

Butler lumber essay



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Butler Lumber Case Study I. Statement of Financial Problem Butler Lumber Company, a growing profitable business has exhausted its credit limit and the key issues facing it are: 1. Need for additional funds to continue the growth 2. Need to consolidate debt 3. Need to improve cash flexibility. In this case study I will be discussing following problem: Why has Butler Lumber been profitable in the increasing volume of sales but at the same time it is experiencing cash difficulties in 1988 – 1990?

This is a historical problem and my calculations and assumptions are based on income statement and balance sheet for 1988 – 1990. II. General Framework for Financial Analyses There are different financial ratios and questions they answer:

- Liquidity ratio – current ratio: Will Butler Lumber be able to pay off his debts as they come due? Satisfactory liquidity ratio is necessary if Butler Lumber is to continue its operations.
- Asset management ratio: Does Butler Lumber have the appropriate amount of assets versus sales? How effectively is Butler Lumber managing its assets?
- Debt management ration: Does Butler Lumber have the right mix of debt and equity?
- Profitability Ratios: Are sales high enough? Do sales exceed the unit cost? It is necessary to calculate different types of financial ratios to examine different aspects of Butler Lumber’s operations. Key accounts for sources of funds for Butler Lumber Company are: retained earnings from previous years, cash accounts, accounts receivables and borrowing funds from bank Uses of funds are: accounts payables, inventory, fixed asset accounts, buyout of Mr. Stark, long term and short term debt.

III.

Applying of the financial framework Before identifying the reasons in increasing/decreasing in sources/funds of cash, I have calculated following

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financial ratios to help understand the trends over the years of 1988 - 1990. The financial ratios are summarized in Exhibit # 1. Current Ratio is significantly decreasing 1988 - 1.8, 1989 - 1.59 and 1990 - 1.45. This indicates that the current liabilities are increasing much faster than current assets and it should be the first indicator of possible financial problems. Current assets include cash, inventory and accounts receivable.

Butler Lumber's current liabilities consist of notes payable, accounts payable, accrued expenses and current portion of long term debt. All of these are due within one year. Butler Lumber was paying the accounts payable more slowly and started to borrow more money from the bank. Inventory turnover ratio, part of asset management ratios, shows how many times is inventory "turned over" during the year. The numbers are: 1988 - 7.1, 1989 - 6.17, 1990 - 6.4. The volume of inventory assets seems to be consistent with the increasing volume of sales. Total asset turnover ratio for 1988 - 2.86, 1989 - 2.74, 1990 - 2.9. To improve the operations, inventories should be reduced and receivables collected faster. Another indicator is debt ratio 1988 - 58.7%, 1989 - 58.7% and 1999 - 62.70%. This means that the creditor supplied more than half of its total funds and this number keeps increasing. The debt ratio is very high and this will make relatively costly for Butler Lumber to borrow additional funds without raising more assets first. Debt ratio can be used to determine the overall of financial risk. The greater the amount of debt, the greater the financial risk to bankruptcy. Profit margin is decreasing : 1988 - 1.8%, 1989 - 1.%, 1990 - 1.8%. This trend could be caused by two reasons: first, Butler Lumber has a high operating cost or second, Butler's high use of debt - higher interest

expenses. We can see an increase in total of working capital for 1988 - \$208, 1989 - \$221 and 1990 - \$241. Also there has been even greater increase in non-financial working capital for 1988 - \$262, 1989 - \$326 and 1990 - \$440. Increase in non-financial working capital is almost doubled in comparison to working capital. Nonfinancial working capital represents notes payable, accounts payable and accrued expenses subtracted from accounts receivable and inventory.

After examining Exhibit # 2 we can identify following sources and uses of funds: Sources of funds are: Uses of funds are: - Retained earnings- Increase in A/R - Decrease in cash accounts - Increase in inventory - Increase in A/P- Increase in fixed asset accounts - Increase in accrued expenses - Buyout of Mr. Stark - borrowing from bank. - Decrease in long term debt. If A/P increases from one year to the next, that means that the difference between the two amounts is cash that was available for current use. That is, instead of paying cash, whatever was purchased was put on an account.

On the other hand, A/R is considered a use of cash because for every dollar that should be coming in to the company from those who owe the company money, that cash has been delayed for a collection time period. Therefore, the company does not have the money to use for its own operations. IV. Assumptions Assumptions in developing a funds flow statements as (shown in exhibit # 2) are that data presented in the case are accurate. Butler Lumber is dealing with changes in business risk. Increasing the internal financial risk by borrowing more money from the bank, Butler Lumber is also increasing total risk of the company.

Conclusions and Recommendations Mr. Butler bought out his equity partner Mr. Stark in order to incorporate the business. However, Mr. Butler became partner with the bank and had to take out long term secure loan. As his business was booming, Mr. Butler kept increasing his debt at a faster pace than increasing his sales. I would recommend to Mr. Butler to take advantage of the extended line of credit from Northrop National Bank. In order to be able to pay out the loan he would have to increase the amount of sales, decrease the operating expenses and decrease the amount of inventories.

Butler should also hire commission based sales representative in order to expand the business to the other parts of the large city where his business is located. The increase in sales should out-grow the cost of additional employee. Even in the case of an economic downturn his business would be protected because 55% of its sales are from the repair market and that's what his sales team should focus on. The company is growing at a good pace of 19%, 34% and 34% for the year 1989, 1990 and forecasting for 1991 respectively. On the other hand, Butler should not take out more loan than needed for second and third quarters of 1991.

Mr. Butler should use part of the loan to decrease his accounts payable and notes payable. Butler should take advantage of the 2% discount on purchases from his suppliers and make payments within 10 business days from the invoice date. This would decrease company's financial risks. It seems to me that Mr. Butler wants to control the entire business on his own which may lead to inefficient management. Let's hope that Mr. Butler will continue to pursue the growth strategy in the best interest of his company.

Butler Lumber Case Study , exhibit # 1 Financial Ratios 1988 -1990 | 1988 | 1989 | 1990 | | Working capital |\$208 |\$221 |\$241 | | Nonfinancial working capital |\$262 |\$326 |\$440 | | Financial Ratios | | | | | Cash/sales | 3. % | 2. 0% | 1. 5% | | AR/sales | 10. 1% | 11. 0% | 11. 8% | | Net property/sales | 7. 4% | 7. 0% | 5. 8% | | Accrued exp/sales | 1. 4% | 1. 5% | 1. 4% | | Profit Margin | 1. 0% | 1. 70% | 1. 60% | | Current Ratio - Liquidity | 1. 8 | 1. 59 | 1. 45 | | Inventory turnover ratio | 7. 1 | 6. 17 | 6. 4 | | Debt ratio | 54% | 58. 70% | 62. 70% | | Total assets turnover ratio | 2. 86 | 2. 4 | 2. 89 | Butler Lumber Case Study , exhibit # 2 Sources and Uses of funds, 1988 - 1990 (thousands of dollars) | | 1988 - 1989 | 1989-1990 | 1988 -1990 | | Sources of Funds: | | | | | Retained Earnings |\$34 |\$44 |\$78 | 16. 0% | | Decrease in Cash Account |\$10 |\$7 |\$17 | 3. 60% | |*Increase in Accounts Payables | \$68 |\$64 |\$132 | 27. 80% | | Increase in Accrued Expenses |\$6 |\$9 |\$15 | 3. 20% | | Bank Borrowing |\$146 |\$87 |\$233 | 49. 0% | | Total Sources |\$264 | \$211 |\$475 |\$100 | | | | | | | Uses of Funds: | | | | | Increase in Accounts Receivable |\$51 |\$95 |\$146 | 30. 0% | | Increase in Inventory |\$87 | \$92 |\$179 | 37. 70% | | Increase in Fixed Asset Account |\$14 |\$17 |\$31 | 6. 50% | | Buyout of Mr. Stark |\$105 |\$0. 00 |\$105 | 22. 10% | | Decrease in Long Term Debt |\$7 |\$7 |\$14 | 2. 90% | | Total Uses |\$264 |\$211 |\$475 | 100% | * | Increase in assets - Use of funds | | Increase in liabilities - Source of funds | | Decrease in assets - Source of funds | | Decrease in liabilities - Use of funds |