BACKGROUND:

Mr. Clarkson, an energetic 49-year-old man, founded the Clarkson Lumber Company in 1981 as a partnership with his brother-in-law. In 1996, after rapid growth in its business, the Clarkson Lumber Company anticipated a further increase in sales. Despite good profits, the company had experienced a shortage of cash and had found it necessary to increase its current borrowing capacity ($399,000) from County National Bank in the spring of 1996. The maximum loan that County National would make to any one borrower was $400,000 and Clarkson had been able to stay within this limit only by relying heavily on trade credit. In addition, County National was now asking Mr. Clarkson to guarantee the loan personally. As a result of the Clarkson Lumber Company financial situation, a friend introduced Mr. Clarkson to the Northwestern National Bank. A much larger bank, Northwestern, would extend a line of credit to Clarkson Lumber up to a maximum amount of $750,000. Furthermore, it was cited that Northwestern would require restrictions on borrowing in excess of $750,000 to reduce loan risk. Mr. Clarkson thought a loan of this size would improve profitability by allowing him to take full advantage of trade discounts. When making a decision about borrowing the money, Mr. Clarkson must be cognoscente and analyze three issues prior to making this financial decision. Moreover, Mr. Clarkson must obtain a good sense of cash flow management to insure the future of his business.

ISSUES:

1. Clarkson Lumber is a profitable company. Whey do they need to borrow money from the bank if they're profitable?

2. Clarkson Lumber is being offered a cash discount from their suppliers. Should they take the discount or not?

3. How much external financing does Clarkson Lumber need at the end of 1996 under two scenarios: A) If Clarkson takes the cash discount from their suppliers; and B) If Clarkson does not take the cash discount from their suppliers.

ANALYSIS OF ISSUE 1:

The Clarkson Lumber Company should borrow money from the bank so they can have the cash needed to take the discount of two percent offered by suppliers for making payments within 10 days of the invoice date. The company has grown profitably in the past three years and sales are expected to continue to increase. Clarkson Lumber will increase its profitability if it can take advantage of the trade discounts offered. Without the discount, Clarkson Lumber's Effective Annual Cost of Trade Credit is 36.73% (if they are paying over 18 periods and 24% if they are paying over 12 periods) versus 11% interest from the bank (see Exhibit 5, Note 1).

Even though Clarkson Lumber is profitable it is unable to take advantage of the trade discounts because of insufficient cash flow. Borrowing cash from the bank will allow the company to improve. For example Clarkson's return on assets, the best indicator of the efficiency of the investment and use of assets, is spiraling downward. In the years from 1993 to 1996 it has decreased from 6.5% to 5.7% while the high profit companies average around 12.2%. (Exhibit 3 and 3a). This indicates that Clarkson Lumber is not utilizing its assets efficiently. This ineffective use of assets has resulted in a reduced return on the investment in the company's assets.

Additionally, in the short term Clarkson Lumber is struggling since its liquidity is inhibited slightly more each year. Evaluating the Current Ratio, the measure of short-term liquidity, the company is nearing the point of break even with assets and liabilities. Where in 1993 Clarkson Lumber's Current Ratio was 2.49%, in 1996 the projected Current Ratio fell below the 'low profit' (Exhibit 3 and 3a) mark for the industry.

In order to remain solvent, Clarkson Lumber must borrow money from the bank to decrease the cost of financing its purchases. Borrowing money from the bank to take advantage of the trade discount is just the first step Clarkson must take. Details of the other recommended steps are explained in the analysis of issue two.

ANALYSIS OF ISSUE 2:

On first blush, Clarkson Lumber should take the two percent discount from their suppliers, however, at this point, they cannot afford it. By taking the cash discount they will be required to borrow more money than the company can sufficiently pay back. Thus, they should not take the discount. Clarkson's profitability, accounts receivable, days sales outstanding, inventory turnover and accounts payable all play an important role in making this decision and are as follows:

Profitability (Exhibits 5):

If Clarkson Lumber takes the discount, their projected Net Income will increase from $84,000 (Net Income without the discount) to $107,000 (see Exhibit 5). By taking the discount, Clarkson will increase their projected 1996 interest expense from $62,000 to $91,100 (because they will need to borrow more money from the bank than they borrow from their creditors) but this additional interest expense will be offset by a projected discount amount of $69,000 which reduces Clarkson's expenses by a projected $40,000 (see Exhibit 5). In terms of profitability, it appears that Clarkson Lumber will be more profitable if they secure an additional loan from the bank and take the cash discount from their suppliers. This profitability overall would result in a Net Income increase of $23,000.

Accounts Receivable (A/R) (Exhibit 3, 3a and 6):

Currently Clarkson Lumber has a shortage of cash flow, which is why they need to borrow money. Their Accounts Receivable (A/R) are not being paid down quickly enough. This is an

indication that they are not able to manage their cash flow properly. They might want to consider changing their credit terms with their customers. As shown in Exhibit 3a, Clarkson's A/R are trending up or it is taking longer for Clarkson to be paid for services rendered. If you follow the trend of Clarkson's A/R as shown in Exhibit 3a (with or without the discount on payables), they are 1.3% higher than the industry during low profit.

Typically there is a consistent relationship between the rate of change in sales dollars and the rate of change in A/R. Exhibit 6, Chart 7 indicates that Clarkson's A/R on average are increasing at a higher rate than their sales dollars. If no trending is done, their A/R is increasing 6.38 percentage points higher than their sales. If trending is factored into the equation, their A/R is increasing 15.73 percentage points higher than their sales.

Days Sales Outstanding (see Exhibit 3a):

Another indicator that Clarkson Lumber is having trouble managing their receivables is their Days Sales Outstanding. While the industry numbers are not given as a comparison in the case, it is indicated that if Clarkson follows their A/R trend, whether they take the discount or not, their Days Sales Outstanding will remain at 54 days. This is an increase of almost 13 days to their 3-year average from 1993-1995. If the trend is not followed, Clarkson's Days Sales Outstanding would be 42.8 in 1996, which matches their 3-year average. Clarkson Lumber basically needs to finance a month and a half of receivables based on their A/R trend.

Inventory Turnover (Exhibit 3a):

Clarkson's Inventory Turnover as seen in Exhibit 3a is trending down. In other words, Clarkson is turning over its inventory 6.3 times in 1996 versus 7.5 times in 1993. This means that they are holding onto their inventory for longer periods of time. This is an indication that they are not managing their inventory efficiently.

Accounts Payable (Exhibit 6):

Clarkson's Accounts Payable (A/P) is not indicating a specific trend. If a discount is taken, their A/P drops off considerably by December 31, 1996. If a discount is not taken, their A/P increases at the average rate (Chart 6). Taking an additional loan decreases the A/P to a balance of 10 days (Chart 4) worth of Accounts Payable. This is based on the credit terms if Clarkson takes the discount. It is ultimately cheaper for Clarkson Lumber to borrow money from the bank than borrow money from their creditors to pay for their A/P.

Summary:

Clarkson Lumber needs more credit than they have. In addition, they are limited to taking a loan of $750,000. If the company goes over this amount, "restrictions on additional borrowing would be imposed" (Page 59 of case). Based on Exhibit 6, whether the Pro Forma Balance Sheet is done based on averages from the previous years or whether it is done based on the trends in A/R and Accrued Expenses, the company will still need to borrow over $750,000 if they want to take the discount from their suppliers. Unfortunately, as seen in Exhibits 7 & 8, Clarkson's Cash Flow will not support the loan amount they will need to take to meet their cash flow needs. As seen in Exhibit 3a, Clarkson's Operating Cash Flow is negative in both scenarios, trending up or averaging which mirrors the Statement of Cash Flow. This indicates that Clarkson may not have the capacity to meet its obligations even though they are profitable. This also raises the question of their ability to generate cash flows in the future. Exhibit 8, Cash Flow from Operating Activities clearly shows that Clarkson Lumber can manage their cash flow better if they do not take the discount from their suppliers. According to this exhibit, if Clarkson takes the discount following their trend, their net cash inflow from operating activities will be ($40,000) versus not taking the discount, their net cash inflow will be $24,000. Based on

averaging, taking the discount will mean a net cash inflow from operating activities of ($210,000). Based on the trending of Clarkson's Accounts Receivables, Inventory and Accrued Expenses combined with their Operating Profit from Cash Flow, Clarkson should not take the discount from their suppliers.

ANALYSIS OF ISSUE 3A:

Clarkson Lumber will need to borrow $1,030,000 if they take the cash discount from their suppliers and if their Pro Forma Balance Sheet follows their Accounts Receivable and Accrued Expenses trend (Exhibit 6). This is taking into consideration no increase in Property, Net, as given in the case, "additional investments in fixed assets could be made only with the prior approval of the bank," if the loan amount is over $750,000. Thus, the Property, Net has not increased but has in fact decreased as the result of depreciation (see Exhibit 6, Property, Net). If Clarkson Lumber does not follow the trend on their 1996 Pro Forma Balance Sheet and does not increase Property, Net, then they will need to borrow $907,000 (Exhibit 6).

ANALYSIS OF ISSUE 3B:

If Clarkson does not follow the trend, does not take the discount from their suppliers and does not increase their Property, net, they will need to borrow $626,000 (Exhibit 6). If Clarkson does follow the trend, does not increase their Property, net and does not take the discount from their suppliers, they will need to borrow $749,000 (Exhibit 6).