CASE STUDY V

Mushroom Manufacturing Ltd

Mushroom Manufacturing Ltd is a fast growing company. However, in anticipation of this growth the directors built up their finished goods stocks at an even faster rate to make sure that they met customer demand and did not cut orders. The managing director was worried about the pressure on the cash flow because of this growth and so proposed implementation of an action plan that included a reduction in stock levels, and pressure on customers to pay within the required 30 days.

The sales manager has reported on the two months actual sales for July and August and estimated sales for the next six months:

July	£2,250,000
August	£2,700,000
September	£2,900,000
October	£3,050,000
November	£3,250,000
December	£3,500,000
January	£3,650,000
Februar	£3,800,000

In August 2001 accounts receivable were 60 days sales. The credit controller has targeted debtor days to reduce from 60 days at 31 August to 45 days at 30 September and 30 days on 31 October. He has also targeted 30 days to be maintained thereafter.

The plant manager has provided a production plan to give level production:
September to February raw material purchases £860,000 per month
July and August were £1,000,000 and £900,000 respectivel
Materials are bought with supplier payment terms of net 45 days
Salaries and wages are £290,000 per month and paid in each month
Overheads and utilities are £560,000 per month and paid in each month

The commercial manager has estimated that selling and administrative costs will be:

September and October	15% of sales
November and December	14% of sales
January and Februar	13% of sales

These expenses will all be paid in the month that they are incurred.

The balance sheet for Mushroom Manufacturing Ltd as at 31 August 2001 was as follows:

	£000	£000	£000
Fixed assets			
Fixed assets at cost	16,480		
Depreciation provision	6,980		9,500
Current assets			
Stocks			
Raw materials	3,840		
Finished goods	8,520	12,360	
Accounts receivable		5,250	
Other assets		2,560	
Bank and cash		1,050	
		21,220	
Current liabilities			
Accounts payable		1,400	
Short-term loans		1,500	
Accruals		1,480	
Corporation tax payable		500	
		4,880	
Net current assets			16,340
Total assets less current liabilities			25,840
less			
Long-term loans			13,060
Net assets			12,780
Capital and reserves			
Share capital			9,000
Profit and loss account			3,780
			12,780

Interest payable on long and short-term loans is accrued at 10% p.a.

Short-term loan repayments are to be made £250,000 at the end of October and £250,000 at the end of January, and half-year interest of £800,000 is payable in January.

Corporation tax £500,000 is expected to be paid in December.

Depreciation (a manufacturing cost) runs at £70,000 a month and cost of sales is 70% of sales.

Materials used during September and October is expected to be £1,100,000 for each month.

Corporation tax on profits can be calculated at 50%.

Required

(i) **Prepare a forecast profit and loss account for the two months of September and October and a forecast balance sheet as at 31 October 2001.**

(ii) **Prepare a cash budget for the managing director for September to February to determine the phasing of the cash flows that would result from his action plan.**

(iii) **The managing director would also like to know the forecast cash flows and month-end cash balances for September to February if the credit controller does not meet his target and debtors remain at 60 days of sales, compared with the results following successful implementation of the action plan.**

(iv) **Draft a report for the managing director that makes use of the analyses that you have carried out to consider arguments both for and against customer terms of 30 days or 60 days. Your report should also consider some of the wider financial and non-financial factors in addition to the cash flow impact of both scenarios.**