Sources of finance and working capital management finance essay

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In the financial context, the working capital management would include the management of debtors, creditors, stock, cash and bank account. This is a kind of short term financing as working capital management will cover current assets and current liability. It is one of the most important and time-consuming activities of the financial manager to ensure the solvency of the firm while attempting to maximize the firm's value, there is a constant need to balance profitability and risk.

Proper cash management plays an important part to meet permanent financing needs (pay creditors, pay taxes etc). few methods to ease the shortage of cash, such as postpone capital expenditure, negotiation with suppliers about the postpone or reduction of payment with extra caution as any in appropriate negotiation might hurt trading relationship.

Furthermore, business can pay the creditor within the discount period so as to pay less to the vendor to enjoy discount, this is a kind of short term financing as it lower down the working capital. No any cost is carried with such kind of financing; business can enjoy higher profit but bear lesser risk.

There are 3 basic financing strategies for working capital management to determine the appropriate mix of short-term and long term financing, which would consist of: the aggressive strategy, the conservative strategy and the moderate strategy.

The aggressive strategy uses short-term funds to finance all of the firm's seasonal and perhaps, a portion of its permanent needs, however, the cost and risk should be taken for consideration. Lower cost since short term financing cost is cheaper but higher risk as the net working capital is lowest.

This may have difficulty in obtaining long term fund in an emergency when more financing is required.

The conservative strategy uses long term fund to finance all of a firm's projected needs and uses short terms funds only in emergencies. Higher cost is incurred since long term financing is more expensive and not needed all year long but low risk since net working capital is high, in addition, short term financing may be readily available in emergency.

The moderate financing strategy is a compromise between the aggressive and conservative financing strategies. This result in a level of net working capital somewhat higher than that in aggressive strategy but lower than that of a conservative strategy.

Question 2

There are different kind of financing sources which business can gather for its needs. There are four major types of financing such as government aid, business owners, borrowing from the bank and other way of borrowing.

For short term financing, all kinds of business would like to borrow loan from the bank, industrial and financial institutions as HSBC (UK) help in promoting new companies, expanding and development of existing companies, providing underwriting facility, provision of local and foreign currency for the purchase of machinery.

Commercial paper can be another type of financing which is an unsecured promissory notes issued by very large firms such as HSBC, GM as commercial paper is usually sold at a discount from its face value.

Factoring and invoice discounting are the other 2 kinds of short term financing, which simply means that organisation get the advance cash by assign its debt or invoice to the factor, which normally can up to 80% of the value of debts or the amount of selected invoices.

Business can through various forms to obtain the medium and long term financing such as debt financing, equity financing and others various forms.

Debt financing is ideal for business as it is cheaper to use debt than other forms of financing because lender take lower risk than other long term contributors of capital, long term debts can be obtained through 2 ways: a term loan made by a financial institution such as HSBC which provides flexible business loan, repay over periods of 12 month to 15 years (10 years for fixed rate). The sale of bonds to institutional and individual investors, normally corporate bond are usually issued with maturities of between 5 to 30 years for raising large sum of money to meet its financing needs.

Medium and long term financing are obtained through equity financing such as capital market and Initial public offering (IPO), through borrowing and selling shares, company can get much more cash which can be used for further development and other business opportunities. In addition, Listed company can also raise capital through issue right share which is relatively cheap and normally large amount of capital often be raised.

Commercial mortgages offered by financial institutes would finance the business to buy freehold or long leasehold premise, for example: bank of Ireland offers flexible payment terms of up to 20 years with optimal

repayments throughout the period of the loan. This would ease the tense of business's medium and long term financing needs.

Finally, a debenture is a long-term debt instrument which companies to obtain funds. A debenture is usually unsecured in the sense that there are no liens or pledges on specific assets. It is however, secured by all properties not otherwise pledged. This would satisfy corporate medium and long term financing needs.

Question 3

Please refer to the appendix. (Excel format)

Question 4

There is different tax liability applied for sole traders, partners and limited companies. For the sole traders, if he/she has any income from self-employment, then he/she should pay any Income Tax and National Insurance contributions due. This will depend on how much you earn from self-employment as he may have to pay Class 2 and Class 4 National Insurance contributions.

Class 2 National Insurance contributions were charged at a flat rate, either by monthly Direct Debit or by quarterly bill. However, income Tax and Class 4 National Insurance contributions are based on sole trader's profits from self-employment. There is several allowances for personal to claim, such as personal allowance, blind person's allowance, married couple's allowance, maintenance payment relief, tax allowances and reliefs.

Similar to sole trader, partners have to file an individual Self Assessment tax return. Moreover, partners have to fill in the partnership supplementary pages – SA104.

In addition, the nominated partner must also file a Partnership Return – SA800 – showing each partner's share of the profits or losses. Supplementary pages might be included too, depending on what types of income the partnership has.

The nominated partner is responsible for filing the partnership return but all partners will be jointly liable for any penalties, surcharges and interest if the return is late or inaccurate.

Each partner is personally responsible for paying the tax and Class 4 National Insurance contributions due on their share of the partnership profits.

Now comes to companies. From 1 April 2010, the corporate tax will be 28%, the taxation changes can be found in the appendix such as small companies tax rate is 21%.

A non-resident company carrying on a trade in the UK through a permanent establishment located in the UK is liable to corporation tax on all income and gains attributable to that establishment.

Corporation tax rates are fixed for each financial year ended 31 March. If the company's accounting period does not coincide with the financial year, its profits must be time-apportioned and the corporation tax rate is applied accordingly.

Marginal relief applies to companies with profits between £300, 000 and £1, 500, 000.

The tax thresholds may be reduced where the UK Company has associated companies worldwide or an accounting period of less than 12 months.

Large companies (broadly, those with profits taxed at 28%) are required to pay their tax to HM Revenue (HMRC) in instalments (generally in four equal instalments). The first payment is due six months and 14 days from the first day of the accounting period. There is a minimum limit which enables companies with an annual corporation tax liability of £10, 000 or less to avoid making such payments.

For companies not required to pay their tax in instalments to HMRC, corporation tax is due for payment nine months and one day after the end of the company's accounting period

Question 5

In the new tax incentive scheme, all business are eligible for the PIC(Productivity and Innovation Credit) for the year of assessment 2011 to 2015 if company invest in any one of following:

Enhanced capital allowance or deduction for acquisition or leasing of prescribed automation equipment;

Enhanced deduction of qualifying training expenditure;

Enhanced writing-down allowance for acquisition of Intellectual Property Rights;

Enhanced deduction of costs for registering certain Intellectual Property Rights;

Enhanced deduction of qualifying research and development expenditure; and

Enhanced deduction of qualifying design expenditure.

Business can deduct up to 250% of their expenditure which incurred during these 5 years on each of these actitivities. Form the YA 2011 to 2012, a combined of 600, 000 dollars of expenditure of each activity and 300, 000 dollars of expenditure for YA 2013 to 2015 can be deducted from their income.

In addition, businesses are eligible to convert up to $300, 000 (but not less than $1, 500) of the qualifying deductions for all six qualifying activities under the PIC at a rate of 7% into a cash payout of up to $21, 000 each year. This new scheme will promote business to invest most on machinery and train their employees to meet one national goal- more productive and innovative for the nation, for the worldwide competitiveness.

For the new start up company, company can claim full tax exemption on the first 100, 000 dollars of normal chargeable income and 50% for the next 200, 000 dollars. This scheme will support local entrepreneurs and help local business grow as the starting of business is always difficult.

Other common expenses or tax incentive companies can enjoy are: business expense, capital allowance, industrial building allowances, land

intensification allowance, loss carry-back relief and unutilised losses, capital allowances and donations.

Question 6

Problem 2

500, 000= 100, 000+150, 000+250, 000

The payback period is 3 years.

Year

Cash Flow

PV of Cash Flow

Cumulative

0

-500, 000

-500, 000

-500, 000

1

100, 000

100, 000×0. 9009= 90090

-409910

2

150, 000

150, 000×0. 8116= 121, 740

-288170

3

250, 000

250, 000×0. 7312= 182, 800

-105, 370

4

300, 000

300, 000×0. 6587= 197, 610

PV= FVx(PVIFn, 11%)

The discounted payback period= 3+ 105, 370/197610= 3. 53years

Since 3 <3. 53, so the project should be accepted, it takes less time to get back the investment amount.

Problem 4

a)

Year

Cash Flow

PV of Cash Flow

0

-225, 000

-225000

1

75, 000

75, 000×0. 8547= 64, 102. 5

2

125, 000

125, 000×0. 7305= 91, 312. 5

3

200, 000

200, 000×0. 6244= 124, 880

(total)= 280, 295

PV= FVx(PVIFn, 17%)

NPV= 280, 295-225, 000= 55, 295

b) PI= 280, 295/225, 000= 1. 26

c) The project should be accepted as a profitability index greater than 1 and there is consistent with a positive net present value, 1. 26 indicates that company can earn the 17% of required rate of return, plus provide a net present value of $ 0. 26 per $1. 00 of net investment.

Problem 6

Year

Cash Flow

PV of Cash Flow

0

-875, 000

-875, 000

1

400, 000

400, 000×0. 8850= 354, 000

2

500, 000

500, 000×0. 7831= 391, 550

3

600, 000

600, 000×0. 6931= 415, 860

Total= 1, 161, 410

NPV= -875, 000+400, 000/(1+r)+500, 000/(1+r)2+600, 000/(1+r)3= 0

IRR= 30%

Beginning Value= 875, 000

Terminal Value= 354, 000+391, 550+600, 000= 1, 345, 550

So: MIRR= 24%

24%> 13% and 30%> 13%, so we should accept the project.

Question 7

There are several technique of financial appraisal, such as NPV, IRR, payback period, discounted payback period etc.

Both NPV and IRR generate same accept/reject decision at given cost of capital but may rank project differently due to underlying assumptions such as NPV assumes cash flow are reinvested at the cost of capital(k is from funding), IRR assumes cash flow are reinvested at the internal rate of return itself(k is for project), thus the magnitude and timing of cash flows will affect the ranking of the projects.

Theoretically, NPV is superiors than IRR as it assumes cash flow s are reinvested at the cost of capital which is more realistic than being able to reinvest at a higher rate(usually) in the IRR. Thus, NPV will be more effective to measure project prospect. There are a number of projects for which using IRR is not as effective as using NPV to discount cash flows. IRR's major limitation is also its greatest strength: it uses one single discount rate to evaluate every investment.

Practically, IRR is superior, as it is easier to understand, though more difficult to calculate as trial and error approach is used to find the IRR. The NPV method is inherently complex and requires assumptions at each stage – discount rate, likelihood of receiving the cash payment, etc. The IRR method simplifies projects to a single number that management can use to determine whether or not a project is economically viable. The result is simple, but for any project that is long-term, that has multiple cash flows at different discount rates, or that has uncertain cash flows – in fact, for almost any project at all – simple IRR isn't good for much more than presentation value, therefore, IRR is less effective than the NPV.

For payback period method, there are two main problems associated with it:

It ignores any benefits that occur after the payback period and, therefore, does not measure profitability and ignores the time value of money. Whereas for discounted payback period method, it considers the time value of money and the riskiness of the project's cash flows (through the cost of capital) but no concrete decision criteria that indicate whether the investment increases the firm's value and it requires an estimate of the cost of capital in order to

calculate the payback and ignores cash flows beyond the discounted payback period.

In general, each method has the certain extent of effectiveness on project prospect measurement.

Question 8

a)Current ratio = Current Assets/Current Liabilities

= 146, 438, 269/220, 500, 307

= 0. 664

A ratio of 0. 664 means that for every $1 owned by the firm, it has $0. 664 of current assets that can be converted into cash to meet these debt obligation, so company can not cover its debt now.

b) Quick ratio = (CurrentAssets-Inventory-Prepaid Expenses)/Current Liabilities

= (146, 438, 269-59, 716, 920)/ 220, 500, 307

= 0. 393

A ratio of 0. 393 means that each dollars of short-term debt is backed by $0. 393 of cash or near-cash assets.

c) Inventory Turnover= Cost of Goods sold/Ending Inventory

= 333, 027, 693/59, 716, 920

= 5. 577

A ratio of 5. 577 times means that during the year, on the average, the company sell its inventory 5. 577 times. Number of days it takes to sell its stock are 365/5. 577= 65. 4.

d) Profit Margin = Gross Profit/Net Sales

= 65, 423, 180/1, 254, 805, 671

= 0. 052

$1 net sales generate $0. 052 towards covering operating expenses and the excess contribute to net profit.

e) Return on assets = Net operating profit before interest/ending total assets

= (44, 815, 036+41, 737, 790)/1, 612, 578, 813

= 0. 054

Every $1 asset generates a profit of $0. 054.

f) Return on common stockholder's equity = net profit after tax/ending ordinary stockholders' equity

= 44, 815, 036/516, 770, 461

= 0. 087

It means that every $1 invested by the ordinary stockholder earns a net profit of $0. 087

g) Debt to total asset ratio = total liabilities/total asset

= 1, 095, 808, 352/1, 612, 578, 813

= 0. 680

It means that 68% of the total asset are finance by borrowing as the percentage of assets financed by creditors increases, the riskiness of the company increases.

h) Times interest earned = (Net profit before deducting interest&tax/interest expense

= (44, 815, 036+41, 737, 790)/ 41, 737, 790

= 2. 074

It means that recurring income is 2. 074 times of interest payment.

i) Asset Turnover = revenue/total asset

= 1, 254, 805, 671/1, 612, 578, 813

= 0. 778

This means that companies with low profit margins tend to have high asset turnover, it indicates pricing strategy. This ratio is more useful for growth companies to check if in fact they are growing revenue in proportion to sales by 0. 778 times.

(2497 words)