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Dilemma of Growth

Deepika Dhawan
Shri Mata Vaishno Devi University - School of Business

Sushil Kumar Mehta
Shri Mata Vaishno Devi University

Abstract

The case study requires students to be familiar with and able to read financial statements. The student assumes the role of a financial consultant who has taken the case of "Dream Homes," which is facing a classic business situation—a growing need for funds to support growing sales. The student analyzes the financial statements and related information provided in the exhibits to address the company's escalated need for funds. Furthermore, the student must investigate whether the growth that the company owner is aiming at is sustainable or not. Finally, the student should work on practical issues concerning the financial situation and come up with possible scenarios to improve the company's creditworthiness of the company. This case study aims to achieve a thought-provoking scenario for the students to enable them in accounting, financial, strategy, and predictive analysis in a general context. This will also help students to analyze and conclude whether an investment is worthwhile.

Introduction

Coming into the conference room of Fincop Consultants, Mr. Joseph said, 'I hate Mondays.' His team, consisting of three members (Carla, Jess, and Andie) who just finished tea break, asked, what happened? Joseph then showed them the file that the boss has given him in the morning. Carla saw the file named "Dream homes." The file stated that the company, which has started in 2017, is a start-up company developing well. The CEO of the company has applied for a credit line of $1.3 million from the bank. The bank manager is hesitating to grant the credit line to the CEO of Dream homes. The reason was stated that the company is growing and would need more funds than the $1.3 million the CEO is asking. The Bank manager is not sure about the capability of the company to pay back its credit. Since the bank manager is known to the CEO of the company, he advised him to consult a financial company to handle the management of funds. If a good projection is not shown in the allotted time, the bank manager has to reject the credit line's request. Joseph then consulted with his team about managing fund with all the information he has been given.

The Business

"Dream homes" is a company established by Mr. David in Chennai in 2017. After gaining experience in construction and renovation of homes for five years, Mr. David established Dream homes. The company deals with the panel distribution and tile fittings for the houses. The company gives a range of products to choose from to its customers.

Its customer includes small housing societies, small contractors, and some people who want to renovate their homes. Due to the on-time works, competitive pricing, and good quality works, the company is gaining recognition in the area. In general, if a customer has works done by the company, a good reference is given. Due to the good references, variety of options, and competitive price, the company is getting itself established instead of stiff competition. At present, its registered customers are 3000 in number. Its workload is constant throughout the year except two months of June and July. Customers try to avoid the new construction or renovation in these two months due to the extreme downpour. In the two months, sales sometimes dropped by 30%.

The company is establishing itself in the industrial area of Chennai. Due to the good reputation of works, Mr. David has garnered a good reputation. He established this company from his savings and investment through his family. In the second year, after watching the company's progress, his friends and acquaintances also invested in the company. Through receiving a new infusion of funds, the management doubled its efforts for the company to grow.

Management and Personnel

Mr. David (33), CEO and founder of the company, is in charge of the purchase and finance section. After graduation, he worked in the business to garner experience. Due to his vigilant performance, he rose to the rank of manager sooner. It gave him the courage to start his own company in 2017 after five years of work experience (3 years as a manager). His educational qualification is as a civil engineer.

At present, the company has ten employees, including Mr. David. One person is to oversee finance and handle financial affairs under the supervision of Mr. David. Two people manage sales and potential sales, and the rest handle the smooth operation of the business. The employees got (5%) stake in the company, making them motivated for work. The rest of the stake is divided between Mr. David (60%), his family (20%), and friends (15%).

Financial Situation

According to Mr. David,
"The first two years of business were difficult. Hiring and training talent, deciding on product catalogue, selling process, every single decision was hectic. And not even enough customers to generate profit. In the start, a lot of investments in inventory were needed. The different variety was included to garner reputation among customers. This was the core focus that could make or break a business- customer satisfaction. For this, it took time, but we were able to deliver good quality products on time at competitive prices. But now that sales have almost tripled, we have good staff, reliable products, and customer satisfaction.

In 2019, we almost touched the $5 million mark sales and made a reasonable profit of $113000. We are now hoping to increase sales as economic restrictions have practically been lifted. Now that real estate has been stabilizing, a lot of new projects will be started by companies. We are targeting the $15 million mark in a few years. My target is to grow at a reasonable pace of the industry, i.e., 25%. If we tighten our belt, we can keep our cost of goods sold at 70% and overhead expense at 14%. With all these efforts, we can make a good profit.

Since it is a distribution company, investment in fixed assets is less; current assets, including receivables, and inventory represent a major chunk of funds. We ideally go for inventory to make up for 60 days of sales and receive money from customers from 60 days to 90 days, depending on the customer. We pay the supplier on a 60 day bill basis and can ideally receive a 2.5% cash discount if we make the early payment (within 7 Days). Although due to the growing business need, this opportunity has yet to be taken. We have rented a warehouse of 1200 sqm in the industrial phase. We use the front as an administrative office.

So far, with our collective efforts, we can do business with some setbacks. On the work front, it is a smooth journey. The main problem that we face continually is lack of timely finance. I have been trying to gather funds

from possible sources. I started the business with my savings and borrowing from my parents. In the second year, I was able to convince my friends to invest in the company. At present, I have eight credit lines of approximately $175000 each through different banks. But it is quite hectic to maintain through all the formalities for it. Now I want to replace these eight credit lines with one credit line of $1.3 million from a bank that understands my business's needs. I hope this move will help with the problems related to finance. I want to focus from permanent cash stress to the core business."

The perspective of the bank

The manager of the local branch knew Mr. David since he started working. He has seen the efforts that Mr. David pulled to start his company. He was one of the foremost persons who granted his first credit line in 2017 since the inception of his company. Bank's focus is to strengthen local businesses and to explore growth opportunities in the locality. So, when "Dream Homes" presented a chance to invest itself through the credit line, the bank manager was interested. Now, the country has started expanding its economic activities after such a slump faced worldwide due to the pandemic. This represents an opportunity for the bank and company to grow together.

After conducting a credit analysis on the company, the manager found the growing need for finance is a concern for the company. CEO and management are quite good. In the words of the supplier, "Mr. David is a hardworking person, who tries to deliver the required on time and keep control of his costs, finance, and management." But the need for funds for the growth Mr. David is aiming for is a concern for the manager.
Due to long-term relations between the bank and the company, the manager has suggested consulting a financial consultant company to handle the projections that can help tackle its problems.

Perspective of Consultants

The questions that the consultants are facing are as follows:
1. Is the finance of $1.3 million enough for the company for the next four years?
2. Does Mr. David's aim at of 25% growth sustainable? If yes, Why? If no, why not?
3. What can be done to tackle the financial situation? What can be done by the management to improve the credit worthiness of the company?

Important Note: *For the sake of convenience, $ currency is used.*

Teaching Notes

The teaching note has been provided to aid the academicians on how to navigate the discussions among the students when discussing the case in the classroom. The students will be given the case study "Dilemma of Growth" through the pages one to three which includes the information given about the company and all the related information in the form of different perspectives and financial situation (exhibits) about the company.

Learning Objective of the Case Study

Achieve a thorough and rational decision—a step by step analysis of financial statements while understanding the dynamic situations revolving around the business.

Intended Audience: How and when to give assignment

The case study is intended to be used by students in undergraduate and master's degree courses of business. For the sake of ease in discussion, this case study goes for a caselet route than a very long case study that goes on and on about describing the situation. This case can either be taught at the beginning of the course to familiarize the students with the general terms and tools related to financial management or at the end of the course to sharpen their

knowledge. The case demonstrates a classic situation a business faces: a growing need for funds to facilitate growing sales.

This case can be used as the teaching case study where the teacher can give out the assignment in the groups beforehand so that it can be discussed in the classroom. Later on, the discussions among the students as a group can be encouraged on whether the investment in the company is worthwhile or the company is in vicious loop of growing need for funds. The strategies to improve creditworthiness of the company can be discussed in the class. However, if the instructor wants to give this case study as a "take-home" assignment, the weightage of questions can be determined by the instructor oneself with the help of answers provided in the teaching notes and when the instructor is giving out "take-home assignment"- at the beginning or the end of the course.

First, let's talk about the background of the case study.

The Dream Homes case is a comprehensive financial and operational management analysis case. The said case does not represent any competent or incompetent management. It just gives a thought-provoking scenario for the students where they assume themselves as a financial consultant to comprehend whether an investment is worthwhile and what decisions and strategies could be followed to make it happen. This case study can enable students to think like a prospective financial manager while handling investment and strategic decisions.

The case focuses on the common dilemma faced by many businesses. In the information era, where it is easy to gather data, it is paramount to analyze data to get useful information. It will make students think and rationalize data. It will initiate students to use various financial analysis tools to grasp the situation to make rational decisions. The main tools to be used in the case to reach a conclusion are as follows.

1. Analysis of Business
2. Analysis of P & L Account
3. Analysis of Balance Sheet, i.e., uses and sources of funds.
4. Forecast P & L Account
5. Forecast of Balance Sheet
6. The need for funds for operations (NFO) and Working Capital (WC)

So, the students should be familiar with the financial statement and be able to read them. If not, the discussion should be navigated in the following order to provoke thoughts.

The following topics can be raised by the instructor to enhance the discussion among the students.

1. ***Business analysis.*** What does it sell? How much? Where? Nature of business? Economic conditions. Is it cyclical? Customer's profile and numbers. Why this company? Strategy. Management, its profile, and evaluation. (By doing business analysis, we expect something from numbers. It helps us to get an idea of what to expect from financial statements.)

2. ***P & L analysis*** (Refer to Exhibit 1). What do they understand from the statements? Is the business profitable? Would they invest? If yes, why? If no, why? (For this, look at the big numbers and their evolution over the years. Like sales, cost of goods sold (COGS), gross margin, operating expenses (OPEX), financial expenses, net margin. After understanding it, they can get a general idea about the financial situation of a business).

3. ***Balance Sheet analysis*** (Refer to Exhibit2). What do they understand from the statement? What are the sources of funds? Are they enough to finance the business's working, or more credit is needed for the said purpose? What is their opinion? Operational ratios- What was the company policy and its stance in reality. (For this, they have to look at big numbers, primary sources, and application of funds. Evaluate strategic options over the years by analysing the pattern between the numbers. After grasping this information, they can get a general idea about the financial implication of operational ratios, i.e., receivables, payables, and

inventory. Remember- a good balance sheet can sustain a lousy P&L account for a while, but a lousy P&L cannot sustain a sound balance sheet for an extended period. Take decision accordingly).

4. ***Forecast P&L and Balance Sheet***. Justifying the decisions cannot be based only on previous performances but also on future performance. Forecasting is done to measure the creditworthiness of customers in the future. How well it can pay potential credit in the future. It will help to support one's financial decisions.

5. ***NFO and WC***. A right balance between source and use of funds is necessary for a successful business. When one forecasts a potential outcome, different variables can affect it. To cover up the potential pitfall that can befall any financial decision, sensitivity analysis is done to ensure a well-informed decision after considering different variables.

6. ***Sustainable growth***. Growth is a fundamental requirement to expand a business. What percent of growth is enough? If one cannot maintain sustainable growth, then, can only wait for the business to go under. Growth needs funds. If one cannot supplement with sufficient working capital, then just can fall into the trap of credit.

By the end of this case study, one should have a complete overview of operational finance's critical aspects. One will also understand what tools financial professionals use to make decisions to strengthen a company's position.

Let's explain the question asked in the assignment one by one and all the steps used to arrive at the conclusion.

Question 1 Is the finance of $1.3 million enough for the company for the next four years?

Answer 1 It is concluded that $1.3 million is not sufficient as funds required for the desired growth of the business analysed through forecasting. This conclusion has been reached at by following the below mentioned steps.
Business Analysis: When one analyses the business, one expects something from numbers. For example, luxury brands generate more profits, and distribution companies earn fewer profits for the less value-added services. In the analysis, the aim is to know about the following questions.

1. What is the business - Service, Manufacturing, distribution?
2. What are the products?
3. To whom do we sell?
4. Who are the suppliers?
5. What is the strategy?
6. Who comprises the management?

These questions will give a general idea for the business.

P & L Analysis*:* The first particular item that garners interest is whether the company is incurring losses or making profits. For a start-up company, it is generally assumed it will take a few years to earn profits. After seeing the profit/loss, one should analyse the P&L account to see the said gain/loss source. The main items that a P&L comprises are sales, cost of goods sold, gross margin, operating expenses, financial expenses, tax, and net gain/loss. Return on sales is an excellent way to get an idea of how much is being made. To better understand the P&L account, one should focus on three things- concept, number, and opinion. It means for a concept, one has a number, and on that basis, one forms an opinion.

By converting numbers to the percentage of sales can give an idea about the general direction the expenses are heading. For example, 23% gross margin means the company's capacity to pay OPEX and financial expenses from that 23% and still able to generate some profits. Stable gross margin indicates the growing capacity of the company without sacrificing margin.

OPEX- Operating expenses include salaries, electricity, rent, and overhead costs. As sales increase, OPEX starts decreasing, showing economies of scale. The reason behind this is the expenses remain constant (for example, rent). As shown in the exhibit1, it is seen with the increase of sales, OPEX percentage to sales is decreasing, showing maximum efficiency.

EBIDTA- This number shows the efficiency of managers. The reason behind this is that the managers are responsible for managing COGS and OPEX. The items below EBIDTA, such as depreciation, financial expenses, and tax, are beyond managers' scope.

Financial expenses- These are dependent on the credit, short and long term loans. Higher the three items, the higher these expenses are. These expenses show the leverage of the company. Generally, it is preferable to have more than 2.5 times the earnings.

Cash Flow- Net income plus depreciation is the cash flow of the company. This helps us to gather data on whether the company will be able to pay back loans and in how much time.

Return on Sales- This helps to see the amount earned in comparison to sales.

The result of the analysis of P&L is that company is profitable.

Analyzing Balance Sheet- This is a statement that reflects the source and usage of funds. For convenience, it can be done in three steps.

1. Look at the big numbers of last year's balance sheet to get a general view about all particulars. For example, fixed assets comprise 8% of total assets, and the rest is invested in current assets. These are funded by approximately 15% through equity, 12% through long-term liabilities, and the rest through current liabilities. It shows high leveraged company.

2. Find out the evolution of numbers, i.e., the difference between the first and last year of numbers. What happened? And Why? For example, in the previous year, promissory notes (payables with a strong legal obligation) were added, hinting at late payment to suppliers. An increase in receivables could be due to the rise in sales or late payment by customers.

3. *Operational Ratios*- The three ratios, namely, days of collection, days of inventory, and days of payment, tells whether the company is well managed or not? All these three ratios show the financial implication for the company. For example, an increase in days of the collection means more days one has to finance sales either through the line of credit or more credit from suppliers. Increased days of payment means the company is getting additional financing through late payment to suppliers.

4. *Forecast P&L- The f*orecast is done to see how the company will perform in the future. The forecast is done based on assumptions about sales. One can predict the rest of the items like COGS and transportation (77 percent), OPEX (19 percent) from sales. The return on sales is between one and a half percent to two percent in the next three years. The students can use sensitivity analysis for iterative calculations in different scenarios to come up with a decision.

5. *Forecast of Balance Sheet*- This shows whether the company will be able to pay back its loans on time. It is done by filling out the known items on the balance sheet. As predicted in the P&L, we calculate receivables, payables, and inventory based on sales. The fixed assets are calculated by subtracting depreciation from the combination of last and latest year fixed assets. Similarly, long-term loans are calculated by combining the previous year's loan, and any new loan might have been taken. The equity is calculated by adding last year's income to the previous year's equity and subtracting any dividends payout. If there is any payment towards repayment of the loan, it is deducted.

Minimum cash requirement (If liabilities side is more than assets side) is filled out. The last item is to be filled in the needed credit (if the assets side is more than the liabilities side).

It is concluded that $1.3 million is not sufficient to fund required by desired growth of the business through forecasting.

Question 2 Does Mr. David's aim for 25% growth sustainable? If yes, why? If no, why not?

Answer 2: This asks for the question of why the company needs more finance every year. The diagnosis is the growth of need of NFO is more than the growth of working capital. It means growth is not sustainable. The definition of the terms is as follows-

NFO = Minimum cash + Receivables + Inventory – Payables – Other spontaneous funds

Working capital = Equity + Long Term Liability – Fixed Assets

Sustainable growth = $g = ROS_t/(NFO_t\% - ROS_t)$

Where g= sustainable growth; ROS = Return on Sales

If the growth is not sustainable, the growth of NFO will always be greater than the growth of WC. This will create a loop for more credit needs, not the answer to the question every time. By putting the values in the above mention formula, one can calculate, at what percentage to grow is sustainable.

Question 3 What can be done to tackle the financial situation? What can be done by the management to improve the credit worthiness of the company?

Answer: The action plan that is just right for this company can be analyzed by checking the feasibility of different options available for the manager.

Feasibility of different options in the Action Plan that can be used

1. ***To decrease the need for funds for operations (NFO),*** it mainly consists of receivables, inventory, and payables, dependent on sales. We can either increase in payables or reduce inventory and receivables. As the company's sales are sensitive due to the economic crisis, one cannot further give more relaxing terms to customers as bad debts can increase. We cannot reduce inventory as it is our competitive advantage to offer many products in the catalog. The days of payment cannot be further delayed as it will affect the company's worthiness. The promissory notes were already issued by some suppliers in 2020. The company cannot afford more risks in the field. Hence, decreasing NFO is not a feasible option.

2. ***To increase working capital*** (WC) - Working capital consists of the amount left over by subtracting the fixed assets from long term funds and equity. Fixed assets are being maintained according to the previous year's values. The company is already much leveraged. The company owners cannot increase equity at will. So, increasing working capital is not a feasible option.

3. ***Increase in sales*** – Due to the economic condition of the country's economy, sales cannot be increased exponentially in a short period. The company can offer various schemes to lure more customers, but the company cannot provide more flexible terms to customers or further offer customers cash discounts.

4. ***Increase in prices***- If the sale price is increased between 1-2%, the company would still suffer through stiff competition, but short term credit will be sufficient to cover the difference between NFO and WC. As in 2021, sales are estimated to show an upward trend, and this option becomes a more feasible one. If the company loses some customers, it will also help to narrow down the difference between NFO and WC.

5. ***The decrease in production cost***- The cost of raw materials is already at optimal prices. Hence, the further reduction in the production cost is not feasible.

6. ***Decrease in operating expenses*** – The Company has already achieved economies of scale. The overhead costs are stable at 19% of sales, so this solution is also not feasible.

7. ***Decrease in financial expenses*** – Due to increased long-term loans and credit lines, overall financial costs are increased. So, this option is also not feasible.

Among all options to increase the commodity price by 1-2% looks like a more feasible option. When the situation improves, the company can offer cash or bulk discounts or loyalty programs for its customers to increase the flow of money.

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Exhibit 1

P&L Account of the Dream Homes for the year ending

Particulars	**2017 ($'000)**	**2018 ($'000)**	**2019 ($'000)**	**2020 ($'000)**
Sales	2,198	3,375	4,950	6,606
COGS*	1,539	2,329	3,465	4,617
Transportation & commercial exp.	155	243	326	468
Gross margin	504	803	1159	1521
Salaries	374	457	569	756
Overhead **	270	344	407	497
OPEX (operational expenses)	644	801	977	1,253
EBITDA	-140	2	182	268
Depreciation	45	74	70	70
EBIT	-187	-72	113	198
Financial Expenses ***	-18	-34	-50	-68
Profit before taxes	-205	-106	63	131
Taxes (25%)	52	27	-16	-34
Net income	-153	-79	47	99
Additional Information:				
Purchases	1,744	2,367	3,726	4,903
Salary of Mr. David	135	203	203	225
New investments in FA	2	263	20	18

P&L Account of Dream Homes

**COGS = Purchases – Purchase returns + Purchase discount +Freight In + Opening Stock – Closing Stock*

*** Overhead = Bad Debts + Sales promotion expenses + Advertisement expenses + Rent +Electricity + Misc. Expenses*

**** Financial Expenses = Loan generation expenses + Interest paid on credit lines + Interest paid on long term loans*

Exhibit 2 Balance Sheet

Particulars	2017 **($'000)**	2018 **($'000)**	2019 **($'000)**	2020 **($'000)**
Cash	2	18	14	14
Receivables*	423	686	1,064	1,460
Other	95	126	85	40
Inventory**	432	470	731	1,017
Current assets	952	1,300	1,894	2,531
Non-current assets	135	325	275	225
TOTAL ASSETS	1,087	1,625	2,169	2,756
Payables to suppliers	295	473	878	900
Promissory notes with supplier				365
Other liabilities	340	167	79	50
Bank lines of credit	225	275	455	698
Current liabilities	860	914	1,411	2,012
Long term debt	225	450	450	338
Capital	338	675	675	675
Net income of the year	-182	-335	-414	-367
Reserves	-153	-79	47	99
Equity	2	261	308	407
LIABILITIES + EQUITY	1,087	1,625	2,169	2,756

Balance Sheet of Dream Homes

**Receivables = Gross credit sales – returns (if any)*

***Inventory = Closing Stock*

****Payables = Gross credit Purchases- returns (if any)*

Exhibit 3 Short Balance Sheet

Particulars	2017	2018	2019	2020
NFO	315	644	925	1,204
NCA. Not current asset	135	324	277	225
Net Assets	450	968	1,202	1,429
Bank Debt	450	725	905	1,035
Equity	2	261	308	407
Liabilities + Equity	452	986	1,213	1,442
Cash Surplus(+) or credit needed (-)	2	18	11	13

Authors' Calculation

Exhibit 4 Cash/ Credit

NFO vs. WC	2017	2018	2019	2020
NFO	315	644	925	1,204
WC	92	387	484	520
Cash Surplus(+) or credit needed (-)	-223	-257	-441	-684

Cash vs. Credit

Exhibit 5 Operational Ratios

Balance Ratios	Company Policy	Forecast for the next 3 Years
Days of Collection	60	80
Days of Inventory	60/90	80
Days of Payment	60	90

Operational Ratios

Appendix 1: List of Abbreviations

Abbreviation	Term
P&L account	Profit and Loss Account
NFO	Need of funds for Operations
WC	Working Capital
EBIDTA	Earnings before interest, depreciation, tax, and amortization
EBT	Earnings before tax
COGS	Cost of goods sold
OPEX	Operating Expenses