Thorpe Company is a wholesale distributor of professional equipment and supplies. The

Company's sales have averaged about $ 900,000 annually for the three year period 2007 -2009.

The firm's total assets at the end of 2009 amounted to $ 850,000.

The President of Thorpe company has asked the controller to prepare a report that summarizes

the financial aspects of the company's operations for the past three years. This report will be

presented to the board of directors as its next meeting.

in addition to comparative financial statements, the controller has decided to present a number

of relevant financial ratios that can assist in the identification and interpretation of trends.

At the request of the controller, the accounting staff has calculated the following ratios for the

three-year period 2007 -2009 :

In preparing his report, the controller has decided first to examine the financial ratios independently

of any other data to determine whether the ratios themselves reveal any significant trends over the

first three-year period

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| **Required** |
| (a) The current ratio is increasing, while the acid-test (quick) ratio is decreasing. Using the ratios |
| provided, identify and explain the contributing factors(s) for this apparently divergent trend. |
| (b) In terms of the ratios provided, what conclusion(s) can be drawn regarding the compnay's use |
| of financial leverage during the 2007-2009 period? |
| C) Using the ratios provided, what conclusion(s) can be drawn regarding the company's net |
| investment in plant and quipment? |

a)

Current Ratio: The current ratio is a liquidity ratio that measures a company's ability to pay short-term and long-term obligations. To gauge this ability, the current ratio considers the current total assets of a company (both liquid and illiquid) relative to that company's current total liabilities.

Quick Ratio : The quick ratio is a measure of how well a company can meet its short-term financial liabilities. Also known as the acid-test ratio, it can be calculated as follows: (Cash + Marketable Securities + Accounts Receivable) / Current Liabilities.

Current Ratio includes all the current assets and all the current liabilities, while Quick ratio considers only those assets which can be quickly liquidated. Inventories are not considered in quick ratio.

The Increasing trend in current ratio tells us the ability of the company to liquify its current assets are healthy, while decreasing trend in quick ratio tells us that it liquifying may not be quick to meet it’s immediate need or pay off liabilities. There may be several factors contributing to this divergence, but with the information provided, can boil down to 2 reasons,

Reason 1: Increased Inventory in Current Assets.

Refer, Inventory Turnover which shows declining trend from 2007 to 2009. In 2007, company sold 5.25 times the average inventory, but in 2009, it was just 3.8 times. Argument for less sales is neglected as Sales has been increased by 6% since 2007, so it has to be only because of inventory.

Reason 2: relaxing the credit policy by increasing credit repay duration to promote more sales.

Refer, Accounts Receivable Turnover Ratio, which evaluates ability of a company to efficiently issue credit to its customers and collect funds from them in a timely manner. Which is also in declining from 2007 to 2009. Company must have relaxed its credit purchase policy to boost sales (sales has increased by 6%), but, unfortunately it has to face more defaulters resulting in declining Accounts Receivable Turnover, which also key contributing input for Quick Ratio.

Financial Leverage

Financial leverage refers to the use of debt to acquire additional assets. The magnitude of increase/decrease in value of assets has direct impact on company’s financial health. Not only that, if margin is very less, that will also have equal amount of impact in company’s financial health. So, we have to see how the debts are used for buying assets and infer the benefits.

There are 2 ratios, which will help us directly in understanding the effect of Financial Leverage.

1. Percent of total debt to total assets
2. Percentage of long term debt to total assets

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| **Financial Ratio** | 2007 | 2008 | 2009 |
| Percent of total debt to total assets | 44% | 41% | 38% |
| Percentage of long term debt to total assets | 25% | 22% | 19% |
| Percentage of Short term debt to total assets | 75% | 78% | 81% |

In 2007, company has used 44% of total debts in its assets, in 2009, it has become 38%. This may be because company is taking little conservative approach. There is also sharp decrease in using its long-term debts in its total assets, from 25% to 19%. As there is no clear information about the proportion of long-term debts with current assets and fixed assets, we assume company is using its long-term debts with only fixed assets, used short term debts in current assets like pumping up it’s inventory.

Now that we understand that company has reduced using its debts for buying assets, another factor which we have to take into account is Return on total assets, since 2007, we can see that ROTA is increasing 10 basis points. Assets are already started giving good results and company has already reaping benefits out of it. This might also be another reason why company has reduced the usage of leverage over the period of 3 years.

Net Investment in Plant and Equipment

It is a measure of amount that a firm spends on a fixed asset (also called as Capital assets) less depreciation. This ratio can be used to measure operating performance efficiency. Value of this ratio has to be interpreted according to the industry that is being evaluated. Here Company under Study is a whole sale distributer of professional equipment and supplies. It’s a wholesale distributor company, that will require good amount of real-estate to store the inventory