MANUKAU INSTITUTE OF TECHNOLOGY
MANUKAU BUSINESS SCHOOL

BACHELOR OF BUSINESS
311.718 FINANCIAL MANAGEMENT 2

SEMESTER 1, 2007

ASSESSMENT 2

CASE STUDY ASSIGNMENT
WORKING CAPITAL POLICY AND FINANCING

Assessment 2 for 311.718 Financial Management 2 comprises a case study – Hanson Publishing Company. This Case Study is based on the Objectives of Topic 8.0 Working Capital Management (P&N Chs 14-15). It incorporates a number of aspects relevant to the course overall, such as financial arithmetic, cost of capital, strategic financing decisions and risk management. Topic 8.0 will not be covered in classes.

You are required to submit a report addressing the issues raised in the case. Your written submission, including spreadsheets (if any), must be your own original work and should be properly referenced, using the "APA Referencing and Citation Guide" available from the Library (see ***eMIT*** external links), where appropriate. Copied work will earn zero mark – see latest MBS student handbook. You are also required to submit a signed 'assignment cover sheet' appended with this case.

Your submission will be marked out of 100 and weighted to 20% of your Final Mark. Answers to each question should be written in a way to allow easy reading and understanding and should be written in business style. Support you answers with the necessary tables and numbers.

You may submit your written report at any time before **3.00 pm on Monday 7 May 2007**. All submissions must be placed in the assignment box of ***Suresh Ramachandra*** on the **3rd Floor of NR Block** before the deadline. **Late assignments and copied work will not be marked and will automatically earn zero** (see Regulations, Section 3.0 of the Course Outline).

HANSON PUBLISHING COMPANY

Lisa Pinto, the managing director of Hanson Publishing Company, a rapidly growing publisher of tertiary textbooks, is concerned about the firm's heavy reliance on its overdraft facility. She feels that the firm can improve the management of its working capital and, as a result, reduce its heavy reliance on overdraft. At the recent monthly meeting she voiced her concerns and charged Arlene Bessenoff, the production executive, and Alan Fisher, the executive in charge of distribution, with assessing the firm's working capital efficiency. In particular Lisa was worried about the increased incidence of bad debts (currently at 5% of gross sales) with some lesser known book sellers. She also requested both Alan and Arlene to suggest a clear policy that would allow increased scrutiny for fresh credit applications. Arlene and Alan are required to submit a report addressing these concerns and recommending solutions at the next monthly meeting.

Immediately after the meeting, Alan and Arlene set out to discuss the options for solving the company's working capital problem. The following options were considered.

1) Refuse credit with immediate effect and to deal only on cash on delivery (COD) basis. Arlene argued that this will totally eliminate the incidence of bad debts which is currently 5% of gross sales. Alan was not happy with this option as he felt that such refusal will affect nearly half his client base. Small book sellers typically rely on trade credit and in its absence they may stop trading with Hanson Publishing Company altogether. Alan estimated that the company's turnover would reduce by 40% if such a policy is adopted.

2) Offer a 2% cash discount for payment within 10 days of the beginning of the credit period while strictly enforcing a 30-day credit limit. Alan was in agreement with this suggestion but differed on two accounts. He argued that the discount offered is insufficient to motivate debtors to pay early and considered the credit period of 30 days to be unrealistic, especially where the industry norm is 42 days. In his opinion a 5% discount for payment within 10 days and a credit period inline with the industry practice would be acceptable to majority of his customers. He estimated that if only a 30-day credit period is offered, the sales would reduce by 20% of the current level

and if the credit period is set at 42 days the drop in sales will only be by 10%. He also estimated that additional enforcement and monitoring costs would be needed for both options amounting to $48,000 per annum. On the positive side he believes that both options would reduce the incidence of bad debts from its current level of 5% to 2% of the gross sales.

3) Establish a credit control department with the specific task of tracking every sale and to report on the progress of collections. Arlene reckoned that debtors are slow in paying due to inaccurate and insufficient information given to them and an efficient accounting system, if put in place, will solve the problem. To this end Arlene suggested that the firm should provide clear guidelines to the accounts clerk who handles credit control. This employee will also be responsible for enforcing credit limits suggested under option (2) above.

4) Introduce stringent measures at the time of evaluating the credit worthiness of clients. The current practice which relies on recommendations by established clients has proven to be inefficient as most small retailers go out of business within a short period of time leaving huge unpaid debts. He suggested that the firm should come up with a new set of criteria to evaluate potential clients seeking credit.

Arlene and Alan wanted to explore the financial and operational viability of all the above options independently and to recommend a suitable strategy for the firm. As the duo had little financial training, they have enlisted your assistance in the preparation of the report.

Arlene has made available to you the following information collected from un audited company records and trade journals.

Hanson Publishing Company – un audited financial statements

Income Statement for the year ending 31 December	**2006**
Revenue	**$**
Sales	1,892,400
Other Income	7,276
Total Revenue	**1,899,676**
Cost of Goods Sold	-1,320,000
Gross Profit	**579,676**
Expenses	
Amortisation	240,200
Audit Fee	11,500
Depreciation	70,900
Directors Fees	12,500
Interest	21,600
Other Expenses	130,400
Total Expenses	**487,100**
Net Income before Taxation	92,576
Taxation	
Net Income after Taxation	**92,576**

Balance Sheet as at 31 December	**2006**
Equity	
Share Capital	2,800,000
Accumulated Deficit	-622,524
	2,177,476
Current Assets	
Balance at bank	13,700
Accounts receivable	551,950
Inventories	296,800
Other Assets	82,600
Total Current Assets	**945,050**
Current Liabilities	
Bank Overdraft	116,700
Accounts Payable	188,000
Accruals and Other Creditors	41,224
Employee entitlements	36,000
Total Current Liabilities	**381,924**
Working Capital/(Deficit)	563,126
Non Current Assets	
Intangibles	740,750
Property Plant and Equipment	873,600
Total Non Current Assets	**1,614,350**
Net Assets	**2,177,476**

Arlene has consulted industry data, which showed that the average payment period for the industry was 30 days. Investigation of three similar publishing companies revealed that their average payment period was also 30 days. The average age of inventory for the industry as reported in a survey by *Publishing World*, the trade association journal, was 60 days. The industry average for collection periods derived from trade association data and information on three similar publishing companies, was found to be 42 days.

Hanson Publishing Company currently manages any shortfall in working capital requirements with a temporary overdraft facility obtained at an interest rate of 18% per annum, which is same as the company's cost of capital. In 2006 the company invested $ 900,000 in current assets which it regards as its current working capital investment.

You are required to prepare a report which recommends the most appropriate working capital strategy for Hanson Publishing Company. Support your recommendation by covering the issues (a) to (e) and (g) to (h) below. Assume that the company operates a 360-day year.

a. Assuming a constant rate of purchases, production and sales throughout the year, what are Hanson's existing operating cycle (OC) and cash conversion cycle (CCC) based on its 2006 accounts?

(8 marks)

b. If Hanson can optimise operations according to industry standards, without having to alter its 2006-sales and cost levels, what would its OC, CCC be under these more efficient conditions?

(8 marks)

c. Judging on the basis of your findings in parts (a) and (b), what is the annual cost of Hanson Publishing Company's inefficiency, given that its cost of capital is 18%

(6 marks)

d. Assuming all customers take advantage of the cash discounts suggested by both Alan and Arlene, how much would it cost the company per annum based on the 2006-sales level? Given that the company's cost of capital is 18%, which one (if any) do you think is an acceptable strategy? Why or why not?

(10 marks)

e. What would be the net increase/decrease in wealth per annum of Hanson Publishing Company by the adoption of options (1) and (2)? In evaluating these options assume that the inventory levels will remain unaltered.

(24 marks)

f. Based on the results obtained for (e) above, which strategy would you recommend? What non financial considerations would be relevant before a final decision is made?

(10 marks)

g. List and discuss the methods that Hanson Publishing Company could employ to analyse the worthiness of a potential customer and methods that could be employed to collect debt.

(12 marks)

h. Discuss in general, other methods that could be available to Hanson Publishing Company to obtain finances for working capital without having to change its credit policy.

(12 marks)

PRESENTATION **(10 marks)**

TOTAL (100 marks)