HARRT Exercise

The Case of the Venture and the Contract

An entrepreneur enters a long-term fixed price contract on January 1, 2014. The terms of the contract call for payment according to the following schedule. The estimated receipts and costs of performing the contract are also shown.

<u>Contact billings, receipts and direct costs ($000s):</u>

	2014	2015	2016	2017	2018	Total
Billing	140	80	80	50	50	400
Receipts	70	110	80	65	75	400
Direct Costs	50	80	40	30	40	240

The first year payment of $70 is paid in two installments: $40 at the point the contract is signed and $30 at the end of 2014. All other cash receipts and cash payments are presumed to happen evenly during the respective year. In addition to the above, the contractor must purchase $100 of special purpose equipment at the start of 2014. It will be worth only scrap value at the end of the contract in 2018. The corporate tax rate is 40%, and the firm requires a 15% rate of return on such contracts. Assume that if there is a loss in any given year, the company receives a tax credit equal to 40% of the loss in that year. Also, assume that the contractor has cash of $100 and capital of $100 before entering into this contract.

Required

1. Complete the attached worksheet. How much profit will the company make over the life of the contract? In each of the five years? How do the net cash flows compare to the net income for each year?
2. How much will this contract be worth to the company at the point it is signed?
3. What is the rate of return earned on this contract?
4. Based on your analysis of the project cash flow patterns, what one recommendation would you make to the entrepreneur?

Worksheet

Cash Flow Statement	Start	2014	2015	2016	2017	2018	Total
Receipts							
Contract Costs							
Capital Expenditures							
Tax Payments							
Net Cash Flow							

Income Statement	2014	2015	2016	2017	2018	Total
Revenue						
Contract Costs						
Contract Income						
Tax Expense						
Net Income					-	

	1-Jan-14		December 31, …				
Balance Sheet	Before	After	2014	2015	2016	2017	2018
Cash	100						
Total Assets	100						
Capital	100						
Total Liab. + S/H Equity	100						