ISEG Lisbon School of Economics & Management
Universidade de Lisboa

Master in Accounting

Sustainability, Accountability and Ethics

Financing policy, profitability and value creation

Managerial balance sheets		Year-end 1		Year-end 2		Year-end 3
Cash		600		$ 350		$ 300
Working capital		3,930		4,440		6,100
Net fixed assets		1,200		1,300		1,450
Total invested capital		**$5,730**		**$6,090**		**$7,850**
Short-term debt		300		500		1,900
Long-term financing		5,430		5,590		5,950
Long-term debt	1,300		1,200		1,100	
Owners' equity	4,130		4,390		4,850	
Total capital employed		**$5,730**		**$6,090**		**$7,850**

Income statements

	Year 1	Year 2	Year 3
Sales	**22.100**	**24.300**	**31.600**
COGS	17.600	19.300	25.100
Selling and general expenses	3.750	4.000	5.000
Depreciation expenses	100	100	150
EBIT	**650**	**900**	**1.350**
Net interest expenses	110	130	260
EBT	**540**	**770**	**1.090**
Income tax expense	220	310	430
EAT	**320**	**460**	**660**

a) What is your long-term perception regarding the financing policy?

b) Compute for **profitability** of FY3: ROA & ROE. Discuss the differences.

c) Explore the drivers of profitability.
   i. Operating margin
   ii. Invested capital turnover
   iii. Financial multiplier
   iv. Tax effect

d) Compute for **value creation** in FY3, considering a cost of equity of 14,55%.

e) Consider the following benchmarking information for FY3.

Industry financial ratios	
Average collection period	30 days
Average payment period	33 days
Inventory turnover	8

Consider the following additional data from firm's financial statements: Inventory of the beginning of FY3 (3.200). Assume a 365-day year.

i. Comment on the operational performance of this firm.

ii. Suppose this firm had managed its operating cycle like the average firm in the sector. What would have been the effect on:

- Financing strategy?
- Profitability?
- Value creation?

Self-sustainable growth rate

Ambersome Inc. has decided to have all its assets financed by equity. Furthermore, it intends to keep its payout ratio at 40%. Its assets turnover ratio is 0,9, its profit margin is 8% and profits are taxed at 40%. The firm's target growth rate in sales is 5%.

a) Is the target growth rate consistent with the firm's financing policy?

b) If not, suppose firm can borrow at 10%. Would borrowing help it meets the target growth rate?