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## Review Classmates: Module 2 Assignment

Review by July 27, 11:59 PM PDT

|  |  |
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Module 2 Peer Graded Assignment



by William Potter

Submitted on July 24, 2016

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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).

The options are to take a loan now and pay interest immediately but reduce the risk of not obtaining the at the future date when required.

Issues that may affect the availability at the future date include the financial situation in the industry, nationally and internationally and the level of interest rates. Consideration could be given to a line of credit whereby for a fee (a percentage of the line of credit arranged) without interest until the loan is drawn. Either way banks do not like surprises.

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)

Accounts receivable are a current asset and part of the working capital. They form part of the quick ratio (acid test) but not the cash ratio. Accounts receivable can be analysed into the number of days sales outstanding. Any increase in accounts receivable is a reduction in cash received from sales and has a negative impact on operating cash flow. As such it is a short term investment in the business.

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)

The starting point here is the cash balance carried forward from the previous year taking into account any minimum cash that the business requires. That may mean the business needs to arrange additional short term finance.  
  
Other sources of short term borrowing could be

* factoring
* extended terms from suppliers
* reduced terms to customers
* increased margins/reduced operating costs
* delayed capital expenditure
* credit line from the bank with the receivables as collateral.
* increase equity with a stock issue

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

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 current ratio may well not be a good indicator. To some extent the risk is reduced because payment to the seed supplier is not due until the crop is sold.The problem here is the accounts payable are now fixed. The crop is not. The liquidity risk associated with this business can arise from;

* a financial crisis suffered by the supplier requiring prompt payment
* a financial crisis for the Agribusiness such as a crop failure or an over-supply of the crop leading to falling prices
* any impediment to the business refinancing

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 5

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)

A line of credit with a bank involves an arrangement that, for a fee which is a percentage of the amount of the line, the business can draw on short term facility to finance any negative cash flows. In NZ you only pay interest on the amounts drawn. The bank can use the crop as collateral, however i suspect they will want more than just the crop. Any line should be arranged in advance. With sufficient borrowing available, there should be no problem paying short term liabilities as they fall due.

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 6

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?

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |
| No Discount |  |  | **Discount** |  |  |
|  |  |  |  |  |  |
| Year | 1 | 2 | Year | 1 | 2 |
|  |  |  |  |  |  |
| Accounts Receivable Previous Year | - | 200 | Accounts Receivable Previous Year | - | 98 |
|  |  |  |  |  |  |
| Sales | 1,000 | 1,000 | Sales | 980 | 980 |
|  |  |  |  |  |  |
| Collectibles |  |  | Collectibles |  |  |
| Current Year (80%) | 800 | 800 | Current Year (90%) | 882 | 882 |
|  |  |  |  |  |  |
| Previous Year | - | 200 | Previous Year | - | 98 |
|  |  |  |  |  |  |
| Total Collected | 800 | 1,000 | Total Collected | 882 | 980 |
|  |  |  |  |  |  |
| Cashflow | - 200 | - | Cashflow | - 98 | - |
|  |  |  |  |  |  |

From the above table for non-discounted sales there is no cash flow from the previous year and there is a negative cash flow of $0.2 billion in year 1

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 7

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?

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |
| No Discount |  |  | **Discount** |  |  |
|  |  |  |  |  |  |
| Year | 1 | 2 | Year | 1 | 2 |
|  |  |  |  |  |  |
| Accounts Receivable Previous Year | - | 200 | Accounts Receivable Previous Year | - | 98 |
|  |  |  |  |  |  |
| Sales | 1,000 | 1,000 | Sales | 980 | 980 |
|  |  |  |  |  |  |
| Collectibles |  |  | Collectibles |  |  |
| Current Year (80%) | 800 | 800 | Current Year (90%) | 882 | 882 |
|  |  |  |  |  |  |
| Previous Year | - | 200 | Previous Year | - | 98 |
|  |  |  |  |  |  |
| Total Collected | 800 | 1,000 | Total Collected | 882 | 980 |
|  |  |  |  |  |  |
| Cashflow | - 200 | - | Cashflow | - 98 | - |
| From the above table for the 2% discounted sales there is a negative cash flow in year 2 of $0.098 billion. |  |  |  |  |  |

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 8

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).

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |
| No Discount |  |  |  | **Discounted** |  |  |
|  |  |  |  |  |  |  |
| Year | 1 | 2 |  | Year | 1 | 2 |
|  |  |  |  |  |  |  |
| Accounts Receivable Previous Year | - | 200 |  | Accounts Receivable Previous Year | - | 98 |
|  |  |  |  |  |  |  |
| Sales | 1,000 | 1,000 |  | Sales | 980 | 980 |
|  |  |  |  |  |  |  |
| Collectibles |  |  |  | Collectibles |  |  |
| Current Year (80%) | 800 | 800 |  | Current Year (90%) | 882 | 882 |
|  |  |  |  |  |  |  |
| Previous Year | - | 200 |  | Previous Year | - | 98 |
|  |  |  |  |  |  |  |
| Total Collected | 800 | 1,000 |  | Total Collected | 882 | 980 |
|  |  |  |  |  |  |  |
| Cashflow | - 200 | - |  | Cashflow | - 98 | - |
| From the above 2 scenarios both have a neutral cashflow in year 2. However the cumulative effect is a negative $0.2 billion for the non-discounted sales and negative $0.098 billion for the discounted sales |  |  |  |  |  |  |

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 9

What will happen at the end of the second year?

While both scenarios are cash neutral in year 2, the cumulative effect is that no-discounted sales are negative by $0.2 billion. The discounted sales are negative by $0.098 billion over the 2 years

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 10

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.

In this case while the profit is down by 0.02 billion in the discounted scenario, the cash flow is better by $$0.12 billion.

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**

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