# BUSINESS STUDIES

**Finance Business Report**

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In your report you should:

- Outline the financial problems that Kingfisher Ocean Charters is experiencing
- Explain strategies that KOC could use to manage its working capital more effectively
- Discuss (identify issues and points for/against) issues involved in raising funds through both debt and equity with a recommendation to the management

To: Kingfisher Ocean Charters Management Team
From: ABC Consultants
Re: Working Capital Management

**Situational Analysis**

Kingfisher Ocean Charters Pty. Ltd. (KOC) is an ocean charter business that operates several boats taking people interested in game fishing offshore to pursue their interests. KOC is experiencing cash flow problems and has decided to purchase more boats and equipment to expand. Managers are unsure about funding expansion by borrowing funds or by selling equity in the business.

This report will:

- Outline the financial problems that Kingfisher Ocean Charters is experiencing
- Explain strategies that KOC could use to manage its working capital more effectively
- Discuss issues involved in raising funds through both debt and equity with a recommendation to the management

**1. Financial Problems**

Currently KOC is experiencing solvency and liquidity problems.

*1.1 Solvency*

Through comparative ratio analysis over time KOCs solvency (gearing) ratio has increased markedly between 2007 and 2009, to the current level of $1.40 liabilities for every $1 of owner's equity. This indicates a highly geared business. Additionally through comparative ratio analysis to industry standards, that is, similar businesses, FOC indicates high risk in terms of long term financial stability as a small business gearing ratio should not exceed 60%.

*1.2 Liquidity*

KOCs current ratio decreased from 15:7 in 2007 to 17:15 in 2008 to 20:22 in 2009. This trend reflects increased current liabilities compared to current assets, impacting on KOCs alibility to pay short term debts (interest and loan repayments, accounts payables etc) as they fall due.

**2. Strategies to manage working capital effectively**

Working capital is an indication of KOCs liquidity or ability to pay short term debts as they fall due. KOC could manage its working capital through management of current assets and current liabilities. This will ensure that KOC has sufficient cash available and accounts receivable and inventory are quickly converted into cash. KOCs current ratio decreased from 15:7 in 2007 to 17:15 in 2008 to 20:22 in 2009. This trend reflects increased current liabilities compared to current assets, impacting

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*2.1 Management of Current Assets through Factoring*

Working capital management could involve factoring (selling accounts receivable at a discount to a third party e.g. GE Money). This can be done at the point of credit sale or after the purchase. By factoring, KOC receives around 90% of the credit sale in cash, which could then be used to reduce accounts payable (immediate debt) or to reduce their bank overdraft which incurs high interest payments.

*2.1 Incentives for early payment*

Discounts for early payment will mean that debtors will be enticed to pay their debt earlier. This will improve KOCs working capital as they would not have to rely on other sources.

*2.2 Credit Policy*

KOC could also tighten its credit policy in order to ensure customers pay their debt on time and therefore improve working capital. This could include not allowing credit to customers with a bad credit history, lowering limits or allocating shorter times to pay. It also may entail phone call reminders, fees and interest on late payment.

*2.3 Sale and Lease Back*

Sale and Lease back involves the sale of non-current assets such as plant and equipment and then leasing them back so that KOC may continue production to generate revenue. The cash from the sale can be used to retire debt and improve solvency or put into the bank as cash at hand. This allows the business to have money available to pay immediate debts.

**3. Recommendation of the combination of debt to equity financing to fund expansion**

KOC must remember that the source of funds should be matched to their purpose/use. Therefore, KOC should use long term equity or debt finance to fund the purchase of capital. Each source, however, does carry risk and benefits and discussed below.

*3.1 Equity Finance*

Equity finance is funds provided by owners or by acquiring new owners. In the case of new owners, there will be a loss of control since equity holders have voting rights. Unlike debt it does not carry the burden of interest rate charges and there are no repayments required. This would allow KOC to work through difficult times and not have a debt repayment burden.

Alternatively, the existing owners could be asked to increase their capital to cover the renovations. This will take time and some owners would have to be convinced that the purchase of new boats and equipment would give them extra or a greater return in the long run. A combination of these two internal sources of finance would be ideal for KOCs needs. Neither will incur contractual repayments as in debt and both will allow the business time to earn revenue.

*3. 2 Debt Finance*

Debt finance is funds raised from external sources such as financial institutions. As already mentioned, due to a high gearing ratio, large amounts of debt finance will put strain on the viability of KOC. Therefore it would not be appropriate or my recommendation.

Additionally, debt finance incurs interest repayments regardless of business performance. This is contractual and a legal obligation. However, it does allow the borrower to maintain total ownership. It is usually quick to arrange and although interest must be paid, it is tax deductible.

KOC must consider the impact of increasing their liabilities through debt finance on future profitability and financial stability. It would be my recommendation that short term debt finance such as an overdraft be used to smooth cyclical cash flows. This would however negatively impact on the working capital of KOC.

Ultimately, I would recommend a mix of debt and equity finance, but with emphasis on long term equity, since expansion is a long-term project, it is best to match the source of funds to the need. Whilst concurrently, short term debt finance is used to finance temporary periods of lower cash inflows or higher cash outflows.

It is these prospects and recommendations that are recommended for your business, Kingfisher Ocean Charters Pty. Ltd.

**Summary of Recommendations**

In order to improve working capital, the managers will have to implement processes such as factoring, sale and lease back, giving incentives for early payment and reviewing their credit policy in order to improve working capital. It is also suggested that due to a high gearing ratio and currently a poor current ratio, long term equity finance is used to finance the purchase of new boats and equipment to expand. Whilst, short term debt finance such as an overdraft could be used to smooth cyclical cash flows.