MCGHEE CORPORATION

For as long as he could remember, Calvin McGhee had enjoyed long car trips. As a child he had spent summers travelling with his family, by car, to most parts of the United States. To him, road trips were the most fun one could have, especially if you could stop along the way and enjoy the sights.

Not surprisingly, Calvin became a long-haul trucker after college. It paid good wages and had the advantage of allowing him to see the country from the cab of his truck. He couldn't do any sightseeing this way, of course, but he figured that there was always time for that later.

Six years of open road trucking took its toll, however, and Calvin was tired of the long hours and poor working conditions. As he became more and more discontent with the trucking industry, he started to look for ways to use his knowledge to start a business of his own. Calvin founded McGhee Corporation in the late 1980s.

McGhee specialized in "jobber" sales at truck stops and travel centers across the U.S. and Canada. "Rack jobbers" came in and stocked one part of the store, maintaining inventory and keeping track of consumer interests and popular products. In many cases, these items were the only shopping opportunity that truckers had during the week. Calvin had been able to start small by capitalizing on his knowledge of the trucker lifestyle and the needs of those on the road. Initially, he contracted for shelf space at truck stops in his region and filled that space with wholesale goods he found at closeout sales and business auctions. Truckers had responded by snapping up the toys, books and small appliances that Calvin thought would be appreciated. Within two years Calvin had hired a dozen other employees to help with his routes, and after another two years he needed dozens more. In addition, he had found ways to buy imported goods and keep his inventory consistent across the country.

GET YOUR MOTOR RUNNING

By the end of 2003, McGhee Corporation had become one of the largest jobbers in the U.S. The firm sponsored many products for import, with its own brand names, and had successfully offered Internet ordering only a year before. The company sold everything from video games and textbooks to laptop computers online and maintained job racks and gift sections in thousands of locations across the country. Finally, Calvin McGhee thought he would be able to take the time to travel and be a tourist again.

In order for Calvin to do this, however, it was necessary for him to spend less and less time in the office. To this end, he had spent time the previous year hiring and training a new assistant and teaching her the intricacies of the rack jobber business. Sheryl Plath was just a few months out of school and trying as hard as she could to learn everything about McGhee and his business. Mr. McGhee had placed a great deal of faith in her, and it was obvious that he planned to put at least part of the future of his company in her hands.

THE CASH-TO-CASH CYCLE

Calvin had challenged Ms. Plath using a series of exercises involving the firm's accounting numbers. This week, the lesson was in the area of "working capital management." In addition to her regular tasks, Sheryl was expected to work on this problem and present her findings to Mr. McGhee at the end of the week. Calvin had prepared a balance sheet (Exhibit 1) and some additional information about the firm's cost structure (Exhibit 2). Both statements were based upon 365 days in the firm's fiscal year.

Exhibit 1. McGhee Corporation. Balance Sheet, December 31, 2003.

Cash	\$140,000
Accounts receivable	\$1,225,000
Inventory	\$875,000
Current assets	\$2,240,000
Net fixed assets	\$2,135,000
Total assets	\$4,375,000
Accounts payable	\$700,000
Accruals	\$140,000
Notes payable - bank	\$788,000
Current maturities of LT Debt	\$87,500
Current liabilities	\$1,715,000
Long-term debt	\$962,500
Common stock & PIC	\$297,000
Retained earnings	\$1,400,000
Total liabilities & equity	\$4,375,000

Exhibit 2. Selected Income Statement Information, December 31, 2003.

Sales Revenue, net	$15,968,750
Cost of Goods Sold, net	$10,675,000
Purchases, net	$11,252,500
Operating expenses	$4,462,500

The current lesson was about the firm's "cash-to-cash" cycles. Calvin stressed that working through the difference between the cash-to-cash cycle for assets and the cycle for liabilities could help Sheryl understand the need for short-term borrowing. "We can only get so much credit from our suppliers," he reminded her. He gave her an outline of the process and its importance (Exhibit 3).

As he left for another road trip, Calvin smiled and reminded Sheryl that "every minute you spend with this finance stuff now is twenty minutes saved later on." He would be back on Friday afternoon, and they could talk about the firm's working capital then.

Exhibit 3. Memo Regarding Firm's Cash Cycle: 12/31/03.

Sheryl:

The usual thing to worry about is the difference between assets and liabilities. If assets convert to cash faster than liabilities, that's a good thing, but that's a very unusual situation. More often, your liabilities will be "due," essentially, before your receivables have come in fully. Cash sales, when they actually happen, will help shorten the asset cash-to-cash cycle and make your job easier -- we rarely have significant cash sales, as you've probably learned in the past few months.

To figure out how the assets and liabilities work together on this, you'll need to have some numbers in front of you. In particular, you'll want to know what our average daily sales and cost of goods sold are, and what our average purchases are. Finally, it would be useful to know our average daily operating expenses, too.

Once you have all of that stuff, convert the balance sheet into its daily equivalent. For example: part of the asset cash-to-cash cycle is the daily level of cash on hand. You can find this by dividing the cash amount on the balance sheet by the average daily sales figure to get "days cash." Accounts receivable is also directly related to our sales figures, but when looking at average inventory be sure to consider our daily COGS instead. On the other side of the balance sheet, payables are closely related to average daily purchases and accruals are related to operating expenses.

The asset cash-to-cash cycle is the combination of the "days cash," the similar measure for accounts receivable, and the inventory "days". This is roughly how long it takes us to convert a sale into cash, on average. For the liabilities, we look at "days payable" and "days accruals" as mentioned. These two numbers tell us how much we rely upon suppliers and employees for credit, and added together give us the number of days in the liability cash-to-cash cycle.

The difference between the total days in the asset cycle and the total days in the liability cycle is the number of days' worth of financing we'll need during the period. When used with our daily COGS number, it can tell us how much bank financing we might need during that time. If nothing else, it provides a rough estimate for using when we plan for a new year, and it helps us evaluate the rest of our working capital.

REQUIRED

1. Using the information in Exhibits 1 and 2, calculate McGhee's average daily sales, average daily cost of goods sold, average daily purchases, and average operating expenses. How much control does the firm have over each of these items?

2. Convert the asset portion of the firm's balance sheet in Exhibit 1 into its daily equivalent. How many days does the firm have in its asset "cash-to-cash" cycle?

3. Convert the short-term liabilities on the balance sheet into their daily equivalents. How many days are in McGhee's liability "cash-to-cash" cycle?

4. Using your answers from 2 and 3, above, determine the number of days that the firm may need to finance itself during the cash-to-cash cycle. How can this number be used to determine the amount of external financing necessary?

5. What types of external funding sources are appropriate for supporting a working capital deficit of the type that is described in Mr. McGhee's memo? Why are some sources more appropriate than others?

6. What are some ways that McGhee could make the asset cash-to-cash cycle shorter?

7. What are some ways that McGhee could make the liability cash-to-cash cycle longer?

8. What considerations would need to be made when changing the company's terms on receivables, and changing policies on other current assets or liabilities? What complications and/or difficulties has Mr. McGhee left out of his memo?