BUSM 5773: MBA Finance Week 5 Problems

Name

Institution

Question 1

By definition, current ratio (CR) is the capability of a firm to fulfil its short term debt obligations using its short term liabilities. It is a measure of the liquidity of a company and the higher the CR, the more liquid the company is.

CR = $\frac{CURRENT\ ASSETS}{CURRENT\ LIABILITIES}$

A current liability is the money a company must pay to its creditors within 12 months of the balance sheet period. Failure to pay creditors within a certain financial year reduces the liquidity ratio of the company.

On the other hand, current assets that include cash and receivables are responsible for offsetting current liabilities. It is, however, safer for any company if current assets exceed current liabilities. Having a CR>1 is an indication that the company is doing good financially.

Inventory is purchased

This action will have no impact on the CR. Purchasing inventory increases a company's stock and at the same time the money used to acquire it deceases cash. The stock and cash cancel out.

A supplier is paid

The CR increases. Paying a supplier reduces current liability and from the CR equation, the CR automatically goes up in value, thus, the company is said to have a higher liquidity ratio.

A short term bank loan is repaid

The CR increases. Short term bank loan is a short term/current liability. Repaying this loan reduces current liability; therein, increasing the CR.

A long term debt is paid off early

The CR decreases. Long term debts are supposed to be settled on long term basis. Using the available cash (current asset) to pay off long term debt reduces cash flow and the company's capability to meet its short term obligations. The short term liquidity of the firm eventually becomes impacted negatively.

A customer pays off a credit account

The CR remains unchanged. Cash increases while receivables decrease

Question 2

CR of 0.5

A CR of 0.5 implies that the company's current liabilities exceed current assets. The company is therefore unable to meet its short term debts. The firm is said to be financially unstable.

CR of 1.5

This means that the company is able to meet its short term obligations. However, having a CR of 1.5 is a show of weakness. Business operations will slow down and make investors fear to invest. Employees might also abandon the firm for greener pastures.

CR of 15.0

A current ratio of 15.0 is strong. It means current assets are 15.0 times over the current liabilities. The short term liquidity of the company is high, thus, chances of having a good financial year are high.

Question 3

Galaxy Enterprises

Balance Sheet

June 8, 2015

ASSETS	
Current Assets	
Cash	$25,000
Accounts receivable	$35,000
Inventories	$30,000
Total Current Assets	$90,000
Investments	
Net plant and equipment	$140,000
Total Investments	$140,000
Total Assets	***$230,000***
Current Liabilities	
Accounts Payable	$24,000
Total Current Liabilities	$24,000
Long term Liabilities	
Long term debt	$130,000
Book rates of return	$100,000
Total Liabilities	***$230,000***

Question 4: CVL Cosmetics

Return of Assets (ROA)

ROA = $\frac{Net\ Income}{Average\ Total\ Asset}$

Net Income

Operating profit margin 8%

Sales to asset ratio 3

Assets $500,000

Sales = Sales to asset ratio * assets = 3*500,000 = $1,500,000

Profit = 0.08*$1,500,000 = $120,000

Less interest payments $30,000 ($120,000-$30,000)

= $90,000

Less tax rate 35% ($90,000 – 0.35*90,000) = $58,500

Net Income/profit = $58,00

ROA = $\frac{\$58{,}500}{\$500{,}000}$

= 0.117

Return on Equity (ROE)

Equity = $300,000

ROE = $\frac{Net\ Income}{Equity}$

ROE = $\frac{\$58{,}500}{\$300{,}000}$

= 0.195