

# Clarkson case

Business



Lumber borrowed increasing amounts despite its consistent profitability?

Why there seems to be difference between profits and cash flows? Prepare a cash flow statement for the years 1994 and 1995. Also prepare a combined cash flow statement for these two years. Ans: Pls refer to TN-E of attached excel sheet for cash flow statement combined for 1994 & 1995. Clarkson Lumber was forced to borrow increasing amounts from Bank due to following reasons. Low Operating cash in hand (77) didn't allow company to claim trade discount of 2% from suppliers.

Supplier's reluctance to supply merchandise on account which is evident from decrease in accounts payable. Buyback of equity from Mr. Holtz (\$200,000) causing additional strain on cash flows. 30 Days credit terms to Customers and delay in collection (AIR) lead to build up of accounts receivable, resulting in cash flow problems. Ineffective management of inventory which lead to build up of inventory over the years.

Q2. Compute and analyze collection period, receivables as percentage of sales and inventory turnover ratios for 1993, 1994 and 1995. How have they affected the cash flow situation?

Ans: Refer to TN-C of attached spread sheet for details of collection period, receivable percentage and inventory turnover ratios. Collection period: Increased from 38 days in 1993 to 49 days in first quarter of 1996. Its evident that money had been locked for longer duration with customers causing serious cash flow problems.

Receivables as % of sales: Jumped from 10.48% in 1993 to 13.7% in 1996. This clearly shows that funds locked with customers had increased

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considerably resulting in cash flow issues. Inventory turnover ratio:  
Decreased from 6.

6 in 1993 to 5.4 in 1996.

This shows that average inventory had increased with ref to sales over this period confirming inventory buildup. Same can also be reconfirmed by number of days in inventory which went up from 56 to 69 for the same period. As a result, Clarkson facing serious cash flow issues to sustain growth in sales. Q3.

Do all companies face the problem of cash flow or liquidity shortage with expanding sales? Can you think of companies or industries, which may in fact have surplus of cash while their revenues are expanding? Which factors in your judgment are most significant in understanding relationship between financing needs and sales expansion?

Ans: Not all companies face liquidity shortage while expanding sales. Major players in IT and computer manufacturing industries are sitting on surplus cash while handling expansion very efficiently thru various business models. Companies like Apple, Samsung, Microsoft, Dell, Intosys etc are having surplus cash while expanding sales every year. The most significant factors in maintaining positive cash flow and surplus cash are Paying less or no dividend to share holders. Innovation of new products to keep improving market share. Low accounts receivables High accounts payable ( Growth sponsored by suppliers)

High inventory turnover ratio / Low number of days of inventory. Manage costs / expenditure more efficiently. Relocating manufacturing units to countries where manufacturing costs and taxes are low.

Q4. How has Mr. Clarkson met the financing needs of the company during the period 1993 through 1995? Has financial strength of Clarkson Lumber improved or deteriorated? Compute debt ratio, times interest earned, current ratio and any other ratio to provide evidence for your position. Ans: Mr. Clarkson managed finances during 1993 – 95 in the following manner.

A loan of \$399, 000 from Suburban national bank.

A term loan of \$140, 000 taken in 1993. Initial contribution of 200, 000 from Mr. Holtz. Delaying payments to suppliers.

A term loan of 140, 000 Refer to spread sheet TN-C for computation of various ratios. As we can see from spread sheet, financial strength of Company had deteriorated over years due to high growth rate of the company and losing equity partner Mr. Holtz which lead to excessive borrowing. This is evident from Debt ratio, which increased from 45% to 73% and current ratio decreased from 2. 5 to 1.

2. Q5. Compute sustainable growth rate based on the following assumptions:  
a. No change in ratio of sales to assets? No change in total liabilities to owners' equities  
c. No new equity will be issued  
d. No dividend payout policy to be continued  
e.

ROE will be maintained at 20% based on beginning equity Ans: Refer to TN-F of spread sheet for growth rate computations. Q6. How attractive is it to take  
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trade discount or to give trade credit? What are the opportunity cost of these for Mr. Clarkson based on the data provided in the case? Ans: Refer to TN-H of spread sheet for calculations. Opportunity cost of availing trade discount is \$47, 800.

Q7. How much capital will he need to finance the expected sales of \$5. million in 996 and to take all trade discount from April 1 to December 31, 1996? You can assume the following in preparing projected financial statements- -balance sheet, income statement and cash flow statement.. You are provided an excel spreadsheet which should be used to prepare these financial statements and to calculate other financial data relevant for your analysis.

(6 Points) Ans: Refer to TN-A, B ; E of spread sheet. Apart from owner equity Of \$454, 000, an additional capital of \$966, 000 required (Assuming Clarkson would clear outstanding loans of 399, 000 to Subarban National bank and \$100, 000 to Mr.

Holtz on receiving additional capital) to meet projected sales of 5. 5 million for 1996. Q8.

Do you agree with Mr. Clarkson's estimate of loan requirements? As Mr. Clarkson's advisor, would you urge him to go ahead with, or to reconsider, plans for sales expansion and additional debt financing? As his banker, would you approve Mr. Clarkson's loan request, and, if so, what conditions would you put on the loan? Why do banks impose such conditions? Discuss some of the options and their implications for future of Mr. Clarkson's business.

(8 Points) A) As Advisor to Mr. Clarkson,

Will advise to reconsider Sales Target in line with sustainable growth rate.

Will Advise to limit growth to 17% which could be funded by business

(Sustainable Growth Rate) Reduce overheads and expenses. To look for an equity partner (s) who are willing to invest in his business or negotiate with Mr. Holtz to Join back as business partner. Improve Cash flow thru Better Working capital Management.

Increasing Accounts payables days. Offering Cash Discount to Debtor to bring in control on Debtors receivables. ( Ideally Discount should be lesser than what Mr. Clarkson gets on Accounts Payable “ 2%) In ase Mr.

Clarkson is adamant on his target for 5. 5 Mn\$, then would request Mr.

Clarkson To avail loan of \$750, 000 ( Maximum borrowing available from Banks) Further \$216, 000 thru personal source thru Mortgaging of House. B)

As a Banker to Mr. Clarkson, Would not approve Mr. Clarkson request

Conditions as per banks standard norms. Cap on withdrawal of fund Cap of Borrowing of limit (\$750, 000) Net working Capital to be maintained as per bank norms.

Current Ratio to be maintained as per bank norms. Current ; Future Fixed asset and Current asset are mortgaged with Banker. C) Bankers Impose condition

Bankers take risk of providing additional funding based on Estimation, These conditions are imposed to keep a check for any direct / indirect deviation on these estimations. To give a framework within which company needs to

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achieve its Target. To give guidance in terms minimum financial deliverable based on projection.

To set Limitation as to ensure there no unduly deviation on Estimation. To device control mechanism ensuring no breach of covenant happening and fund are utilized for the purpose it was meant for. D) Some of the option ; Implication of Future of Mr. Clarksons Business.

Capping withdrawal of Fund: – Implication would be Mr. Clarkson would not have been able to pay for Mr.

Holtz share from accrual of business. In Future, Mr. Clarkson would be able to withdraw fund to an extent which could have an impact on business as per Bankers estimation. Capping on Borrowing of Fund: – Implication would be, Mr. Clarkson would not have been able to pay for Mr.

Holtz share from Banks Borrowing on company balance sheet.. In Future, Mr. Clarkson would be able to borrow fund beyond stipulated norm which could have an impact on business as per Bankers estimation. Capping Debt to Equity :- Would have pushed

Mr. Clarkson to raise Debt within given Cap area, Would be forced to stick to estimation given to Bankers.

Q9. What are the challenges in interpreting financial statements of a sole proprietorship? (2 Points) Difficult to follow “ Entity concept” of accounting. Cash from business might be used for personnel use. Credibility of record keeping and financial statements. In sole proprietorship firms, books are maintained by less qualified persons. Owner makes final decisions in making <https://assignbuster.com/clarkson-case/>

financial statements and same can be adjusted / fabricated to meet requirements of firm in saving tax, securing loan from banks etc.