Finance and its importance in the business world

ASSIGN BUSTER

FINANCE FINANCE AND ITS IMPORTANCE IN THE BUSINESS WORLD SHIRLEY BONGBONG FOR ACADEMIA RESEARCH Discussion question Cash conversion cycle

a. Define the purpose of working capital. How does extending credit affect working capital requirements and the cash conversion period (cycle)

Working capital is the total amount of cash or ready convertible to cash assets available in a certain company to complete production without stoppage of work. It is a computed amount of cash available that will answer the cost of labor, short term liabilities of the company during its production until all accounts receivables were collected. It should meet the requirements of the business to run in a matter of months plus allowances for bad debts and delayed collections.

Extending credit is not a normal practice with small businesses at present or even big businesses because it will ultimately affect their revolving funds. Usually corporations only give 7 days credit term at most is 15 days credit term. If it will go more than that then they have to seek bank loans in order to provide buffer or answer the shortfall of cash for its operating cost.

A good simple example is this:

A lending company has available funds for $300. 00. The average amount borrowed in a month is usually $200. 00. If in case, one borrower name Sally cannot pay the amount of $100. 00, they still has a buffer left in the amount of $100. 00. In case the borrowings on that week go as high as $300. 00, then they are going to the bank to make a short term loan in lower interest rate. This thereby affects their income since the interests that they paid with the bank already eat up a portion of the income that they generate out of the transaction. Still they have to put up the funds, otherwise they cannot

maintain their line of borrowers. It is the idea of financing of contingencies and seasonal peaks in working capital.

b. What costs are associated with inventory Why is controlling turnover in the inventory important How can improvements in inventory management impact profitability

Inventory is the art of warehousing. It entails a list of the raw materials, equipment and parts, office supplies needed to run the business or production without faltering. The list is readily available at the stores section or at the warehouse for the requisition of other departments. The amount allocated for inventory should be in a matter of monthly with regards to office supplies, or quarterly with regards to raw materials or yearly when it comes to equipments. Inventory is not only mere listing of the materials needed to be stocked at the stores section. It should include in its calculations the location of the suppliers and the leadtime that it will take to place an order and get it. Other factors like the production schedule and the nature of the raw materials shall be taken into consideration also. Like the perishable products and its handling, this will prove costly in maintaining such inventory of goods or raw materials. What is important is that we have to adhere to the availability of the materials, continuity of supply and current prospective sources. We don't maintain only one for it will prove detrimental to the costing and availability of the materials. If there is too much inventory, we are going to lessen our working capital also. The large part of it goes to the inventory which has a great impact in our income equation. The required raw materials and supplies must be listed down and the basis of their selection must be carefully evaluated. Descriptions and specifications on their physical, mechanical and chemical properties must be taken into

consideration. A clear analysis of the volume required at various phases of the operations must be clearly defined and presented.

The cost accounting that is being used in inventories is the LIFO method or the FIFO method. This shall come in terms with the factors of determining the cost of goods that was entered into the production process. In production cycle and processes PERT /CPM is normally used to detail leadtimes and processing time in each cycle which is very important with a company inventory strategy. Inventory must be maintained in a minimal value for it will weigh down profitability of a company.

c. How can management practices speed the collection of receivables Which management practices tend to slow the collection of receivables

Management can speed the collection of receivables if they only maintain the creditors that are paying in time. Payment term extensions must not be allowed in customers who neglect their payment obligations. Another practice that can speed up collection is the giving of discounts for those who can pay as early as three days term or cash. A lot of companies can save on this method so they prefer to pay on time and use the discounts.

Management tends to slow the collection of receivables if they will just wait on their chairs and never get out of the office to collect. They should assign a collector to run their collections. Payment method shall be made available and easy for them too like the low fees on wire transfers for international transactions, waiver of bank charges for interbank or interbranch deposits, payment thru website and a lot other that technology has to offer to elevate the risk in carrying cash on collections errands.

Discussion 2

Study the WACC, build up method and cost of capital in the Course Materials

Newsgroup. Then discuss your opinion of the strengths and weakness of each method in determining cost of capital which is the threshold rate of return for choosing capital investments.

WACC is the weighted average cost of capital. WACC is the average of the costs of the company's assets financed by debt or equity. By taking its average a company can determine the interest for each dollar it finances thus can make a very reliable forecast material for the feasibility of expansion and mergers. Here one will clearly see if intended investments or projects or simply purchases are worth the risk that it takes. In discounted cash flow analysis, it is being used as the discount rate applied to future cash flows in order to derive the net present value. However WACC presents the minimum rate of return for its investors. A very simple example of its computation is tabulated below:

Capital Component

Cost

Times

% of capital structure

Total

Retained Earnings

10%

X

25%

2. 50%

Common Stocks

11%

X

10%

1. 10%

Preferred Stocks

9%

X

15%

1. 35%

Bonds

6%

X

50%

3. 00%

TOTAL

7. 95%

So the WACC of this company is 7. 95%. 1

Valuation is not dependent on the debt equity ratio. Tax deduction on interest is allowed. This is difficult to calculate but a solid way of measuring investment opportunities.

Cost of capital is the weighted sum of the cost of equity and cost of debt. Tax advantages on debt issuances make it cheaper to issue debts rather than new equity. Sometimes the cost of issuing debts is higher than the cost of issuing new equity which increases the interest rate that the company must pay to borrow money. Cost of capital determines how to raise money by use of stock issue and borrowing. Cost of capital must be minimized to attain the maximum value of the firm. Failing to adjust differences in risk leads a firm to accept high risk projects and reject low risk ventures. 2

The most common method used by investors is the build up method that gets to assume smaller risk in your investments portfolio and obtain the ROI you expect to get. There are only three elements that get to consider in this method: forecast of expected future benefits, determination of terminal value and the selection of appropriate discount rate. This is the easiest method among the three.

References:

The cost of capital,

McCracken, M. E. (2005). The cost of capital. Retrieved July 16, 2005