

FINANCIAL STATEMENT ANALYSIS ACCT 620 August 2008

Instructor: Carmelita Troy, PhD, CPA (Inactive) Office Hours: TBA
Email contact: uscacct620@gmail.com Phone: TBD
IM contacts: Windows Messenger – carmelitaprincess@hotmail.com Office: TBA
Yahoo! – princessvalencia@yahoo.com
Gmail – inmyelement@gmail.com

Required Text and Calculator:

Stice & Stice, Financial Accounting Reporting & Analysis 7th edition. Thomson South-Western, 2006.

Financial Calculator: Texas Instruments BAII Plus

Textbook Website:

http://websites.swlearning.com/cgi-wadsworth/course_products_wp.pl?fid=M20b&product_isbn_issn=0324227329&discipline_number=400

Calculator Website:

http://education.ti.com/educationportal/sites/US/productDetail/us_baii_plus.html

Course Description and Objectives

This course explores both underlying theory and practical applications of financial reporting and analysis. Throughout the course we will develop an understanding of alternative accounting measurements, determine ways to better communicate financial performance and financial position to users and emphasize techniques for analyzing financial reports. The course highlights the importance of financial statements as an information source for creditors and investors and will address different forms of financial analysis based on financial report information. We will also discuss earnings management and fraudulent financial reporting.

The central objective of the course is to assist students in developing an understanding of and the ability to interpret the content of financial statements and to use the information garnered in decision-making. The primary focus of this course is on accountability of publicly-traded enterprises. The course covers a wide range of accounting topics; however, all topics covered are related to accounting for the information contained in external financial reports.

American Disabilities Act

If you qualify for accommodation under the American Disabilities Act, please see the instructor as soon as possible for referral and assistance in arranging such accommodation.

Class Procedures:

Class Participation: Classes will generally be conducted using a lecture and discussion format. Lectures and homework problems will be used to focus the discussion on important topics. Class participation is an essential part of the learning experience in this course. You should be ready to answer questions that arise in class concerning the assigned topics, and feel free to ask questions about the material being discussed and offer your own opinions and views.

Project: Throughout the term we will be learning many of the ratios used in financial analysis. We will incorporate these ratios with other tools that are used in financial analysis. To apply this knowledge a financial analysis group project of a company of is required. The final written project is due on Monday, 18 August 2008. Each student will provide feedback on the participation of each of the other members of their group. Projects submitted late will not be accepted.

Presentation: A presentation brief on your company will be made in class on Sunday, 17 August 2008. The briefing is to be 12-15 minutes max. The focus should be on the historical background of the company, a current analysis of the company including an analysis of its financial position, and a strong buy/buy/sell/strong sell/hold recommendation for the company’s stock. Clearly state the reasons for and justifications of your recommendation. The briefing is not a regurgitation of the written project. Make it interesting! Additionally, each student will provide feedback on the presentations of each of the other groups.

Homework: The homework assignments are given for practice only and will not be collected. Due to time restrictions, we may discuss in class the questions pertaining to International Financial Statements and Ethics Dilemmas. If needed and as time permits we can go over other homework assignments in class. The solutions to the exercises and problems will be provided to the students. I would suggest that you attempt the problems first, before consulting the solutions.

Examination: The examination will emphasize application of knowledge and problem solving.

Grading System:

Your course grade is based on your participation, the final examination, a project, and a presentation. Each student is to select how they want their overall grade evaluated using the percentage ranges below. Attached is the grading request form that each student is to complete, print and submit to the instructor no later than, Tuesday, 5 August 2008.

Participation and Miscellaneous	10%-15%
Project	25%-35%
Presentation	15%-25%
Final exam.....	<u>35%-50%</u>
Total	<u>100%</u>

Your final grade in the course will be determined as follows:

<i>Grade</i>	<i>Overall Percentage</i>
A.....	At least 95.0%
A-.....	At least 90.0%, but less than 95.0%
B+.....	At least 87.0%, but less than 90.0%
B.....	At least 83.0%, but less than 87.0%
B-.....	At least 80.0%, but less than 83.0%
C+.....	At least 75.0%, but less than 80.0%
C.....	At least 70.0%, but less than 75.0%
D.....	At least 55.0%, but less than 70.0%
F.....	Less than 55.0%

Academic Integrity

The University is an academic community. Its fundamental purpose is the pursuit of knowledge. The University can function properly only if its members adhere to clearly established goals and values. Essential to the fundamental purpose of the University, not only as an academic institution, but as one upholding Christian values, is the commitment to the principles of truth and academic honesty. While all members of the University share the responsibility of upholding the principles of academic honesty, special responsibility lies with the students. Academic dishonesty is not tolerated. *On the examination you will be required to sign a statement indicating your compliance with the policy of academic integrity – ie. you have neither received nor given any unauthorized assistance on the examination.*

Grading Request Form:

Name (print) _____

Grade distributions requested:

	Allowed Range	My Selected Percentages
Participation	10%-15%	
Project.....	25%-35%	
Presentation	15%-25%	
Final exam.....	35%-50%	
Total	100%	
Must add up to 100%		

By signing below I acknowledge that this is the grade distribution that I am requesting for ACCT 620, August 2008; and I recognize that this cannot be changed after Tuesday, 5 August 2008.

Signature and date

If you do not submit a form, then your grade distribution will default to:

Participation	10%
Project	25%
Presentation	15%
Final exam.....	<u>50%</u>
Total	<u>100%</u>

Tentative Course Schedule

<i>Day</i>	<i>Date</i>	<i>Topic</i>	<i>Readings & Other</i>	<i>Homework.</i>
Sunday	3 Aug	Introduction, Overview of Financial Reporting and The Balance Sheet	Ch 1, 2 & 4	P2-21, 22, 24; International Financial Stmts (p. 69); Ethics Dilemma (p. 71)
Monday	4 Aug	Time Value of Money (using the calculator) & The Income Statement	Ch 5	P4-21, 26, E5-15, P5-23, 25; Int'l Fin Stmts (p. 171, 226); Ethics Dilemma (p. 171, 227)
Tuesday	5 Aug	The Operating Cycle	Ch 9, 10, 11 (p. 477-485, 491, 500-508)	P9-20, 27, P10-25, 32, E11-18, P11-20, 26; Int'l Fin Stmts (p. 420, 473); Ethics Dil (p. 526)
Wednesday	6 Aug	The Operating Cycle cont'd		
Thursday	7 Aug	Earnings Management and Financial Statement Fraud	Ch 8	TBD
Sunday	10 Aug	Financial Statement Analysis & <i>The Smartest Guys in the Room</i>	Ch 3	P3-25, 26; International Financial Stmts (p. 118); Ethics Dilemma (p. 119)
Monday	11 Aug	Investments	Ch 12 & 13	P12-21, 22, 33, P13-20, 23; Int'l Fin Stmts (p. 582, 637)
Tuesday	12 Aug	Financing with debt & equity	Ch 14 & 15	P14-21, 24,25, P15-20
Wednesday	13 Aug	The Statement of Cash Flows (indirect method only)	Ch 6	P6-18, 19, 26; Int'l Fin Stmts (p. 283)
Thursday	14 Aug	Accounting in a Global Market	Ch 16	
Sunday	17 Aug	Final Exam & Presentations		
Monday	18 Aug	Written Projects Due by noon (both in hard copy and by email).		

Homework Solutions

P 2-21 The Entity Assumption and Preparation of a Balance Sheet

1. Explanation of Errors
 - a. In almost all cases, inventory is recorded at its historical cost which is \$25,000 in this case. The inventory replacement cost of \$30,000 is a very relevant number but U.S. accounting practice precludes including this number in the financial statements.
 - b. The \$2,500 of the cash listed on the balance sheet that is in John's personal account should not be included in the store's account.
 - c. The delivery truck is used in the business, and therefore it should be included in the store's account. The bank holds title because the acquisition is being financed. The remaining balance owed to the bank of \$8,000 should also be included in the store's balance sheet.
 - d. The personal residence and its mortgage and the family car and the note payable on this car should not be included in the store's accounts since they are personally owned and used by John and not by the store.

2. Alexander's Rental Outlet
Balance Sheet
December 31, 2006

<i>Assets</i>		<i>Liabilities and Stockholders' Equity</i>	
Cash	\$ 2,000	Liabilities	
Accounts receivable	9,000	Accounts payable	\$6,000
Inventory	25,000	Bank loan payable	<u>8,000</u>
Equipment	12,000	Total liabilities	\$ 14,000
Delivery truck	10,000	Stockholders' equity	<u>46,700</u> ¹
Store supplies	<u>2,700</u>		
		Total liabilities and stockholders' equity	<u>\$ 60,700</u>
Total assets	<u>\$ 60,700</u>		

¹ Needed to balance statement

3. **ANALYSIS.** A first approximation of the value of a business is the value of its equity, which is equal to assets minus liabilities. Thus, one can argue that John's business is worth \$46,700. You can also make an argument that the business is worth more than this because many of the assets are reported at their historical costs which are less than their current values. For example, we have already seen that, in the adjusted balance sheet in (2), the inventory is reported at \$25,000 which is less than the current replacement cost of the inventory. Finally, you might argue that John's business is worth even more because of intangible factors not reported in the balance sheet. For example, John's business may have a good reputation, a large customer base, and good relations with a network of suppliers. On the other hand, these intangibles may be tied to John himself and would not be transferred to a new owner if the business were to be sold.

P 2-22 The Income Statement and Statement of Cash Flows

1. Ocr Corporation
Income Statement
For the Six Months Ended December 31, 2006

Revenues		
Commissions earned	\$ 325,000	
Interest revenue	<u>1,400</u>	
Total revenues		\$ 326,400
Expenses		
Operating expenses		<u>248,000</u>
Net income		<u>\$ 78,400</u>

Ocra Corporation
 Statement of Cash Flows
 For the Six Months Ended December 31, 2006

Cash flows from operating activities		
Cash commissions collected	\$ 250,000	
Interest collected	<u>1,000</u>	
	\$ 251,000	
Less: Cash paid for operating expenses	<u>(208,000)</u>	
Net cash provided by operating activities		\$ 43,000
Cash flows from investing activities		
Purchase of property, plant, and equipment	\$(130,000)	
Purchase of long-term investment	<u>(20,000)</u>	
Net cash used by investing activities		(150,000)
Cash flows from financing activities		
Issuance of capital stock	\$ 200,000	
Bank loan borrowing	75,000	
Less: Dividends paid	<u>(15,000)</u>	
Net cash provided by financing activities		<u>260,000</u>
Net increase in cash		<u>\$ 153,000</u>

2. The statement of cash flows contains information about the various sources of cash and how the business is using its cash. In this particular problem, the corporation's other resources, such as the issuance of capital stock for \$200,000 and a bank loan of \$75,000, cannot be found on the income statement. Likewise, the corporation's uses of cash, such as the purchase of various items of property, plant, and equipment of \$130,000, the purchase of the long-term investment of \$20,000, and the cash dividends of \$15,000, cannot be determined from the income statement.

3. ANALYSIS. Instead of paying \$15,000 in cash dividends, Ocra could have used the cash in its purchase of long-term assets and reduced its need to borrow. Thus, instead of borrowing \$75,000,

Ocra could have borrowed just \$60,000. Normally, when a business is just starting out it is unable to pay cash dividends because all resources must be kept within the company to finance the initial growth. However, Ocra is an exceptional company. Note that in its first six months it is already profitable (net income of \$78,400) and its operations are already generating positive cash flow (\$43,000). Thus, in this case, there does not seem to be any compelling reason to prevent the payment of the \$15,000 cash dividend to investors.

P 2-24 Review of Financial Accounting Concepts

- a. Recording an asset when the new chef is hired violates conservatism, historical cost, and reliability. The additional profits that the new chef is expected to generate are not certain, so it is overly optimistic to report them now. Also, the \$100,000 amount is a very uncertain estimate, not supported by any historical cost, so the valuation cannot be verified.
- b. The estimate of a firm's uncollectible accounts, and hence the net accounts receivable (the amount that is estimated to be ultimately collectible) should be based on the best information available. To deliberately overstate the estimate of uncollectible accounts impairs the reliability of the financial statements.
- c. By delaying the preparation of financial statements, the company is violating the time period concept and is making it difficult for financial statement users to get timely information with which to make decisions. This also means that the financial statements are less relevant.
- d. Since it is difficult to objectively determine the future benefits associated with the advertising expenditure, recognizing advertising as an asset would violate the concepts of conservatism and reliability.

- e. The health club has violated the revenue recognition concept because the club has not yet provided the service it has promised (lifetime health club benefits), so it seems inappropriate to recognize all of the revenue immediately.

P 3-25 Can a Ratio Be Too Good?

1. Shaycole's current ratio is well above the industry norm. This fact would be comforting to Shaycole's short-term creditors, but it also may indicate that Shaycole has an excess of current assets. A firm certainly needs adequate levels of cash, accounts receivable, and inventory, but there is no benefit to be gained from having an excess. Holding an excess of current assets ties up resources that would be better used elsewhere. The low levels of inventory and accounts receivable suggest that the excess current assets are in the form of cash and investment securities.
2. This ratio is usually used to detect sluggish movement in inventory. An increase in the number of days' sales in inventory is often an early sign of more serious trouble. However, a number of days' sales in inventory that is too low also is a warning signal. If inventory levels are too low, the firm may be very vulnerable to supplier problems, strikes, and unexpected increases in demand. In today's business world, many companies are trying to minimize inventories using the "Just-In-Time" philosophy. This will cause a significant decrease in the number of days' sales in inventory.
3. Slow receivable collection means that excess funds are tied up in receivables and that the possibility of substantial bad debts is increased. However, receivable collection that is too fast also may indicate potential problems. The credit policy may be too restrictive or the collection policy may be too aggressive, driving away potential customers and alienating existing customers.
4. Again, this ratio is good news to creditors. However, stockholders might not be as pleased. If the firm's projects can generate a return that is higher than the cost of debt, it would make sense from the stockholders' standpoint to borrow more, thus leveraging their investment and resulting in a higher return for the same investment.
5. **ANALYSIS:** Shaycole Company can reduce the amount of assets it needs to do business by lowering its excess current assets. As discussed above, these excess current assets appear to be in the form of cash and investment securities. By reducing the level of assets, Shaycole will increase its overall efficiency, reduce its need for external financing, and increase return on equity. In addition, Shaycole is currently obtaining a very small amount of its external financing through borrowing. By increasing its leverage, Shaycole can increase its return on equity.

P 3-26 Ratio Analysis

1.	Ratios	<u>2006</u>	<u>2005</u>
	a. Current ratio	6.1	7.4
	b. Debt-to-equity ratio	0.96	0.89
	c. Debt ratio	49.0%	47.0%
	d. Asset turnover	1.59	1.52
	e. Average collection period	2.9	5.9
	f. Number of days' sales in inventory	398.2	436.0
	g. Fixed asset turnover	12.5	10.8
	h. Times interest earned	14.5	16.6
	i. Return on sales	18.0%	19.8%
	j. Return on assets	28.7%	30.0%
	k. Return on equity	56.3%	56.7%

Calculations

- a. Current ratio

- 2006: \$548,000/\$90,000
- 2005: \$486,000/\$66,000
- b. Debt-to-equity ratio
 - 2006: \$308,000/\$320,000
 - 2005: \$266,000/\$300,000
- c. Debt ratio
 - 2006: \$308,000/\$628,000
 - 2005: \$266,000/\$566,000
- d. Asset turnover
 - 2006: \$1,000,000/\$628,000
 - 2005: \$860,000/\$566,000
- e. Average collection period
 - 2006: $\$8,000 / (\$1,000,000 / 365)$
 - 2005: $\$14,000 / (\$860,000 / 365)$
- f. Number of days' sales in inventory
 - 2006: $\$480,000 / (\$440,000 / 365)$
 - 2005: $\$430,000 / (\$360,000 / 365)$
- g. Fixed asset turnover
 - 2006: $\$1,000,000 / \$80,000$
 - 2005: $\$860,000 / \$80,000$
- h. Times interest earned
 - 2006: $(\$560,000 - \$270,000) / \$20,000$
 - 2005: $(\$500,000 - \$234,000) / \$16,000$
- i. Return on sales
 - 2006: $\$180,000 / \$1,000,000$
 - 2005: $\$170,000 / \$860,000$
- j. Return on assets
 - 2006: $\$180,000 / \$628,000$
 - 2005: $\$170,000 / \$566,000$
- k. Return on equity
 - 2006: $\$180,000 / \$320,000$
 - 2005: $\$170,000 / \$300,000$

2. No, profitability declined slightly in 2006. Overall efficiency improved slightly; this is also reflected in the decrease in the average collection period, the decrease in the number of days' sales in inventory, and the increase in the fixed asset turnover. Return on assets was down slightly. However, return on equity was maintained at approximately the same level because of an increase in leverage during the year.
3. ANALYSIS: The book value of Urch's equity on December 31, 2006 is \$320,000. Thus, at first glance, it might seem a bit expensive to pay \$800,000 for the company. However, another way to view the valuation is that the price of \$800,000 implies a price-earnings ratio of just 4.4 ($\$800,000 / \$180,000$) which is quite low. In fact, assuming a PE ratio of 20, the implied price for the company is \$3,600,000 ($\$180,000 \times 20$). Thus, the \$800,000 price for the company appears to be a bargain.

P 4-21 Preparation and Analysis of a Balance Sheet

1.

Mayer Corporation
 Balance Sheet
 June 30, 2006

Assets

Liabilities and Stockholders' Equity

Current assets Cash \$ 40,000 Accounts receivable 60,000 Inventory <u>116,000</u> Total current assets <u>\$216,000</u>	Current liabilities Accounts payable \$ 82,000 Long-term debt Note payable—due Oct. 1, 2007 <u>60,000</u> Total liabilities <u>\$ 142,000</u>
Property, plant, and equipment Land \$140,000 Building 200,000 Equipment <u>40,000</u> Total property, plant, and equipment <u>\$380,000</u>	Stockholders' equity Common stock, par value \$ 20,000 Additional paid-in capital 130,000 Retained earnings ¹ <u>304,000</u> Total stockholders' equity <u>\$454,000</u>
Total assets <u>\$596,000</u>	Total liabilities and stockholders' equity <u>\$596,000</u>

¹ \$234,000 + \$80,000 – \$10,000 = \$304,000

The \$40,000 net income is computed as follows:

Sales	\$ 550,000
Cost of goods sold	<u>290,000</u>
Gross profit on sales	\$ 260,000
Operating expenses	
Salary expense	\$54,000
Rent expense	36,000
Utilities expense	<u>12,000</u>
Total operating expenses	<u>102,000</u>
Income from operations	\$ 158,000
Other income (expense)	
Interest expense	<u>(8,000)</u>
Income before taxes	\$ 150,000
Taxes	<u>70,000</u>
Net income	<u>\$ 80,000</u>

2.
 - a. Working capital = \$216,000 – \$82,000 = \$134,000
 - b. Current ratio = \$216,000/\$82,000 = 2.63
 - c. Debt-to-equity ratio = (\$142,000/\$454,000) = 0.31
 - d. Debt ratio = (\$142,000/\$596,000) = 23.8%

3. **ANALYSIS:** The reporter must be made aware of the following facts. First, the total amount initially invested by the shareholders of Mayer is \$150,000, not \$20,000. The accounting rules result in the division of shareholder investment between par value and additional paid-in capital. In addition, the \$304,000 retained earnings amount also represents stockholder investment—stockholders own the profits of the company and they have chosen to reinvest \$304,000 of those profits in business expansion. Total shareholder investment is actually \$454,000, not \$20,000.

P 4-26 Asset and Financing Mix

1.		2006	%	1996	%
	Cash	\$ 151	3.2%	\$ 137	4.8%
	Accounts receivable	141	3.0%	52	1.8%

Inventory	1,208	25.5%	925	32.6%
Other current assets	<u>83</u>	<u>1.8%</u>	<u>70</u>	<u>2.5%</u>
Total current assets	\$1,583	33.4%	\$1,184	41.7%
Property, plant, and equipment	3,287	69.4%	2,776	97.9%
Less: Accumulated depreciation	(992)	(20.9%)	(1,153)	(40.7%)
Other long-term assets	<u>861</u>	<u>18.2%</u>	<u>29</u>	<u>1.0%</u>
Total assets	<u>\$4,739</u>	<u>100.0%</u>	<u>\$2,836</u>	<u>100.0%</u>
Accounts payable	\$ 843	17.8%	\$ 808	28.5%
Short-term bank loans	<u>537</u>	<u>11.3%</u>	<u>162</u>	<u>5.7%</u>
Total current liabilities	\$1,380	29.1%	\$ 970	34.2%
Long-term debt	3,005	63.4%	881	31.1%
Other long-term liabilities	<u>537</u>	<u>11.3%</u>	<u>49</u>	<u>1.7%</u>
Total liabilities	\$4,922	103.9%	\$1,900	67.0%
Paid-in capital	320	6.8%	106	3.7%
Retained earnings	<u>(503)</u>	<u>(10.6%)</u>	<u>830</u>	<u>29.3%</u>
Total liabilities and equity	<u>\$4,739</u>	<u>100.0%</u>	<u>\$2,836</u>	<u>100.0%</u>

* Differences in addition due to percentage rounding.

1. It does not appear that Kara Supermarket has been profitable during this ten-year period since retained earnings has gone from a positive \$830 to a negative \$503.
2. Evidence of the acquisition of other companies would be the appearance of recorded goodwill in Kara's balance sheet. It is possible that a portion of the \$861 in "Other long-term assets" is goodwill, indicating that Kara may have acquired other companies.
3. Kara's property, plant, and equipment is probably younger in 2006. The evidence for this is the fact that accumulated depreciation, as a percentage of the cost of property, plant, and equipment, has decreased over the ten-year period. This indicates that, in 2006, Kara has used its existing property, plant, and equipment for a smaller fraction of its useful life compared to the situation in 1996.
4. The biggest change in financing mix between 1996 and 2006 is the large increase in long-term debt. Of course, the large reduction in retained earnings is also a significant change.
5. ANALYSIS: If Kara's creditors were to try to force liquidation in order to collect the money they are owed in 2006, they would likely receive only a small percentage of the amounts they are owed. Liquidation is a very poor way to get the value from a company's assets. Kara's creditors have a much better chance of collecting the full amount they are owed if Kara stays in business and pays off its obligations in an orderly fashion. In fact, as long as Kara has sufficient cash flow to meet its periodic interest and principal payments, the creditors couldn't care less whether Kara's recorded liabilities are in excess of recorded assets.

E 5-15 Income Statement Items

1. a. Sales are recorded in the period in which they are made, if cash collectibility is reasonably assured. Thus,

- a sale on account is recognized in the same manner as a cash sale.
- b. The amount and timing of any future benefit from this general advertising is so uncertain that the cost is expensed immediately.
- c. The purchase of equipment is not an income statement transaction. Equipment is an asset and appears on the balance sheet.
- d. Dividends are not an expense; they are a direct deduction from retained earnings.

2.

Jimbo Company
Income Statement
 For the Year Ended December 31, 2006

Sales		\$400,000
Cost of goods sold		<u>190,000</u>
Gross profit		\$210,000
Operating expenses:		
Salary expense	\$60,000	
Advertising expense	50,000	
Rent expense	<u>30,000</u>	
Total operating expenses		<u>140,000</u>
Operating income		\$ 70,000
Interest expense		<u>10,000</u>
Income before taxes		\$ 60,000
Income tax expense		<u>5,000</u>
Net income		<u>\$ 55,000</u>

P 5-23 Income Statement Preparation

1.

Eyring Company
Income Statement (Multiple-Step Format)
 For the Year Ended December 31, 2006

Sales		\$806,000
Cost of goods sold		<u>435,500</u>
Gross profit		\$370,500
Operating expenses:		
Salaries expense	\$104,000	
Repairs and maintenance expense	<u>70,200</u>	
Total operating expenses		<u>174,200</u>
Operating income		\$196,300
Other revenue (expenses)		
Interest revenue	71,500	
Interest expense	<u>(58,500)</u>	<u>13,000</u>
Income before taxes		\$209,300
Income tax expense		<u>39,000</u>
Net income		<u>\$170,300</u>

- 2. All sales during the period, whether or not actually collected in cash, are recognized as revenue.
- 3. **ANALYSIS:** The \$130,000 dividend is equal to 76% of net income. New, start-up companies typically pay a much smaller fraction of income out as dividends. It is likely that Eyring Company is an old, established company.

P 5-25 Revenue and Expense Recognition

1.
 - a. Revenue must be both earned and collectible in order to be reported on the income statement. Until Hadley ships the inventory, the \$18,000 of orders paid for in advance should not be reported on the income statement.
 - b. Because experience suggests that customers are not returning the products, the earnings process can be considered substantially complete when the sale is made. The revenues and associated cost of goods sold should be included on the income statement.
 - c. The rent will benefit several accounting periods and should be allocated in a systematic fashion.
 - d. It is difficult to determine the period of time that is benefited by general advertising. Because the advertising costs cannot be related to specific revenues, the costs are typically recognized as expenses immediately.
 - e. If warranty costs can be reasonably estimated, then the expenses are matched directly to the period in which the revenue is generated. Using the actual costs incurred to approximate warranty expense violates the matching principle.

2.	Sales	\$183,000
	Cost of goods sold	<u>101,500</u>
	Gross profit	\$ 81,500
	Rent expense	(12,000)
	Advertising expense	(24,000)
	Warranty expense	(9,150)
	Other expenses	<u>(20,000)</u>
	Net income	<u>\$ 16,350</u>

Sales: $\$185,000 - \$18,000 + \$16,000 = \$183,000$

Cost of goods sold: $\$94,000 + \$7,500 = \$101,500$

Rent expense: $\$18,000 - \$6,000 = \$12,000$

Advertising expense: $\$6,000 + \$18,000 = \$24,000$

Warranty expense: $\$183,000 \times 0.05 = \$9,150$

3. ANALYSIS: The stock price would probably decline for a number of reasons. First, if investors were convinced that they had previously been valuing Hadley's stock based on artificially inflated earnings, the stock price would drop on the realization of that fact. In addition, if this announcement caused investors to doubt the integrity or competence of Hadley's management, the stock price would drop in anticipation of the uncovering of even more bad news.

1. In order to decide when revenue should be recognized, we must consider the following two revenue recognition criteria:
 Is the work done?
 Is the cash collected or collectible?

Work done: The work is not done when the order is received. If past history shows that the amount of free repairs is not a large amount, then the work is done, or virtually done, when the ship is delivered to the

customer. You could also argue that the work is done bit by bit during the four-year construction period.

Cash collected or collectible. If past history shows that customers generally are reliable in paying for ships, then we do not have to wait until the cash is collected during the 10-year payment period before recognizing revenue.

In summary, if past history shows that the repairs are not significant and customers are fairly reliable in paying, then revenue should be recognized at the time the ship is delivered to the customer, which is choice (d). In addition, you could also argue for proportionate recognition during the four-year construction period, which is choice (c). When the revenue is recognized, an estimated liability for future free repairs should also be recognized (along with an associated expense).

2. **ANALYSIS:** First of all, note that the entire world should be nervous when Congress decides to get into the accounting standard-setting business. The argument in favor of method (f) is that no one would ever be deceived by deceptive revenue recognition because no revenue would be recognized until after the cash was in hand and the guarantee period was over. This view ignores the fact that there are two sides to a transaction. Yes, it is true that this rule eliminates the possibility of overly optimistic revenue recognition. But the rule also guarantees overly pessimistic revenue recognition. This bill can make it impossible for shipbuilding companies to produce financial statements that accurately reflect their economic activity. The general point is this: Overly conservative accounting rules may protect some financial statement users, but such rules also may harm other financial statement users and this would violate the underlying concepts that lead to fair presentation of financial statements.

P 9-27 The Aging Method

1.

Category	Amount	Percentage	Total	
Less than 30 days	\$147,000		0.01	\$1,470
31 to 60 days	33,000		0.10	3,300
61 to 90 days	5,000		0.40	2,000
Over 90 days	7,500		0.90	<u>6,750</u>
Total				<u>\$13,520</u>

2.

Bad Debt Expense 11,770

Allowance for Bad Debts 11,770

To adjust the allowance for bad debts to the appropriate ending balance.
 (\$13,520 + \$8,250 [write-offs] – \$10,000 [beginning] = \$11,770)

3. The net Accounts Receivable balance as of December 31, 2006 is \$178,980 (\$192,500 – \$13,520).

4. **ANALYSIS:** Since we know that the accounts receivable balance is \$192,500, we could compute the total volume of credit sales if we also knew the average collection period. We can estimate the average collection period using the aging information, as follows:

<u>Average Life of Accounts in Category</u>	<u>Fraction of Accounts in Category</u>	<u>Contribution to Weighted Average</u>
15 days	\$147,000/\$192,500	11.45 days
45 days	\$33,000/\$192,500	7.71 days
75 days	\$5,000/\$192,500	1.95 days
120 days	\$7,500/\$192,500	<u>4.68 days</u>
Estimated average collection period		<u>25.79 days</u>

Note: For the first three categories, the average life of the accounts in the category is assumed to be the midpoint of

the category interval. For example, the average life of the accounts in the 0 to 30 day category is assumed to be 15 days. For the accounts over 90 days, the 120-day average life assumption is somewhat arbitrary.

Average collection period = $365 / (\text{Sales} / \text{Accounts receivable})$

Estimated Credit Sales = $(365 \times \$192,500) / 25.79 = \$2,724,409$

P 10-25 Inventory Costing Using Different Assumptions

1.

2005	a. FIFO	b. LIFO	c. Average Cost
Goods available for sale	\$2,740.00	\$2,740	\$2,740.00
Ending inventory*	<u>1,057.50</u>	<u>950</u>	
Cost of goods sold	<u>\$1,682.50</u>	<u>\$1,790</u>	<u>\$1,737.75</u>

*Ending inventory:

FIFO: $(400 \times \$2.25) + (75 \times \$2.10) = \$1,057.50$

LIFO: $(475 \times \$2.00) = \950

Average cost: $\$2,740 / 1,300 = \2.11

$\$2.11 \times 475 = \$1,002.25$

2006	a. FIFO	b. LIFO	c. Average Cost
Beginning inventory	\$1,057.50	950	\$1,002.25
2006 purchases	<u>4,470.00</u>	<u>4,470</u>	<u>4,470.00</u>
Goods available for sale	\$5,527.50	\$ 5,420	5,472.25
Ending inventory*	<u>950.00</u>	<u>600</u>	<u>852.00</u>
Cost of goods sold	<u>\$4,577.50</u>	<u>\$4,820</u>	<u>\$4,620.25</u>

*Ending inventory:

FIFO: $(200 \times \$3.20) + (100 \times \$3.10) = \$950$

LIFO: $(300 \times \$2.00) = \600

Average cost: $\$5,472.25 / 1,925 = \2.84

$\$2.84 \times 300 = \852

2. **ANALYSIS:** It sounds very much as if Corey Snyder is using the LIFO inventory method. When LIFO is used, reduction in inventory levels results in the liquidation of old LIFO layers. If those layers were created when the cost of inventory was lower, then the LIFO liquidation will result in artificially inflated profits and higher tax payments. In this case, the controller was concerned that the JIT system would reduce inventory levels to the extent that LIFO liquidation would increase the income tax payments. You can verify this by calculating what Snyder's cost of goods sold in 2006 would have been if enough inventory had been purchased at the end of 2006 to avoid the LIFO liquidation.

P 10-32 Manipulating Profits Using Inventory Purchases

1. Cost of Goods Sold:

(a) Without Purchase	(b) With Purchase	
Cost of goods sold		
Beginning inventory	\$ 1,200,000 ¹	\$1,200,000 ²
Purchases	<u>11,240,000¹</u>	<u>12,940,000²</u>
Goods available for sale	\$12,440,000	\$14,140,000

Ending inventory	<u>400,000</u> ³	<u>1,600,000</u> ⁴
Cost of goods sold	<u>\$12,040,000</u>	<u>\$12,540,000</u>

¹ $\$4,000,000 + \$3,040,000 + \$4,200,000 = \$11,240,000$

² $\$11,240,000 + (5,000 \times \$340) = \$12,940,000$

³ $2,000 \times \$200 = \$400,000$

⁴ $(1,000 \times \$400 = \$400,000) + (6,000 \times \$200 = \$1,200,000) = \$1,600,000$

2. Net Income:

	<i>Without Purchase</i>	<i>With Purchase</i>
Sales	\$15,300,000	\$15,300,000
Cost of goods sold	<u>12,040,000</u>	<u>12,540,000</u>
Gross profit on sales	\$ 3,260,000	\$ 2,760,000
Expenses	<u>1,000,000</u>	<u>1,000,000</u>
Net income before taxes	\$ 2,260,000	\$ 1,760,000
Taxes (0.30 rate)	<u>678,000</u>	<u>528,000</u>
Net income	<u>\$ 1,582,000</u>	<u>\$ 1,232,000</u>

3. Cash Flows:

	(a)	(b)
		<i>Purchase in January Purchase in December</i>
Cash flows:		
Taxes	\$ (678,000)	\$ (528,000)
Purchase in December (5,000 × \$340)		(1,700,000)
Purchase in January (5,000 × \$300)	<u>(1,500,000)</u>	
Net cash flows	<u>\$ (2,178,000)</u>	<u>\$ (2,228,000)</u>

4. **ANALYSIS:** If the forecast for the continued decline in the price of gold is accepted, the firm should wait until January to purchase the gold because this choice results in a lower negative cash flow. Whether the price of gold actually will decline cannot be known until after the decision is made. If the price of gold is expected to remain near the \$340 level, it is better to make the purchase in December in order to save the tax dollars.

E 11-18 Contingent Liabilities

The following are provided as possible (or probable) answers.

- a. A 30% probability of occurrence would most likely fall between remote and probable. If Bell Industries determined this contingency was reasonably possible, then note disclosure would be appropriate.
- b. If the probability of incurring fines levied by the government is less than 10%, most would classify this event as remote and provide no information (or only a brief mention, with no details) in the notes to the annual report.
- c. A probability of 90% is likely to be interpreted as probable. If management determines the likelihood of losing its foreign assets is probable, the loss would be formally recognized in the accounting records.

P 11-20 Stock Options

1. Fair Value Method

Total compensation expense over the three-year service period (2006–2008) is \$2,000,000 (\$5 fair value × 400,000 options). The compensation expense for 2006 is \$666,667 (\$2,000,000/3 years).

2. Intrinsic Value Method

Total compensation expense over the three-year service period (2006–2008) is \$0 [(\$20 – \$20) × 400,000 options]. Under the intrinsic value method, no compensation expense is recognized in 2006.

3. If Tiger Man were to use the intrinsic value method, the company would have to make the following supplemental disclosure:

Reported net income is \$675,000. If the fair value method had been used, net income would have been \$8,333 (\$675,000 – \$666,667).

4. ANALYSIS: The fair value method reveals that, if the value of the options granted is recognized as compensation expense, virtually the entire amount of 2006 net income is wiped out. This means that all of the profits of the company are going to pay executive compensation and none are accruing to the benefit of the shareholders. This is a case where the fair value method provides much more useful information than does the intrinsic value method.

P 11-26 Classifying Expenditures as Assets or Expenses

1. Return on equity = Net income ÷ Stockholders' equity
 = \$38 million ÷ (\$325 million – \$180 million)
 = 26.2%

Yes, Cole exceeded its profitability goal of 25% ROE.

2. The following adjustments are necessary:

- a. Decrease net income and total assets by \$18 million capitalized R&D. For regular R&D expenditures, technological feasibility is irrelevant—all costs are expensed.
- b. Decrease net income and total assets by \$1.4 million to reflect advertising expenses not directed to established customers.
- c. Decrease net income and total assets by \$7 million. The switch to the full cost method appears to have been made simply to manipulate income, so the total amount should have been expensed.

After the adjustments, net income is \$11.6 million (\$38 million – \$18 million – \$1.4 million – \$7 million); total assets are \$298.6 million (\$325 million – \$18 million – \$1.4 million – \$7 million); total liabilities are the same.

$$\text{Return on equity} = \$11.6 \text{ million} \div \$118.6 \text{ million} (\$298.6 \text{ million} - \$180 \text{ million}) = 9.8\%$$

After the adjustments, Cole does not meet its profitability goal.

3. ANALYSIS: The auditors should catch this kind of accounting abuse. However, even a good audit may fail to detect such abuses when employees collude in order to bias the accounting numbers in some way.

2.
 - a. No depreciation is recorded for land.
 - b. Depreciation Expense \$25,300
 $(\$253,000 \times 10\% = \$25,300)$
 $1/20 \text{ years} = 5\% \times 2 = 10\%$
 - c. Depreciation Expense \$208,000
 $(\$1,040,000/5 \text{ years} = \$208,000)$
 - d. No depreciation is recorded for land.

3. **ANALYSIS:** This exchange of a machine for shares of stock will not be reflected in the statement of cash flows since no cash was involved. Instead, this transaction should be disclosed in the notes to the financial statements as a significant non-cash transaction.

P 12-23 Calculating Depreciation

Basic Data

Annual straight-line depreciation: $(\$550,000 - \$50,000)/10 \text{ years} = \$50,000$

Double-declining-balance: $2 \times 0.10 = 0.20$

	a.			b.	
	Straight-Line			Double-Declining-Balance	
<u>Year</u>	Depr. <u>Exp.</u>	Book 12/31 <u>Value</u>	Depr. <u>Exp.</u>	Book 12/31 <u>Value</u>	
1	\$50,000	\$500,000	\$110,000	\$440,000	
2	50,000	450,000	88,000	352,000	
3	50,000	400,000	70,400	281,600	

Straight-line:

$$\$550,000 - \$50,000 = \$500,000$$

$$\$500,000 - \$50,000 = \$450,000$$

$$\$450,000 - \$50,000 = \$400,000$$

Double-declining-balance:

$$\$550,000 - (0.2 \times \$550,000) = \$440,000$$

$$\$440,000 - (0.2 \times \$440,000) = \$352,000$$

$$\$352,000 - (0.2 \times \$352,000) = \$281,600$$

2. Straight-line depreciation would be \$55,000 per year ($\$550,000/10 \text{ years}$). Therefore, the book value at the end of three years would be \$15,000 lower $[(\$55,000 - \$50,000) \times 3]$ than in part 1. There would be no effect on the double-declining-balance method book value at the end of three years.

3. **ANALYSIS:** Assuming that the residual value is zero accomplishes two purposes. First, an underlying motivation of the tax depreciation rules is to give taxpayers their depreciation deductions as rapidly as possible. Assuming a zero residual value contributes to this. Second, residual values are usually not large, and their amounts are very uncertain. Lots of time could be spent in tax court arguing about residual value assumptions. Assuming a zero residual value eliminates this pointless contention and makes the tax depreciation system easier and less costly to implement.

P 13-20 Trading and Available-for-Sale Securities

1. Trading Securities
 - a. Realized Gains/Losses
Security B: Cash received \$4,700 – Cost \$7,000 = \$2,300 Realized Loss
 - b. Unrealized Gains/Losses
Cumulative unrealized gain/(loss), end of year: (\$4,500 – \$5,000) \$ (500) loss
Less: Cumulative unrealized gain/loss, beginning of year: (\$14,000 – \$12,000) -2,000 gain
Unrealized gain/loss for the year (\$2,500) loss

2. Available for Sale Securities
 - a. Realized Gains/Losses
Security C: Cash received \$19,500 – Cost \$10,000 = \$9,500 Realized Gain
 - b. Unrealized Gains/Losses
Cumulative unrealized gain/loss, end of year: (\$18,000 – \$18,000) \$ 0 loss
Less: Cumulative unrealized gain/(loss), beginning of year: (\$11,500 – \$16,000) -(4,500) loss
Unrealized gain/loss for the year \$4,500 gain

Note: Subtraction of a negative number (loss) = addition in arithmetic process.
The \$9,500 realized gain will appear in the income statement.

3. **ANALYSIS:** The total gains and losses, both realized and unrealized, for the two portfolios for 2006 are as follows:

Trading, realized	\$2,300 loss
Trading, unrealized	2,500 loss
Available for sale, realized	9,500 gain
Available for sale, unrealized*	<u>4,500 gain</u>
Total	<u>\$9,200 gain</u>

Rate of return: $\$9,200 \text{ gain} / \$37,500 = +24.5\%$

* This amount is not reported in the income statement but is included in this rate of return calculation.

P 13-23 Investment Security Classification and Financial Ratios

1.
 - a. Current Ratio: $\$250,000 / \$210,00 = 1.2$
 - b. Debt Ratio: $\$405,000 / \$590,000 = 69\%$
 - c. Return on Sales: $\$42,250 / \$310,000 = 14\%$
2.
 - a. Current Ratio: $(\$250,000 - \$63,000) / \$210,000 = 0.9$
 - b. Debt Ratio: $\$405,000 / \$590,000 = 69\%$
 - c. Return on Sales: $(\$42,250 + \$28,000) / \$310,000 = 23\%$
The unrealized loss on available for sale securities must be added to net income because it wouldn't be recognized on the income statement.
3. **ANALYSIS:** Because these securities suffered an unrealized loss of \$28,000 during the year, Jesse's income statement looks much better with the securities classified as available for sale rather than as trading. The misclassification error that an auditor would have to watch out for is classifying these securities as available for sale and non-current assets when they should be trading and current assets.

P 14-21 Amortizing a Mortgage and the Effect on the Financial Statements

	Yearly	Principal	Interest	Outstanding
	Payment	Paid	Paid	Balance
			\$1,500,000	

2006	\$344,411	\$194,411	\$150,000	1,305,589
2007	344,411	213,852	130,559	1,091,737
2008	344,411	235,237	109,174	856,500
2009	344,411	258,761	85,650	597,739
2010	344,411		284,637	59,774
2011	<u>344,411</u>		<u>313,102</u>	<u>*31,3100</u>
Totals	<u>\$2,066,466</u>	<u>\$1,500,000</u>	<u>\$566,467</u>	

*Rounding Difference

	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>
2. Warehouse	\$1,500,000	\$1,500,000	\$1,500,000	\$1,500,000	\$1,500,000	\$1,500,000
Acc. Dep.	<u>(75,000)</u>	<u>(150,000)</u>	<u>(225,000)</u>	<u>(300,000)</u>	<u>(375,000)</u>	<u>(450,000)</u>
Book Value	<u>\$1,425,000</u>	<u>\$1,350,000</u>	<u>\$1,275,000</u>	<u>\$1,200,000</u>	<u>\$1,125,000</u>	<u>\$1,050,000</u>

3. The primary difference between the liability and asset for the warehouse is the period over which the amount is reduced to zero. The mortgage is paid off over six years, but the useful life of the warehouse is 20 years. In addition, the depreciation decreases the book value of the asset in a straight-line fashion whereas the reduction in the principal of the liability changes each year as the carrying value of the liability changes.
4. ANALYSIS: This mortgage is similar to a capital lease arrangement in that both a large liability and a large asset amount are recognized in the balance sheet when the mortgage is signed. In addition, the mortgage is a way for a company to secure the long-term use of an asset without completely paying for the asset up front; a capital lease accomplishes the same objective. Finally, the mortgage represents an obligation that is secured by an asset as collateral; a capital lease can be thought of in the same way. The mortgage differs from a capital lease in that formal legal ownership of the asset is transferred at the beginning of the payment period with a mortgage; with a capital lease, ownership transfers, if at all, at the end of the lease term. Also, in this case the payment period of six years is much less than the asset life of 20 years; with a capital lease, the payment period and asset life are likely to be closer in magnitude. Finally, this mortgage requires a large down payment (25%); lease agreements often, though not always, have lower initial cash outlays.

P 14-24 Issuing and Retiring Bonds

1. Because the stated rate was equal to the market rate of interest when the bonds were sold, they were issued at par for \$500,000.
2. Assets increase by \$500,000 (cash) and Liabilities increase by \$500,000 (bonds payable).
3. 2006: six month's interest expense $\$500,000 \times 0.08 \times 6/12 = \$20,000$
2007: full year's interest expense $\$500,000 \times 0.08 = \$40,000$
 No amortization of a discount or premium is required.
4. Liabilities decrease by \$500,000 (bonds payable), assets decrease by \$495,000, and stockholders' equity increases by \$5,000 (gain on retirement). The gain is a normal item that is shown as a component of continuing operations on the income statement.
5. ANALYSIS: Bond covenants often include restrictions as to dividends, working capital, and the issuance of additional long-term debt. The purpose of these agreements is to ensure that the borrower will maintain a strong enough financial position to meet the scheduled bond interest and principal payments. The borrower agrees to these restrictions because the restrictions lower the risk to the lender and thus lower the interest rate on the bonds.

P 14-25 Lease Criteria

1.
 - a. Operating lease—none of the four criteria are met for a capital lease.
 - b. Capital lease—contains a bargain purchase option.
 - c. Capital lease—lease term is 87.5% (7/8) of economic life.
 - d. Capital lease—present value of future payments is 92% (\$17,000/\$18,500) of the fair market value.
 - e. Operating lease—none of the four criteria are met for a capital lease.

2. The lease is reported at the present value of the future minimum lease payments.
 - a. \$0
 - b. \$33,930
 - c. \$63,725
 - d. \$17,000
 - e. \$0

3. ANALYSIS: Once a lease agreement is finalized, the classification of the lease as operating or capital is fixed. The four lease criteria are based on the terms on the lease, and nothing can be done to a lease after it is signed to change it from a capital lease to an operating lease. So, if King Construction had wished to classify all of these leases as operating leases, any accounting advice would have to be incorporated into the lease agreements before the signing. [Note: As explained in intermediate accounting courses, there is at least one action a lessee can take after a lease is signed that can change a capital lease into an operating lease. This involves finding a third party (such as an insurance company) to guarantee a portion of the lease payments.]

P 15-20 Stockholders' Equity Comprehensive Problem

1. Shares of preferred stock issued: $\$4,000,000/\$50 = 80,000$.
 2. Preferred stock was issued at par since there is no paid-in capital account from the issue of preferred stock in excess of par.
 3. Shares of common stock issued: $\$300,000/\$3 = 100,000$.
 4. 100,000 shares issued less 2,000 shares held in treasury = 98,000 shares of common stock outstanding.
 5. Average issue price per share of common stock: $(\$300,000 + \$1,700,000)/100,000 = \$20$.
 6. The treasury stock transactions have decreased the firm's net assets by \$24,000 ($\$44,000 - \$20,000$). This \$24,000 is the difference between the \$44,000 used to buy the existing 2,000 treasury shares and the \$20,000 excess proceeds from the reissue of past treasury shares.
 7. Cost of treasury stock per share: $\$44,000/2,000 \text{ shares} = \22 .
- | | | | |
|----|---|--------------------|--------|
| 8. | Preferred stock | \$4,000,000 | |
| | Common stock | 300,000 | |
| | Paid-in capital in excess of par, common | 1,700,000 | |
| | Paid-in capital from sale of treasury stock | 20,000 | |
| | Donated capital | | 40,000 |
| | Total contributed capital | <u>\$6,060,000</u> | |
| 9. | Contributed capital | \$6,060,000 | |
| | Retained earnings | 1,120,000 | |
| | Treasury stock | | |
| | (44,000) | <u>\$7,136,000</u> | |
| | Total stockholders' equity | <u>\$7,136,000</u> | |
10. ANALYSIS: The retained earnings balance is \$1,120,000. If the incorporation laws are restrictive, then total dividends declared cannot exceed this amount. If this entire amount were declared as a

dividend this year, \$200,000 ($\$4,000,000 \times 0.05$) would go to the preferred shareholders and the remaining \$920,000 would go to the common shareholders.

P 6-18 Types of Changes in Cash

1. Item	Operating	Investing	Financing	None
a. Net income for the year, \$3,000	X			
b. Purchase of a new building through the issuance of a mortgage for the entire amount				X
c. Issuance of capital stock in exchange for land valued at \$20,000				X
d. Collection of accounts receivable, \$12,000	X			
e. Payment of interest on bond debt, \$9,000	X			
f. Payment of cash dividends, \$12,000			X	
g. Issuance of additional common stock, \$300,000			X	
h. Depreciation for year, \$6,000				X
i. Purchase of equipment for cash, \$12,000		X		
j. Sale of long-term investments, \$25,000		X		
k. Sale of merchandise on account, \$35,000				X
l. Deposit of cash in a savings account, \$5,000				X

Note: For item (l), the savings account would probably be considered to be a cash equivalent. As a result, this transaction merely results in changing cash from one form into another; there is no net financial statement effect.

2. **ANALYSIS:** As seen in items (b) and (c), some very significant transactions can be excluded from the cash flow statement. The FASB's position makes some sense because it restricts the cash flow statement to just those transactions involving cash. A compromise position might be to exclude the significant non-cash transactions from the formal cash flow statement, but to require that they be briefly mentioned at the bottom of the statement of cash flows and then more fully explained in the financial statement notes. In this way, financial statement users would be less likely to overlook these important non-cash transactions.

P 6-19 Determining Cash Flow from Operations

1. The Laker Basketball Company
Partial Statement of Cash Flows—Indirect Method
For the Year Ended June 30, 2006

Cash from operating activities		
Net income		\$ 50,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	\$ 12,000	
Loss on sale of investment securities	1,000	
Restructuring charge	105,000	
Loss on sale of land	20,000	
Gain on early extinguishment of debt	(70,000)	
Increase in accounts receivable	<u>(8,000)</u>	<u>60,000</u>
Net cash provided by operating activities		<u>\$110,000</u>

Note: Because the investment securities are NOT part of the Laker's active trading portfolio, the purchases and sales of the investment securities are investing activities. As such, the loss is excluded from the calculation of cash from operating activities.

2. **ANALYSIS:** Without the \$70,000 gain from the early extinguishment of debt, The Laker Basketball Company would have reported a net loss of \$20,000 (\$50,000 – \$70,000) for the year. Clearly, the company accelerated the extinguishment of the debt in order to avoid the embarrassment of reporting a net loss. However, because the company was preparing to extinguish the debt anyway, management can hardly be faulted for taking

advantage of the timing to erase the potential net loss.

P 6-26 Interpretation of Cash Flow Information

1. The statement of cash flows provides information about Denslowe’s current liquidity, a measure to assist Denslowe in setting a dividend payment for the year and in evaluating the effects of the company’s investing and financing strategies during the year. It also provides a basis for anticipating the company’s future cash flows (especially those from operations) to determine whether additional financing (debt, equity, or liquidation of existing assets) will be required to continue operations, meet obligations as they come due, and pay dividends.
2. The principal explanation for why Denslowe earned a profit for the year yet couldn’t pay its current debts is revealed in the statement. Most of the net income of \$100,000 for the year was attributable to the \$90,000 gain on sale of the plant. This is deducted from net income because the transaction affects net income but does not affect cash flows from operations (the sale of a long-term asset such as property, plant, and equipment is an investing activity). A look at the financing section tells us that of the \$120,000 received from the sale of the plant, \$80,000 was spent paying off long-term debt (most likely related to the plant), so the net cash generated by the sale is \$40,000 (\$120,000 – \$80,000). In addition, the company spent \$45,000 on the plant during the year (the plant may have required capital improvements before it could be sold to the buyer). Thus, from a cash standpoint, the company came out of pocket by \$5,000 (\$45,000 – \$40,000) as a result of the entire “cycle” of improving the plant, selling it, and paying off the related debt.

In addition, the company paid \$35,000 in dividends during the year. Receivables and inventories increased by \$20,000 and \$30,000, respectively. Thus, expenditures totaling \$85,000 were made using cash that potentially could have been available to pay current debts. The company should examine and refine its policies for spending cash if it wishes to make cash available to meet current debts.

3. ANALYSIS: Denslowe Associates
FORECASTED Statement of Cash Flows
For the Year Ended December 31, 2007

Cash flows from operating activities		
Net income	\$ 10,000 ¹	
Adjustments:		
Provision for depreciation and amortization	40,000	
Changes in assets and liabilities:		
(Increase) in receivables	(20,000) ²	
(Increase) in inventory	(30,000) ²	
(Decrease) in payables	<u>(20,000)²</u>	
Net cash used by operating activities		\$(20,000)
Cash flows from investing activities		
Addition to plant and equipment	<u>(45,000)³</u>	
Net cash used by investing activities		(45,000)
Cash flows from financing activities		
Dividends paid	(35,000) ⁴	
New financing (loans or stock issuance)	<u>100,000⁵</u>	
Net cash provided by financing activities		<u>65,000</u>
Change in cash		<u>\$ 0</u>

Assumptions:

1. The gain on the sale of the plant was a one-time thing. The best guess of next year’s net income is

- \$10,000 which is this year's net income without the gain (\$100,000 this year's net income – \$90,000 gain).
2. Without information to the contrary, it seems reasonable to expect current assets and current liabilities to continue to increase or decrease as in the past. Alternatively, it may be assumed that, instead of decreasing, accounts payable will be unchanged or even increase.
 3. In order to stay in business, Denslowe will have to continue to update and improve its plant and equipment. Accordingly, it is assumed that expenditures for new plant and equipment in 2007 will be the same as in 2006. It is also assumed that no additional asset disposals will occur.
 4. Companies are very reluctant to reduce the amount of cash dividends. Also, given Denslowe's operating cash flow problems, it seems unlikely that dividends will be increased. Thus, it is assumed that dividends in 2007 will be the same as in 2006.
 5. This \$100,000 is a plug figure—this is the amount of new financing needed if the total change in cash for the year is to be \$0.

This simple exercise illustrates the power of a forecasted statement of cash flows. A few basic assumptions lead one to the conclusion that, unless something changes dramatically, Denslowe will be forced to obtain a significant amount of external financing in 2007. Armed with this forecasted information, the president of Denslowe Associates can now consider what changes to operating policy and dividend policy need to be implemented in 2007.