**Lubin School of Business**
FIN 663: Applying Financial Theory to Strategic Decision Making
Prof. P.V. Viswanath

Team Test 1

* **Answer all questions. Explain all your answers**; correct answers without explanations may not be given any credit at all. Question 1 is a bonus question; so please do questions 2 and 3 well and if you have time, attempt question 2. Obviously bonus points will be given only if the answers are substantial.
* **Make sure that your answer is clear and concise.**Confused and rambling answers will lose points.

1. (Bonus: 10 points) Consider the case of firms using trade credit.

1. (5 points) Take the example of a specific firm that receives trade credit (such a firm would have a positive number for Accounts Payable). Why does this firm use trade credit as opposed to using banks or commercial paper to obtain short-term credit?
2. (5 points) Choose a firm and show how the use of trade credit interacts with its operating strategies. Provide a link to an article or a news item. This firm can be the same as the firm in part a.

2. (60 points) An online textbook on Strategic Management has the following paragraph (<https://saylordotorg.github.io/text_mastering-strategic-management/s09-05-best-cost-strategy.html>, viewed March 10, 2022):

*Target appears to be following a best-cost strategy. The firm charges prices that are relatively low among retailers while at the same time attracting trend-conscious consumers by carrying products from famous designers, such as Michael Graves, Isaac Mizrahi, Fiorucci, Liz Lange, and others. This is a lucrative position for Target, but the position is under attack from all sides. Cost leader Walmart charges lower prices than Target. This makes Walmart a constant threat to steal the thriftiest of Target’s customers. Focus differentiators such as Anthropologie that specialize in trendy clothing and home furnishings can take business from Target in those areas. Deep discounters such as T.J. Maxx and Marshalls offer another viable alternative to shoppers because they offer designer clothes and furnishings at closeout prices. A firm such as Target that uses a best-cost strategy also opens itself up to a wider variety of potentially lethal rivals.*

1. (40 points) Compute Target’s NOPAT margin and Operating Asset Turnover for the last three years. On your Word document, show exactly what computations you undertook in order to arrive at your ratios. You have been provided with an Excel spreadsheet containing the income statement and balance sheet for Target for the last five years. Add a separate worksheet with formulas using links to the existing two worksheets to show the ratios. Create a graph showing the change over time in these ratios.
2. (20 points) Show and explain the difference between the standard Dupont decomposition and your modified Dupont decomposition. That is, provide the numbers for the two different identities: 1) ROA (NI/TA) = Net Profit Margin (NI/Sales) x Asset Turnover (Sales/TA) and 2) RNOA = Operating Profit Margin x Net Asset Turnover and explain why the numbers are different. Explain how your interpretation of the decomposition would change going from the standard decomposition to the modified decomposition.

Reproduce whatever you need from these computations (including the graph, if you deem it necessary) on the Word document, but provide your Excel document as well. Name your Excel file as team#\_target.doctype; thus if your team is team 1 and you are using an .xlsx document type, name your file team1\_target.xlsx.

3. (40 points) Alcoa reported a $2.73 billion liability at the end of 2008 for accrued postretirement benefits*.*In a note to the Alcoa financial statements, the company explains part of this liability amount as follows:

*“Alcoa maintains health care and life insurance benefit plans covering eligible U.S. retired employees and certain retirees from foreign locations. Generally, the medical plans pay a percentage of medical expenses, reduced by deductibles and other coverages. These plans are generally unfunded, except for certain benefits funded through a trust. Life benefits are generally provided by insurance contracts. Alcoa retains the right, subject to existing agreements, to change or eliminate these benefits.”*

Postretirement benefits cover a broad array of promises that companies make to their employees to boost morale and keep them from seeking other jobs. Alcoa is providing two of the most common: health care insurance and life insurance. Based on stipulations that may be required for eligibility, Alcoa helps employees by paying a portion of their insurance cost even after they have retired. This benefit is apparently earned by working for the company. After a person retires, Alcoa continues to provide these payments as a reward for years of employee service.

1. (15 points) Is this a financial liability or an operating liability?
2. (15 points) Should this liability be on the right hand side of the balance sheet or the left-hand side of the balance sheet according to GAAP? On which side of the balance sheet would you put it from an internal, managerial decision-making point of view? Explain.
3. (10 points) If you answered in part (a) that this is an operating liability, why is it important to recognize that this is an operating liability? If you answered that this is a financial liability, what would the implication of wrongly classifying it as an operating liability?

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| Question | Your score | Maximum |
| 1a. |  | 10 |
| 1b. |  | 15 |
| 1c. |  | 10 |
| 2a. |  | 10 |
| 2b. |  | 15 |
| 2c. |  | 10 |
| 3a. |  | 5 |
| 3b. |  | 5 |
| 3c. |  | 10 |
| 3d. |  | 10 |
| Total |  | 100 |