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Subject : Working Capital Management

Q#1

1. Some firms finance their working capital with short term financing. What impact would this decision have on there profitability and risk?

Answer#1

1. Short term debt carries a lower explicit cost of capital. The decision to finance the permanent component of working capital with short-term debt may result in higher reported earnings per share. If stockholders donot perceive a higher risk characteristic for the firm as a result of higher proportions of short term debt, the financial manager may be exploiting an imperfection in the capital market to maximize the wealth of stockholders. However, the use of short term debt is likely to result in higher profits because debt will be paid off during periods when it is not needed.
2. Some companies finance their seasonal current asset with long term financing. What impact would this policy has on their profitability and risk?

B) The use of permanent financing for short term needs may result in inefficient operations of the firm. During periods of slow operation in the seasonal cycle, the firm will be unable to reduce it’s asset volume. Consequently, the firm will be paying for capital when it is not needed. Further, the explicit cost of long term funds is usually higher than the cost of short term financing. Thus, the firm is paying a higher cost of capital in exchange for reduction in the risk characteristic of the firm. The reduction may be insignificant in relation to the cost paid for it.

1. If the firm follows hedging approach to financing, how would it finance it’s current assets ?

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C) If a firm adopts a hedging (maturity matching) approach to financing, each asset would be offset with a financing instrumental of the same approximate maturity. Temporary or seasonal variations in current assets would be financed with short term debt. The permanent component of current assets would be financed with long term debt or equity. A hedging maturity matching approach to financing suggests that apart from current borrowings at a seasonal installments on long term debt. As a firm moves into a period of seasonal asset needs, it would borrow on a short term basis, paying of the borrowings with the cash released as the recently financed temporary assets were eventually reduced.

Q#2

1. Discuss the important variables in selection of the marketable securities for investment ?

Answer #2

1. The important variables in selection of the marketable securities for investment are :

1) Safety

2) Marketability

3) Yield

4) Maturity

Safety : The most basic test that marketable securities must pass concerns safety of principal. This refers to likehood of getting back the same numbers of dollars originally invested. Safety is judged relative to US treasury securities, which are considered certain if held to maturity. For securities other than the treasury issues, the safety of these securities will vary depending on the issuer, and the type of security issued. A relatively high degree of safety is must for a security to be seriously considered for inclusion in the firm’s short term marketable securities portfolio.

Yield : The yield or return on a security is related to the interest and appreciation of principal provided by the security.

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Some securities, notably treasury bills, do not pay interest. Instead, they are sold at a discount and redeemed at face value.

Maturity : Maturity simply refers to the life of the security. Some marketable securities have a specific life. Treasury bills, have original lives of 4, 13, or 26 weeks. Usually, the longer the maturity, the greater the yield, but also the more exposure to yield risk.

1. What is meant by net float? How a company can play with it’s float through controlling it’s disbarments.

B) Net float is the dollar difference between the balance shown in a firm’s checkbook balance on the bank’s books. Until a check is collected at the bank, it is not deducted on the bank’s book. A company can play the float by anticipating the size of net float, reducing bank balances not needed to cover checks actually present for payement, and using these otherwise idle funds until needed. It is very possible for a company to have a negative cash balance on it’s books and a positive bank balance, because checks just written by the company may still be outstanding. If the size of the net float can be estimated accurately, bank balances can be reduced and the funds invested to earn a positive return. This activity has been referred to by corporate treasurers as playing the float.

Q#3

1. What is outsourcing ? Why a company outsource some or all of it’s recievables?
2. Outsourcing consists of subcontracting a certain business operation to an outside firm, instead of doing it in-house.

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As firms have increasingly focused on the core processes of their businesses, all other essential, but non core areas of business are candidates for outsourcing. Cash management is an essential, but generally non core business activity. Therefore, all major areas of cash management, collections, disbarments, and marketable securities investment are ripe for outsourcing consideration. Reducing and controlling costs is a reason often cited for outsourcing a cash management process. Other popular reasons for outsourcing include improving company focus and gaining access to world class capabilities. Outsourcing has the potential to reduce a company’s costs. The outsourcer can use economies of scale and their specialized expertize to perform an outsourced business operation. As a result, the firm may get the service it needs at both lower cost and a higher quality than it could have provided by itself. Outsourcing may free up time and personnel so that the company can focus more on it’s core business.

1. Discuss the three motives for holding the cash?
2. The three motives for holding the cash are as following :
3. Transactions motive
4. Speculative motive
5. Precuationary motive

Transactions motive : Transaction motives are used to meet payements, such as purchases, wages, taxes, and dividends, arising in the ordinary course of business. In an ordinary course of business, the firm requires cash to make payements.

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Speculative motive : To take advantage of temporary opportunities, such as a sudden decline in the price of the raw material. A firm holds cash to exploit the possible opportunities that are out of the normal course of business. These opportunities could be in the form of low-interest rate charged on the borrowed funds, expected fall in the raw material prices or favourable change in the government policies. Thus, the cash is the most significant as it used to pay off the firm’s obligations and helps in the expansion of business operations.

Precautionary motive : Precuationary motives are used to maintain a safety cushion or buffer to meet unexpected cash needs. The more predictable the inlfows and outflows of cash for a firm, the less cash that needs to be held for precautionary needs. Ready borrowing power to meet emergency cash drains also reduces the need for this type of cash balance. Since the future is uncertain, a firm may have to face contingencies such as increase in the price of the raw materials, labour, strike, lockouts, change in the demand, etc. Thus, in order to meet with these uncertainties, the cash is held by the firm to have an uninterrupted business operations.