**Liquidity and debt to equity solutions:**

**Question 1 (4 marks)**

|  |  |
| --- | --- |
| **What is the difference between liquidity and leverage, and how can these be evaluated?** | **4** |
| **Answer:** |  |
| **Liquidity** |  |
| Liquidity is referred to as the extent to which a business’s assets can be converted into cash to meet a firm’s debt obligations | (1) |
| Liquidity can be evaluated by calculating the amount of working capital, or the working capital ratio or quick ratio | (1) |
| **Leverage** |  |
| Leverage is the amount of debt finance that a business uses in its operations as compared to equity finance. | (1) |
| Leverage can be evaluated by calculating the debt to equity ratio. | (1) |
| Total | /4 |

**Question 2 (16 marks)**

1. Calculate the following ratios expressed as a percentage to two decimal places*.* (8 marks)

|  |  |  |  |
| --- | --- | --- | --- |
| **Ratios** | **2020** | **2019** | Marks |
| **Working capital ratio:**  Current assets  Current liabilities | 25,500 (1)  25,500 (1)  **= 100.00%** | 27,500 (1)  5,500 (1)  **= 500.00%** | **4** |
| **Quick asset ratio:**  Current assets-inventory-prepayments  Current liabilities-bank overdraft | 9,500 (1)  25,500 (1)  **= 37.25%** | 10,000 (1)  5,500 (1)  **= 181.82%** | **4** |

1. Comment on the liquidity position of Grandstand Industries.(8 marks)

* Overall the liquidity has declined as indicated by both the working capital and quick asset ratios, which is very concerning.
* **Working capital** has decreased during the year from having $5 available to pay every dollar of current liabilities to only $1, showing they are only just able to meet short term debts in 2020.
* The significant decline is a consequence of the increase in the short term loan.
* *Current assets are tied up in debtors and given the current economic climate during Covid-19 a larger than normal proportion of these may become uncollectable.*
* *Covid lock downs may further affect the businesses future ability to generate revenue and cash from sales.*
* **Quick asset** highlights the liquidity problem as unlike 2019 the business would be unable to meet immediate debts in 2020.
* Further, the business currently has no cash. Without an injection of cash, the business may not be able to continue as a going concern.
* The business will be unable to meet the loan repayment due in November.
* A possible cash capital injection may be required to assist liquidity unless the bank can extend the loan.
* Inventory may need to be discounted which will place further pressure on liquidity.

*6 marks for valid liquidity comments*

*2 marks awarded for responding to the impact of Covid-19*