

clarkson lumber company essay sample

[Finance](#)



1. Identify the key problem in the case and explaining why it is the key problem. Clarkson Lumber Company's biggest problem by far is the fact that Mr. Clarkson had agreed to buy out Mr. Holtz for \$200, 000 with semi-annual installments of \$50, 000. It wasn't necessarily a bad idea for Mr. Clarkson to buy out Mr. Holtz altogether, but the \$100, 000/year of payments is an unrealistic amount for Clarkson Lumber at this point in time. Between 1993 and 1995, there hasn't been a year where they have realized more than \$77, 000 in net income, so the payment of \$100, 000/year is clearly unrealistic and a sure problem for the company. Another problem, which isn't nearly as important as the former, is that net income is growing at a slower rate than sales are between 1993-1995. Sales grew 19% and 29% in 1994 and 1995, respectively, while net income grew just 13% in both years. This is important because the company can't use intercompany funds to finance its projected sales growth.

2. Why has Clarkson Lumber borrowed increasing amounts despite its consistent profitability? Clarkson Lumber is borrowing at increasing amounts because the company's sales are growing at a rate that can't be financed from intercompany funds. The company's sales have grown 19% and 29% in 1994 and 1995, respectively, which have consequently caused an increase in the company's spontaneous assets as well as their net property. Their net property has grown 12% and 48% in 1994 and 1995, respectively, and we can expect that it will grow at 30% in 1996. Furthermore, their accounts receivables and inventories have been growing at an average rate of 41% and 32%, respectively. These increases in spontaneous assets and property

need to be financed in some way, most likely through spontaneous liabilities and long/short-term debt.

3. How has Mr. Clarkson met the financing needs of the company during the period 1993 through 1995? Has the financial strength of Clarkson Lumber improved or deteriorated? Thus far, Mr. Clarkson has been meeting the financial needs of the company through the term loan from Suburban bank. This bank loan helped finance the increase in property and other related assets. The spontaneous assets that were increased as a result of an increase in sales were financed by an increase in spontaneous liabilities. Spontaneous liabilities have grown by 35%, which supports the claim that they finance the increase in accounts receivable and inventories. In the period between 1993-1995, the financial strength of Clarkson Lumber has deteriorated significantly. As seen from the financial ratios excel spreadsheet attached, the current and quick ratios have been gone down substantially.

This means that the company's ability to meet its short term obligations has deteriorated. Furthermore, the return on sales and return on assets have also gone down, which means that their increase in net income has not stayed consistent with the increase in sales and increase in assets to finance these sales. Their falling inventory turnover ratio means that even though their sales are increasing, they are not moving inventory at the same pace they had before. Their low accounts receivable turnover ratio and high sales outstanding indicates that there's a large amount of money tied in this account.

4. How attractive is it to take the trade discounts? Trade discounts are very beneficial to a company, especially when these trades are of significant amounts. In the case of Clarkson Lumber, they can save 2% on a payment that is made within 10 days, which would save them approximately \$69, 000 as reflected on the pro forma income statement for 1996. This is calculated by taking the total amount of purchases made in 1996 and backing out the purchases already made through quarter one of the year. Multiplying this value by 2% saves Clarkson Lumber \$69, 200. This is a substantial amount of money for Clarkson Lumber because it makes up a significant portion of their net income for 1996.

5. Do you agree with Mr. Clarkson's estimate of the company's loan requirements? How much will he need to finance the expected expansion in sales to \$5. 5 million in 1996, and to take all trade discounts? My pro forma balance sheet and income statement can be found attached to this document. Based on this analysis, I found that Mr. Clarkson had overestimated the company's loan requirements for 1996 to finance the expected expansion. This is likely because Mr. Clarkson had not anticipated to take advantage of the trade discounts offered by their suppliers. If they take into consideration these discounts among other projections reflected in my pro forma statements, its reasonable to conclude that the company will only need to borrow approximately \$676, 000 from Northrup National Bank. This is assuming that they have not yet made payments to the debt owed to Suburban Bank. Because we didn't know the loan terms with Suburban, I couldn't determine what portion of that debt is paid off during the year 1996.

6. As Mr. Clarkson's financial adviser, would you urge him to go ahead with, or to reconsider, his anticipated expansion and his plans for additional debt financing? As Mr. Clarkson's financial advisor, I would recommend that he doesn't take the loan and look for other ways in which to finance his anticipated expansion. As seen by the debt to equity ratios in my attached spreadsheets, his debt ratio has gone up significantly in the last 3 years. In 1993 he had a debt to equity ratio of just 31.75% and then increased this to an astounding 164.14% in 1995. This is a very dangerous situation for Clarkson Lumber Company because an increased debt to equity ratio increases the riskiness of the company especially if they don't reach their anticipated sales numbers. If I were Mr. Clarkson, I would recommend that he decrease his expectations for what he is to expect in 1996. The industry that he is in is very risky and as a result, his sales expectations could very well be overprojected. If this were the case, Clarkson Lumber Company would suffer a great deal of risk from their ridiculously large outstanding debt numbers. This is especially true because an overprojection of sales numbers would substantially decrease net income as well, which could potentially bankrupt the company if they can't meet their obligations.

7. What do you think Mr. Dodge should do and why do you think so. If you were the banker, would you approve Mr. Clarkson's loan request, and if so, what conditions would you put on the loan? If I were Mr. Dodge, I would decline to offer Clarkson Lumber company an outstanding credit of \$750,000 just because of their financial ratios in the last three years. Clearly, the company has been deteriorating in the last three years and the company's risk has gone up significantly. I would hesitate to allow Mr. Clarkson to take

up an additional \$750, 000 in debt. Instead, I would suggest that Mr. Dodge offer Mr. Clarkson an outstanding credit of between \$300, 000-\$500, 000. This would decrease Mr. Clarkson's hopes of his significant expansion and decrease the risk of him not reaching his anticipated sales numbers. However, if Mr. Clarkson agreed to put up his financial assets (his house, life insurance policy, and his wife's house) as collateral for the loan, I would agree to give him a credit of \$750, 000.

Although the company's financial ratios have been deteriorating over the years, the company has still been able grow their sales numbers substantially. If Mr. Clarkson were to take the trade discounts, their net income would increase by a large amount to \$120, 000. Consequently, they can use this amount to pay off their debt and finance further expansions. Besides, Mr. Clarkson has very strong reviews and recommendations from his business partners and has a great outstanding relationship with Suburban Bank in his abilities to meet his obligations with the bank. Mr. Dodge also needs to consider the fact that after 1996, the company will have completely bought out Henry Holtz, which is a massive financial burden that is finally off of their shoulders.