**Final Term**

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**Course Title: Financial Management**

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**ABC CORPORATION COMPARATIVE BALANCE SHEET AT DECEMBER 31(IN MILLIONS)**

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| --- |
| **ASSETS 20X1 20X2 LIABILITIES 20X1 20X2** |
| Cash $5 $3 Accounts payable $5 $8  Account receivable 15 22 Note payable 20 0  Inventories 12 17 Accrued Wages 2 2  Accrued taxes 3 5 Net fixed assets 52 55 Long-term debt 0 15  Other assets 10 5 Common stock 20 26  Retained earnings 40 44  Total assets $94 $102 Total $90 $100 |
|  |
|  |

**ABC CORPORATION INCOME STATEMENT 20X2(IN MILLIONS)**

Sales $48

Cost of goods sold $25

Selling, general and administration expense 5

Depreciation 5

Interest expense 2 37

Net Profit before taxes $11

Less: Taxes 6

Net income 5

Add: Retained Earnings at 12/31/X1 40

Subtotal 45

Less: Dividends 3

Retained earnings at 12/31/X2 $44

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

**ABC CORPORATION**

**SOURCES AND USES OF FUNDS FLOW STATEMENT**

**FOR DEC 31,20X1 TO DEC 31, 20X2 (IN MILLIONS)**

Sources Uses

Funds provided by operations Dividend $ 3

Net profit $ 5 Additions to fixed assets 8

Depreciation 5

Decrease, other assets 5 increase, account receivable 7

Increase, account payable 3 increase, inventory 5

Increase, accrued taxes 2 decrease, note payable 20

Increase, long term debt 15

Increase, common stock 6

Decrease, cash and equivalents 2

$43 $43

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

**ABC CORPORATION**

**STATEMENT OF CASH FLOW**

**FOR THE YEAR ENDED DEC 31, 20X2 (IN MILLIONS)**

**CASH FLOW FROM OPETATING ACTIVITIES**:

Net income……………………………………………………………..$5

Deprecation……………………………………………………………. $5

Cash provided (used) by current assets and operating related current liabilities:

Increase, account payable ………………………………………. $3

Increase, accrued taxes…………………………………………..$2

Increase, account receivables………………………………………$(7)

Increase, inventories …………………………………………………$(5)

Net cash provided (used) by operating activities: $3

**CASH FLOW FROM INVESTING ACTIVITIES:**

Addition to fixed assets………..……………………………………… (8)

Proceeds from sale of other assets……………………………………5

Net cash provided (used) by investing activities ……………….… (3)

CASH FLOW FROM FINANCING ACTIVITIES:

Decrease in short term bank borrowings………………………. (20)

Addition to long term borrowing………………….………………15

Proceeds from the sale of common stock………………………6

Dividends paid …………………………………………………….3

Net cash provided (used) by financing activities ………. $(2)

Increase (decrease) in cash and equivalents………………… (2)

Cash and equivalents, Dec 31, 20x1 ………………………….5

Cash and equivalents, Dec 31, 20x2…………………………..3

**Supplemental cash flow disclosers:**

Interest paid……………………………………………………2

Taxes paid\*……………………………………………………4

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?

In determining the appropriate amount of current assets, management must consider the trade-off between profitability and risk. With existing fixed assets, a firm can produce up to 100,000 units of output a year.

Here we have 3 policies

In policy A we have high liquidity low profitability and low risk

In policy B we have average liquidity average probability average risk

In policy C we have low liquidity high profitability high risk

The company should choose policy B because

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” where policy B has good liquidity good profit and medium risk

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

**Maturity matching approach**

Maturity matching or [hedging](https://efinancemanagement.com/derivatives/hedging) approach is a strategy of [working capital financing](https://efinancemanagement.com/working-capital-financing) wherein 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.

**Explanation**

This matching approach of [working capital](https://efinancemanagement.com/working-capital-financing/working-capital) financing can be explained in terms of a simple equation as follows

Long Term Funds will Finance = [Fixed Assets](https://efinancemanagement.com/financial-accounting/fixed-asset) + Permanent Working Capital

Short Term Funds will Finance = Temporary Working Capital

In the equations, long term funds are matched to long term assets and vice versa.

**Example**

Let’s 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](https://efinancemanagement.com/sources-of-finance/benefits-and-disadvantages-of-debentures) or apply for [cash credit](https://efinancemanagement.com/sources-of-finance/cash-credit) renewable every year. What will the best option to adopt?

The obvious answer would be 5 Year Debenture because of Maturity matching approach

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

**Permanent working capital**

A firm’s permanent working capital is the amount of current assets required to meet a firm’s long-term minimum needs assets required to meet long-term minimum needs. You might call this “bare bones” working capital

**Explanation**

Permanent [working capital](https://www.wisegeek.com/what-are-common-sources-of-working-capital.htm) is that portion of working capital that is expected to generate on a consistent and uninterrupted. This is in contrast to temporary working capital, which revenue is coming from sources that may or may not continue. Businesses tend to cultivate and maintain sources of permanent working capital as the foundation for their continued operation from one year to the next.

The precise value of your business’s fixed working capital will be relative to the size of your business, as well as the value of your current assets and your current liabilities. If you [scale up business](https://www.become.co/blog/scaling-your-business/) (and have higher operating costs), or if your business has more liabilities (debts to pay), you’ll have relatively higher permanent working capital.

Add to that the fact that your sources of ‘reliable’ and ‘uninterrupted’ capital may very well change over time, and you’ll begin to understand why it can get a little tricky to pinpoint exactly how your business is operating with respect to meeting the required permanent working capital. Since it changes as time goes on, measuring permanent working capital remains an ongoing process no matter how long you’ve been in business.

**Example**

Salaries

Electricity and telephones bills

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

**Significance of working capital management**

Working capital is a daily necessity for businesses, as they require a regular amount of cash to make routine payments, cover unexpected costs, and purchase basic materials used in the production of goods.

Efficient [working capital management](https://www.investopedia.com/ask/answers/041015/what-are-components-associated-working-capital-management.asp) helps maintain smooth operations and can also help to improve the company's earnings and profitability. Management of working capital includes inventory management and management of accounts receivables and accounts payables. The main objectives of working capital management include maintaining the working capital operating cycle and ensuring its ordered operation, minimizing the cost of capital spent on the working capital, and maximizing the return on current asset investments.

Working capital is an easily understandable concept, as it is linked to an individual’s [cost of living](https://www.investopedia.com/terms/c/cost-of-living.asp) and, therefore can be understood in a more personal way. Individuals need to collect the money that they are owed and maintain a certain amount on a daily basis to cover day-to-day expenses, bills, and other regular expenditures.

Working capital is a prevalent metric for the efficiency, liquidity and overall health of a company. It is a reflection of the results of various company activities, including revenue collection, debt management, [inventory management](https://www.investopedia.com/terms/i/inventory-management.asp) and payments to suppliers. This is because it includes inventory, [accounts payable](https://www.investopedia.com/terms/a/accountspayable.asp) and receivable, cash, and portions of debt due within the period of a year and other short-term accounts.

The needs for working capital vary from industry to industry, and they can even vary among similar companies. This is due to several factors, including differences in collection and payment policies, the timing of asset purchases, the likelihood of a company writing off some of its past-due [accounts receivable](https://www.investopedia.com/terms/a/accountsreceivable.asp), and in some instances, capital-raising efforts a company is undertaking.

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.

Managing working capital means managing inventories, cash, accounts payable and accounts receivable. An efficient working capital management system often uses key performance ratios, such as the working capital ratio, the inventory [turnover ratio](https://www.investopedia.com/terms/t/turnoverratio.asp) and the collection ratio, to help identify areas that require focus in order to maintain liquidity and profitability.