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**Subject:** Financial Management

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**Q1. Prepare a sources and uses of funds statement for ABC Corporation.**

ABC Corporation,  
Sources and uses of funds statement,  
For December 31, 20X1 to December 31, 20X2 (in millions),

<b>SOURCES</b>		<b>USES</b>	
Funds provided by operations:			
Net profit	\$5	Addition to fixed assets	\$8
Depreciation	\$5	Dividends	\$3
Decrease, other assets	\$5	Increase, account receivable	\$7
Increase, account payable	\$3	Increase, inventory	\$5
Increase, accrued tax	\$2	Decrease, note payable	\$20
Increase, long term debt	\$15		
Increase, common stock	\$6		
Decrease, cash and cash equivalent	\$2		
<b>TOTAL</b>	<b>\$43</b>	<b>TOTAL</b>	<b>\$43</b>

**Q2. Using the data from Q1 prepare a cash flow statement using the indirect method for ABC Corporation.**

ABC Corporation.

Statement of cash flow,

Year ended December, 31 20X2 (in millions).

- **Cash-flow from Operating Activities:**

Net income	\$5
Depreciation	\$5
Cash provided by current assets and	
Operating-related current liabilities:	
Increase, Account payable	\$3
Increase, Accrued tax	\$2
Increase, Account receivable	(\$7)

Increase, inventory	(5)	
Net cash provided by operating activities		<b>\$3</b>
• <b><u>Cash-flow from Investing Activities:</u></b>		
Addition to fixed assets	(\$8)	
Proceeds from sales of other assets	\$5	
Net cash provided by investing activities		<b>(\$3)</b>
• <b><u>Cash-flow from Financing Activities:</u></b>		
Decrease in short term bank borrowing	(\$20)	
Addition to long term debt	\$15	
Proceeds from sales of stock	\$6	
Dividends paid	(\$3)	
Net cash provided by financing activities:		<b>(\$2)</b>
Increase (decrease) in cash and cash equivalent	(\$2)	
Cash and cash equivalent, December 31 20X1	\$5	
Cash and cash equivalent, December 31 20X2	<b><u>\$3</u></b>	
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Supplemental cash flow disclosure:		
Interest paid	\$2	
Taxes paid	\$4	
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**Q3. (a) A company has to produce 100,000 units of output. It has to choose among three policies i.e. policy A, B & C. Policy A proposes to maintain current assets of worth 12 lacs, policy B of 10 lacs and policy C of 6 lacs. Which policy must the company choose if it has to increase liquidity, profitability and decrease risk? And why?**

If we equate liquidity with “conservativeness,” Policy A is the most conservative of the three alternatives. At all levels of output, Policy A provides for more current assets than any other policy. The greater the level of current assets, the greater the liquidity of the firm, all other things equal. Policy A is seen as preparing the firm for almost any conceivable current asset need; it is the financial equivalent to wearing a belt and suspenders. Policy C is least liquid and can be labeled “aggressive.” This “lean and mean” policy calls for low levels of cash and marketable securities, receivables, and inventories. We should keep in mind that for every output level there is a minimum level of current assets that the firm needs just to get by. There is a limit to how “lean and mean” a firm can get. We can now

summarize the rankings of the alternative working capital policies in respect to liquidity as follows:

	<b>High</b> ←-----→ <b>Low</b>		
<b>Liquidity</b>	Policy A	B	C

Though policy A clearly provides the highest liquidity, we need to recast the familiar return on investment (ROI) equation as follows:

**ROI = Net profit**  
**Total assets**

From the equation above we can see that decreasing the amounts of current assets held (for example, a movement from Policy A toward Policy C) will increase our potential profitability. If we can reduce the firm’s investment in current assets while still being able to properly support output and sales, ROI will increase. Lower levels of cash, receivables, and inventory would reduce the denominator in the equation; and net profits, our numerator, would remain roughly the same or perhaps even increase. Policy C, then, provides the highest profitability potential as measured by ROI.

However, a movement from Policy A toward Policy C results in other effects besides increased profitability. Decreasing cash reduces the firm’s ability to meet financial obligations as they come due. Decreasing receivables, by adopting stricter credit terms and a tougher enforcement policy, may result in some lost customers and sales. Decreasing inventory may also result in lost sales due to products being out of stock. Therefore more aggressive working capital policies lead to increased risk. Clearly, Policy C is the most risky working capital policy. It is also a policy that emphasizes profitability over liquidity. In short, we can now make the following generalizations:

	<b>High</b> ←-----→ <b>Low</b>		
<b>Liquidity</b>	Policy A	B	C
<b>Profitability</b>	C	B	A
<b>Risk</b>	C	B	A

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**(b) Briefly explain the maturity matching approach with an example.**

- **MATURITY MATCHING:**

Maturity matching or hedging approach is a strategy of working capital financing wherein we finance short term requirements with short-term debts and long-term requirements with long-term debts. The underlying principle is that each asset should be financed with a financial instrument having almost the same maturity.

- **EXAMPLE:**

To understand it with an example, assume a company bought machinery with a life of 5 Years' worth \$10 million. Let's assume if there are two options to finance it i.e., issue of 10 Year debenture or apply for cash credit renewable every year. What will you opt for? The obvious answer would be 5 Year Debenture.

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**Q4. (a) Briefly explain permanent working capital with an example.**

- **PERMANENT WORKING CAPITAL:**

Some minimum amount of raw materials, work-in-progress, bank balance, finished goods etc. and a business has to carry all the time irrespective of the level of manufacturing or marketing operations. This level of working capital is referred to as core working capital or core current assets.

The amount of current assets required to meet a firm's long-term minimum needs is known as permanent working capital.

- **EXAMPLE:**

Take a can of red paint and paint some of the firm's fixed assets (like plant and equipment). If you come back in a month, these same assets are there and they are still red. Now, paint the firm's cash, receivable invoices, and inventory green. If you come back in a month, you may still find some green items, but many, if not most, will have been replaced by new, unpainted items. Thus permanent working capital does not consist of particular current assets staying permanently in place, but is a permanent level of investment in current assets, whose individual items are

constantly turning over. Viewed still another way, permanent working capital is similar to the level of water that you find in a bay at low tide.

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**(b) Briefly explain the significance of working capital management.**

- **WORKING CAPITAL MANAGEMENT:**

Working capital management is essentially an accounting strategy with a focus on the maintenance of a sufficient balance between a company's current assets and liabilities. An effective working capital management system helps businesses not only cover their financial obligations but also boost their earnings.

- **SIGNIFICANCE OF WORKING CAPITAL MANAGEMENT:**

For one thing, the current assets of a typical manufacturing firm account for over half of its total assets. For a distribution company, they account for even more. Excessive levels of current assets can easily result in a firm realizing a substandard return on investment. However, firms with too few current assets may incur shortages and difficulties in maintaining smooth operations.

**EXAMPLE:**

For small companies, current liabilities are the principal source of external financing. These firms do not have access to the longer-term capital markets, other than to acquire a mortgage on a building. The fast-growing but larger company also makes use of current liability financing. For these reasons, the financial manager and staff devote a considerable portion of their time to working capital matters. The management of cash, marketable securities, accounts receivable, accounts payable, accruals, and other means of short-term financing is the direct responsibility of the financial manager; only the management of inventories is not. Moreover, these management responsibilities require continuous, day-to-day supervision. Unlike dividend and capital structure decisions, you cannot study the issue, reach a decision, and set the matter aside for many months to come. Thus working capital management is important, if for no other reason than the proportion of the financial manager's time that must be devoted to it. More fundamental, however, is the effect that working capital decisions have on the company's risk, return, and share price.