profit, but headed down a course where it's going to run out of cash.

We'll use nice round numbers that may not be "real life" but that will be easy to understand.

Matt has a hardware store and in that store he has goods for sale. Let's say that last month Matt purchased $6,000 in hardware and put it on his shelves. He sold ALL of his inventory for $10,000 which means he had a GROSS profit of $4,000. Once he paid his rent, utilities, and other expenses, he had $1,000 remaining, which was his NET profit.

When we look at Matt's bank account we see $7,000 which includes the $1,000 in net profit and the $6,000 he recouped from selling his products. The only cash he doesn't have is the $3,000 he paid out in expenses.

Well the first month went so well Matt takes his $7,000 and spends it all on more hardware for his shelves. So he's re-investing his $1,000 in profit into the business. In month two, he again sells $10,000 in product but this time he still has product on his shelf. Not everything sold. He calculates that the $10,000 in product he sold cost him $6,000, just like the first month. Again he has $3,000 in expenses and again the result is a $1,000 net profit. But after two months in business, instead of having $8,000 in the bank ($6,000 from goods sold+ $1,000 month 1 profit+$1000 month 2 profit), Matt only has $7,000 in the bank because the profit from month 1 was re-invested into inventory which didn't sell. It's still sitting on the shelf.

If Matt continues this strategy, before long he's going to have all his cash tied up in inventory. Assuming sales stay constant and Matt continues to post a $1,000 profit each month, his income statement will show a $12,000 profit for the year. But if he continues to invest each month's profit into inventory, he can forget looking for that $12,000 in the bank. It's not there. It's sitting on his shelves in the form of inventory, about $17,000 worth, which he can't use to pay bills or his employees.

This scenario assumes that sales and profits stay constant. Being optimistic, what if sales go up? Then the investment in additional inventory pays off. Profits increase and growth occurs. But what if sales don't go up? What if sales lag? What if expenses go up? What if the additional inventory is the wrong for the season or the market changes? Of course that's the worst case scenario, but it happens all too often and it's impossible to predict the future.

Matt's Hardware Store Example

	Balance Sheet		Income Statement			
	Inventory	CASH	Sales	Gross Profit	Expenses	Net Profit
Month 1	6,000	7,000	10,000	4,000	3,000	1,000
Month 2	7,000	7,000	10,000	4,000	3,000	1,000
Month 3	8,000	7,000	10,000	4,000	3,000	1,000
Month 4	9,000	7,000	10,000	4,000	3,000	1,000
Month 5	10,000	7,000	10,000	4,000	3,000	1,000
Month 6	11,000	7,000	10,000	4,000	3,000	1,000
Month 7	12,000	7,000	10,000	4,000	3,000	1,000
Month 8	13,000	7,000	10,000	4,000	3,000	1,000
Month 9	14,000	7,000	10,000	4,000	3,000	1,000
Month 10	15,000	7,000	10,000	4,000	3,000	1,000
Month 11	16,000	7,000	10,000	4,000	3,000	1,000
Month 12	17,000	7,000	10,000	4,000	3,000	1,000
TOTALS	**$17,000**	**$7,000**	**$120,000**	**$48,000**	**$36,000**	**$12,000**

Instead of having $18,000 in cash, Matt kept investing in more and more inventory, despite flat sales.

This stresses the fact the inventory must be managed properly and any additional investment in inventory must be carefully considered because you're using your profit to make that investment. The fact is, inventory is a necessary evil. You have to have it to generate revenue, and in turn profits, to spur growth. But it can be evil if you have too much, especially if it's too much of the wrong thing. Cash can be turned into inventory as quick as writing a check. Converting inventory back in to cash, can take days, weeks or months, if ever. Yes, some inventory may never sell and have to be written off the books as a loss. Talk about your worst case scenario.

So what's the answer? Well the answer could be different depending on what type of business you're in but there are a few common components that apply to any business.

1. Know what inventory you have now. Count it. Count it often if you can. How often, again depends on what type of business you have, but you can't even begin to make educated decisions about inventory acquisition and disposition until you know what you have to begin with.

2. Bring in new inventory in the smallest increments possible. Instead of 1,000 widgets a month, bring in 250 each week. Instead of paying for all 1,000 at one time, you're now paying for 250 every week, smoothing out your cash flow.

3. Avoid FISH inventory at all costs. FISH is "First In, Still Here". Sometimes FISH occurs due to bad purchasing decisions. Maybe you got a good deal on some gizmos so you bought extra. Unfortunately the extra inventory isn't selling and it's still sitting on the shelf. If it continues to sit there you'll eventually have to write it off. Avoid the temptation. Buy only what you know you can sell or what you need to produce your products.

4. Use some type of inventory control software package to manage your inventory. These packages range in price from a few hundred dollars to a few hundred thousand dollars. Obviously you need to scale your investment to match the size and needs of your operation, but having the availability to look at your inventory in "real time" and know what you have and where it is, is crucial to effectively managing it.

5. Use technology to your advantage. Implement barcoding throughout your operation, if for nothing else so you can count it quickly and accurately. Barcode labels are cheap and the scanning technology will pay for itself in no time at all when you consider the time saved compared to manually counting and entering data, and then trying to track down and correct count errors. Don't be penny wise and pound foolish. The inventory count needs to be done quickly, especially if it means stopping operations. Many manufacturing operations count inventory perpetually, choosing to "cycle count", or count a few items every day so that every item gets counted at least once in each "cycle" which might be a month or a quarter.

It might be easier to think about inventory in the same way you would think about buying groceries for your home. Most people simply buy enough groceries to get their families through a few days or a week. They don't intentionally buy grocery items that they know might go bad before they use them. They wouldn't want to see their hard earned cash go into the trash or down the disposal. A lot of people will buy non-perishable items in bulk because we get a better price for buying the bigger cans. But these "bulk buys" also mean greater outlay in cash up front, tying up cash that might be needed next week. Remember buying 250 widgets a week instead of 1,000

a month? Beware the ill-fated perception of the "volume purchase".

Small business owners need to remember that cash is their life blood. Often times they don't have the credit facilities available to larger companies so preserving cash and maintaining more than adequate operating capital is paramount. Manage expenses properly, but above all, manage inventory properly. It can be a quiet killer and once out of control, is very difficult to fix. Count your inventory. Know what you have and where it is. Order only what you need in the smallest increments practical… and conserve your cash.

AML was founded in 1983 to respond to a need in the barcode data collector marketplace for high performance, easy-to-use, and cost-effective barcode and data collection products. Our goal is to provide sensible solutions for mission critical activities, to improve efficiency and productivity, and to make barcode data collection applications worry-free.

We believe there is more to buying a product, than just the product. It's also the service and support that is available before, during, and after the sale. It's being able to communicate when you need to, and get action and responses that work for you. It means not being at the mercy of anyone, but rather being the recipient of stellar customer service and support. That's AML.

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