The new scott equipment organization paper essay sample

Finance, Investment

Scott Equipment Organization is investigating the use of various combinations of short-term and long-term debt in financing its assets. The organization has decided to employ $25 million in current assets, along with $40 million in fixed assets, in its operations next year. Anticipated sales and Earnings Before Interest and Taxes (EBIT) for next year are $60 million and $6 million, respectively. The organization’s income tax rate is 40%; stockholders’ equity will be used to finance $40 million of its assets, with the remainder being financed by short-term and long-term debt. Scott’s is considering implementing one of the following financing policies:

AMOUNT OF SHORT-TERM DEBT

FINANCIAL POLICY

IN MILLIONS

LTD

(%)

STD

(%)

Aggressive

(large amount of short-term debt)

$20

8. 5

5. 5

Moderate

(moderate amount of short-term debt)

$15

8. 0

5. 0

Conservative

(small amount of short-term debt)

$10

7. 5

4. 5

Based on the above information, the following calculations were determined.

BALANCE SHEET

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INCOME STATEMENT

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EXPECTED RATE OF RETURN ON STOCKHOLDERS' EQUITY

ROE (RETURN ON COMMON EQUITY) = EAT (EARNINGS AFTER TAXES) / EQUITY

AGGRESSIVE

Interest = ($20, 000, 000 x . 055) + ($5, 000, 000 x . 085) = $1, 525, 000

EBT = EBIT – interest = $6, 000, 000 – 1, 525, 000 = $4, 475, 000

Taxes = EBT x 40% = $4, 475, 000 x . 40 = $1, 790, 000

EAT = EBT – taxes = $4, 475, 000 – 1, 790, 000 = $2, 685, 000

ROE = EAT / equity = $2, 685, 000 / 40, 000, 000 = 6. 71%

MODERATE

Interest = ($15, 000, 000 x . 05) + ($10, 000, 000 x . 08) = $1, 550, 000

EBT = EBIT – interest = $6, 000, 000 – 1, 550, 000 = $4, 450, 000

Taxes = EBT x 40% = $4, 450, 000 x . 40 = $1, 780, 000

EAT = EBT – taxes = $4, 450, 000 – 1, 780, 000 = $2, 670, 000

ROE = EAT / equity = $2, 685, 000 / 40, 000, 000 = 6. 68%

CONSERVATIVE

Interest = ($10, 000, 000 x . 045) + ($15, 000, 000 x . 075) = $1, 575, 000

EBT = EBIT – interest = $6, 000, 000 – 1, 575, 000 = $4, 425, 000

Taxes = EBT x 40% = $4, 425, 000 x . 40 = $1, 770, 000

EAT = EBT – taxes = $4, 425, 000 – 1, 770, 000 = $2, 655, 000

ROE = EAT / equity = $2, 655, 000 / 40, 000, 000 = 6. 64%

NET WORKING CAPITAL POSITION

NWC = CURRENT ASSETS – CURRENT LIABILITIES

AGGRESSIVE

$25, 000, 000 – 20, 000, 000 = $5, 000, 000

MODERATE

$25, 000, 000 – 15, 000, 000 = $10, 000, 000

CONSERVATIVE

$25, 000, 000 – 10, 000, 000 = $15, 000, 000

CURRENT RATIO

CR = CURRENT ASSETS / CURRENT LIABILITIES

AGGRESSIVE

$25, 000, 000 / 20, 000, 000 = 1. 25

MODERATE

$25, 000, 000 / 15, 000, 000 = 1. 67

CONSERVATIVE

$25, 000, 000 / 10, 000, 000 = 2. 50

EVALUATION

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SUMMARY

According to the calculations the aggressive financial policy will yield the highest profitability with $50, 000 less interest deducted resulting in a $50, 000 higher earnings before taxes. Although the aggressive policy will pay the most taxes, it will result in the highest return on equity at 6. 71%, which is better for the owners. But the higher profitability brings with it greater risk. The net working capital is $10 million less than the conservative policy coupled with the lowest current ratio of 1. 25 indicates the possibility that Scott Equipment Organization will be unable to pay its bills as they come due.

The conservative financial policy has the lowest profitability and the lowest risk, but has the highest net working capital of $15 million and current ratio

of 2. 50. This indicates that the company is in a good position to pay its bills as they come due. The difference in the return on equity is small at 0. 07%. The choice of which financial policy is best for Scott Equipment Organization is dependent on the risk preference of the decision maker.

References

Gitman, L. (2006). Principles of managerial finance. (11th ed.). New York, NY: Pearson, Addison Wesley.