## Review Classmates: Module 2 Assignment

Review by July 27, 11:59 PM PDT

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Assignment Two



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Question 1

You are the CFO of a small manufacturing company, and you just figured out that your company will need to raise 30 million dollars to finance an expansion plan. The company will likely not need the 30 million now, but only in a few years as capital expenditure needs grow. You are considering two options. Option 1 is to wait until the future capital expenditure needs arise to borrow money. The second option is to borrow now, and retain the funds in the balance sheet. Discuss the trade-off that you would need to consider before making this decision (1 paragraph maximum).

First option of waiting has the advantage of deferring interest payments abut leaves the company open to the uncertainties of the future market environment (Market risk). Option 2 on the other hand, puts the cash safely in the coffers of the company which could be invested in the short term to match interest expense incurred. The funds becomes readily for the investment project of expansion in a few years irrespective of the uncertainties of market condition

See the Review Criteria section of the Instructions tab for details, then allocate points for Question #1 below.

* **10 pts - 10 points for a reasonable answer that is based on the arguments that we discussed in the lectures**
* 5 pts - 5 points for an incomplete answer or a correct answer that is too long (longer than 1 paragraph)

Question 2

Explain why an increase in accounts receivable is a short-term investment in the business. (1 paragraph maximum)

An increase in receivables is equated to increment in the demand for products although it ties up cash temporarily. it gives credence to the possibility of future conversion (in the short term) to cash given that the company undertakes stringent and innovative ways of collection

See the Review Criteria section of the Instructions tab for details, then allocate points for Question #2 below.

* **10 pts - 10 points for a reasonable answer that is based on the arguments that we discussed in the lectures**
* 5 pts - 5 points for an incomplete answer or a correct answer that is too long (longer than 1 paragraph)

Question 3

You are the CFO of a small retailing business that has strong seasonality in sales. Your business consistently generates negative cash flow in the first two quarters, though cash flow is positive if you consider the year as a whole (sales are strong in the third and fourth quarters). Which options does the CFO have to manage this company’s short term finances ? (2 paragraphs maximum)

As the CFO, I can negotiate for a credit line or a short term loan with the bank to make up for the shortfalls in the first two quarters paying specific attention to the upper limit of each quarter's deficit. i will also retain cash from operations to be ploughed back into the business in the first 2 quarters. alternatively, the retailing operations could be re adjusted to either extend timing on payables , reduce receivables collection period or outright sale of receivables.

See the Review Criteria section of the Instructions tab for details, then allocate points for Question #3 below.

* **10 pts - 10 points for a reasonable answer that is based on the arguments that we discussed in the lectures**
* 5 pts - 5 points for an incomplete answer or a correct answer that is too long (longer than 2 paragraph)

Question 4-A

You are the CFO of a medium-sized Agribusiness, and you have negotiated favorable terms to pay for supplies of seeds and equipment. Your suppliers allow you to pay for most these necessary inputs at the end of harvest, after you have sold your main crops. After harvest, your business needs to restock on seeds and equipment for next year’s harvest. As as a result of this business model, your Agribusiness carries a significant amount of accounts payable throughout the year.

Explain why this business model creates liquidity risk for the company. (1 paragraph maximum)

The question of liquidity risk pops up when the supplier demands payment of indebtedness and does not agree to new financing terms. when the supplier of the seeds and equipment reneges on the favorable terms negotiated (payments for the inputs at the end of the harverst) and demands instant payment for the supply of seeds and equipment for the next planting instead of extending new finance.

See the Review Criteria section of the Instructions tab for details, then allocate points for Question #4a below.

* **10 pts - 10 points for a reasonable answer that is based on the arguments that we discussed in the lectures**
* 5 pts - 5 points for an incomplete answer or a correct answer that is too long (longer than 2 paragraph)

Question 4-B

You are the CFO of a medium-sized Agribusiness, and you have negotiated favorable terms to pay for supplies of seeds and equipment. Your suppliers allow you to pay for most these necessary inputs at the end of harvest, after you have sold your main crops. After harvest, your business needs to restock on seeds and equipment for next year’s harvest. As a result of this business model, your Agribusiness carries a significant amount of accounts payable throughout the year.

Explain how you can use a bank credit line to help manage the liquidity risk that you identified in part a. (1 paragraph maximum)

the terms of a credit line with a bank is negotiated ahead of the time the load is needed with such details as the interest rate and credit limit drawn. the company could use its Assets, Inventory or receivables as collateral to guarantee financing of its seeds and equipment to facilitate operations. The Credit Line will operate as a credit card with a credit limit and an interest rate that is negotiated ahead of time hence the rates do not shoot up when the company is in liquidity crisis

See the Review Criteria section of the Instructions tab for details, then allocate points for Question #4b below.

* **10 pts - 10 points for a reasonable answer that is based on the arguments that we discussed in the lectures**
* 5 pts - 5 points for an incomplete answer or a correct answer that is too long (longer than 2 paragraph)

Question 5-A

You are the CFO of a company that is considering whether it is worthwhile to speed up the collection of accounts receivable to reduce the cash conversion cycle. This is the current situation in your company

* Expected annual sales = 1 billion
* 80% of these sales are received immediately, 20% after one year

You are considering whether it is worth to demand quicker payment from your costumers. You estimate that you can collect 90% of annual sales immediately if you lower prices by a certain amount. As a result of these discounts, your expected annual sales will decrease by 2%, to 980 million a year.

To solve this question, assume that there are no costs and no taxes. Thus, sales are equal to profits. In addition, there are no existing receivables to collect at the beginning of the first year.

In the current situation (80% collected immediately), what are the cash flows at the beginning and at the end of the first year?

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See the Review Criteria section of the Instructions tab for details, then allocate points for Question #5a below.

* **10 pts - 10 points for the correct cash flows**
* 5 pts - 5 points for an answer that is partially correct

Question 5-B

You are the CFO of a company that is considering whether it is worthwhile to speed up the collection of accounts receivable to reduce the cash conversion cycle. This is the current situation in your company

* Expected annual sales = 1 billion
* 80% of these sales are received immediately, 20% after one year

You are considering whether it is worth to demand quicker payment from your costumers. You estimate that you can collect 90% of annual sales immediately if you lower prices by a certain amount. As a result of these discounts, your expected annual sales will decrease by 2%, to 980 million a year.

To solve this question, assume that there are no costs and no taxes. Thus, sales are equal to profits. In addition, there are no existing receivables to collect at the beginning of the first year.

If you decide to implement the change (90% collected immediately), what are the cash flows at the beginning and at the end of the first year?

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| |  |  |  |  |  | | --- | --- | --- | --- | --- | |  | $millions | $millions | $millions |  | |  | 0 | 1 | 2 |  | | Opening Balance |  | 98 | 98 |  | | Cash Receipt | 882 | 882 | 882 |  | | Closing Balance | 882 | 980 | 980 | 2,842.00 | |

See the Review Criteria section of the Instructions tab for details, then allocate points for Question #5b below.

* **10 pts - 10 points for the correct cash flows**
* 5 pts - 5 points for an answer that is partially correct

Question 5-C

Now consider what happens in the folllowing year. To do so, assume that sales are expected to remain stable irrespective of which collection system you use. That is, sales are 1,000 a year in the current system and 980 a year in the new system.

At the end of the first year, you will collect receivables that were generated in the beginning of the first year, and make new sales for the second year. Notice that the beginning of the second year coincides with the end of the first year (think December 31 – January 1.)

Compute the cash flows for the second year in the two cases (80% and 90% collection systems).

|  |  |  |
| --- | --- | --- |
|  | $millions | $millions |
|  | 2 year | 2 year |
| Opening balance | 200.00 | 98 |
| Cash Receipt | 800.00 | 882 |
| Closing Balance | 1,000 | 980 |

See the Review Criteria section of the Instructions tab for details, then allocate points for Question #5c below.

* **10 pts - 10 points for the correct cash flows**
* 5 pts - 5 points for an answer that is partially correct

Question 5-D

What will happen at the end of the second year?

The original option brings in more funds $1,000 million at the end of the second year compared to $980 million when discount of 2% is applied

See the Review Criteria section of the Instructions tab for details, then allocate points for Question #5d below.

* **10 pts - 10 points for correctly explaining what happens at the end of the second year**
* 5 pts - 5 points for an answer that is partially correct

Question 5-E

Now you should be ready to discuss the trade-off that the CFO will face when making the decision to speed up collection or not. What do you gain if you make this decision? What do you lose?

Important note: To make a decision about the collection system we need the concept of Net Present Value (NPV). We will develop this concept in Module 3 and finish this problem after we have learned how to calculate and use NPV.

The trade off to this decision to speed up collection is between early cash collection and reduction in Revenues. By the application of the 2% discount, $20 million yearly is automatically forgone from Revenue signifying the cost of the transaction. on the other hand, application of the discount led to an early cash receipt of $882 million immediately and $980 million in the first year bringing total cash receipt at the end of both periods to $2,842 million. it is worthy of note that a discount factor should be applied on the receivables to actually ascertain its value.  
  
if the CFO is to maintain the status quo, total revenue remains at $1 billion each year but cash receipts delays to a total of $2,800 million as at the end of both first and second years. Less nominal cash is received in comparison but Revenue is intact.

See the Review Criteria section of the Instructions tab for details, then allocate points for Question #5e below.

* **10 pts - 10 points for a reasonable answer that correctly discusses the trade-off in light of the answers from a) to d)**
* 5 pts - 5 points for an incomplete answer, for example if either the benefit or the cost of changing the system is not well explained