

Week 4: Week 4 - W4 Assignment 2

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Assignment 2: External Funding Requirement and Degree of Leverage

Part One: External Funding Requirement

Your company, Martin Industries, Inc., has experienced a higher than expected demand for its new product line. The company plans to expand its operation by 25% by spending \$5,000,000 for an additional building.

The firm would like to maintain its 40% debt to total asset ratio in its capital structure and its dividend payout ratio of 50% of net income. Last year, net income was \$2,500,000.

Required:

1. What are retained earnings for last year?
2. How much debt will be needed for the new project?
3. How much external equity must Martin use at the beginning of this year in order to finance the new expansion?
4. If Martin decides to retain all earnings for the coming year, how much external equity will be required?

Part Two: The Degree of Leverage

Assume that two companies, Brake, Inc. and Carbo, Inc., have the following operating results:

	Brake, Inc.	Carbo, Inc.
Sales	\$300,000	\$300,000
Variable Costs	60,000	180,000
Fixed Costs	210,000	90,000
Operating Income	\$30,000	\$30,000

Required:

1. Calculate the contribution margins for the two companies.
2. Calculate the break-even point for each firm, in dollars and in units.

3. Compare the two companies. What conclusions could you make regarding the use of operating leverage employed by the two firms?
4. Assume that both companies experience an increase in sales by 15% next year. What would be the operating income for each firm net year? Explain the difference in the change in operating income between the two companies.
5. Based on the information from the above questions, what recommendations would you make to the two companies and why?

Deliverables:

- Submit your findings from Parts One and Two above in a Microsoft Excel document to the **W4: Assignment 2 Dropbox**, by **Tuesday, June 7, 2016**. Show all your calculations.

Name your document SU_FIN3030_W4_A2 _LastName_FirstInitial.

Assignment 2 Grading Criteria	Maximum Points
Correctly determined retained earnings for last year.	5
Correctly determined the amount of debt that will be used for the new project.	5
Correctly identified the external equity funding needed.	10
Correctly identified the break-even points for each firm.	10
Correctly described the use of leverage in each firm.	10
Correctly answered all other questions in parts one and two.	5
Presented the findings in good form and identified all sources.	5
Total:	50