1-calculate the z-score and comment on the results,2- find a debt rating and comm...

Finance

Finance and Accounting s affiliation Finance and Accounting Question The Z-score is a model used to determine whether a firm is about to go through financial distress. Financial distress of a company can be defined as the state in which the company fails to honour the promises made to their creditors and this can lead to bankruptcy if correct measures are not taken to correct the situation (Jacob, Bas, Joseph, & Arie, 2013). Altman applied statistical method of discriminant analysis to test the probability of corporate failure for publicly held companies.

Altman’s Z-score is important as it helps in establishing the firm’s viability to enter into strategic alliances and mergers with others. It can also be used to evaluate the managers of a company, if the Z-score is favourable then the managers are doing a good job and the converse is also true. Additionally, the model can be used to check the viability of the firm before seeking employment and also to predict business failure of the company

The Z-score is obtained by considering five variables. The decision criterion is given as follows;

Z˃2. 99- this is the safe zone for the company

Z= 1. 8-2. 99-this is referred as the grey zone

Z˂1. 8-this level indicates high chances of financial distress for the company.

The variables include;

X1 = Working Capital/Total Assets

2011 2012

= (11, 060)/1, 456, 952 = (10, 656)/1, 513, 319

= (0. 00759) = (0. 00704)

X2 = Retained Earnings/Total Assets

2011 2012

= 30, 715/1, 456, 952 = 31, 491/1, 513, 319

= 0. 021 = 0. 021

X3 = Earnings before interest and tax/Total Assets

2011 2012

= 51, 482/1, 456, 952 = 52, 156/1, 513, 319

= 0. 0353 = 0. 0345

X4 = Market Value of Equity/Total Liabilities

2011 2012

= 30, 715/1, 426, 237 = 31, 491/1, 481, 828

= 0. 0211 = 0. 0212

X5 = Net Sales/Total Assets

2011 2012

= 16, 849/1, 456, 952 = 776/1, 513, 319

= 0. 0116 = 0. 000513

Z = 1. 2*X1 + 1. 4*X2 + 3. 3*X3 + 0. 6*X4 + 1. 0*X5

2011

Z = 1. 2*(0. 00759) +1. 4*0. 021+3. 3*0. 0353+0. 6*0. 0211+1. 0*0. 0116

= 0. 16104

2012

Z = 1. 2*(0. 00704) +1. 4*0. 021+3. 3*0. 0345+0. 6*0. 0212+1. 0*0.

000513

= 0. 14804

The Z-score obtained for the two years is below 1. 8 and therefore the corporation is in a state of financial distress.

Question 2

Debt rating refers to the continued monitoring of the firm's financial status after they have been issued with a debt (Javier, 2014). The ratings are expressed as letters ranging from ' AAA' which represents the highest investment grade to ' C' which represents the lowest investment grade. This rating has an impact on the returns that must be offered in order to sell the debt instrument. For a firm to be considered suitable for investment, it must achieve a greater credit rating which is a crucial threshold because many funds are prevented by their ratings from any investments in bonds.

The following ratios will help to determine which grade the power corporation falls;

Earnings before interest and tax/equity

= 52, 156/31, 491

= 1. 656

Cash flows from operations/total debt

= 3, 880/1, 481, 828

= 0. 0026

Debt/equity

= 1, 481, 828/31, 491

= 47. 06

Using the Standard and Poor's debt rating agency, the above ratios indicate that the firm has a credit rating grade of B and below which is the low credit rating also referred to as the non-investment grade and is an indicator that the company is facing significant financial risks. Therefore, the power corporation should take necessary steps to prevent the company from being declared bankrupt.

References

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