COURSE TITLE: Financial and Managerial Accounting

(Problems and Cases from Financial Accounting 11TH Edition)

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EXECUTIVEE SUMMARY

This assignment presents problem 13 –1 about the cash flow of the Vandergriff Inc. It includes cash flow operating activities, investing activities and financing activities.

Problems 14 – 4, 14 –7, 14 –8 and 14 –10 discusses critically about the financial ratios of different companies.

In the financial statement analysis chapter we evaluated three different cases: i.e., in Case 14 – 3, Jenkins Improvement Center because of its lower current ratio, the company tries to qualify for better credit terms.

Case 14 –5 of Kelsay MicroLabs which develops and manufactures Pharmaceutical – products, which the company had been growing rapidly during the past 10 years and its profit increased annually by 30 % which the company doesn't pay dividend, but has a very high price earning ratio. Due it its rapid growth and large expenditures which the company faces cash shortages and the company tries to improve its cash shortage by reducing credit periods and reducing its expenditures for R&D by 25 %. Here we evaluated the situation from the perspective of short-term creditors and common stock holders.

Case 14 – 6, we evaluated the situation from 5.5% bondholders, 14 % bondholders and in the view of the common stock holders. Where in 5.5% and 14 % bondholders, the company calls at 103 market value and at 8 % bond issue.

Solutions to Problem 13-1

Cash flow operating activities

f. Cash received from customers;

a. Payment to suppliers of merchandize;

b. Payment of interest;

e.. Payment to employers;

i. Depreciation (now cash expense decrease)

j. Payment of insurance policy;

l. Payment of accrued interest;

m. Receipt of dividend;

Cash Flow from Investing Activities

h. Cash paid to acquire plant assets

Cash Flow from Financing Activities

b. Payment to acquire bonds;

d. proceeds from issuance of bonds;

k. Payment of dividend;

n. Proceeds from sale of capital stock

G and O according FASB cash equivalents are not viewed as cash receipts or cash payments so they are not included in the cash flow statement as they are already considered as cash.

Solutions to Problem 14 – 4

Assets

Current Assets

Cash 74, 800.00

Receivables 152,700.00

Merchandize Inventories 1,191,800.00

Pre paid expenses 95,500.00

Total Current Assets 1,514,800.00

Plant and Equipment

Fixture and equipment 2,592,900.00

Total Assets 4,107,700.00

Current Liabilities

Total current liabilities .... …. 1,939,000.00

A) Total current asset = $ 1,514,800.00

Total quick asset = $ 227,500.00

B) 1. Current ratio = $\frac{\text{Current asset}}{\text{Current Liability}} = \frac{1,514,800.00}{1,939,000.00}$ == **0.8:1**

2. Quick ratio = $\frac{\text{Quick asset}}{\text{Current liabilities}} = \frac{227,500.00}{1,939,000.00}$/ = **0.1:1**

3. Working capital = Current asset – Current Liabilities

1,514,800.00 – 1,939,000.00

= **- 424,200.00**

C) Safeway. Inc is one of the world's largest supermarket chains. It has a negative working capital of 424,200.00 and a current and quick ratio less than 1. However, this could not mean that the Incorporation is at risk. Since the super market can

convert its inventory to cash at a faster rate before liabilities come due. But having quick and current ratios less than 1, one may read the Incorporation as less favorable and less satisfactory to pay its debts, but if we see the ratio of total liabilities to total assets is favorable, i.e., the organization is able to cover its obligations.

D) Supermarkets unlike large department stores shows convert their inventories to cash faster. The essential difference between supermarkets and departments is, while supermarkets sell their products in pieces, large departments sell their goods in bulky. So the supermarkets chain customers prefer to have fresh, and buy in small quantities. The contact with the supermarkets is continuous. Normally, customers of supermarkets purchase items for a month or two, to maintain freshness so the operating cycle of supermarkets is shorten than the large departments.

E) Safeway Inc. current and quick ratio shows less than 1. Looking simply at these ratios, one cannot conclude that Safeway is on the brink; however, one will need to verify further by looking at the net cash available by the operating activities. Calculating Safeway's maturity of obligation will also indicate how much is it liquid. The turn over of accounts receivable and of inventories gives the clue of its operating cycle. Not least, the free flow of cash measures also the liquidity of Safeway. Since this cash money is left for discretionary use after all operating and non-operating expenses are paid.

<u>Solutions to Problem 14-7</u>

a) **Computing the amounts**

Quick Assets are the most liquid assets, that is, Cash, Marketable securities, Notes receivable, Accounts receivable.

Cash	= 425,000.00
Marketable securities	= 216,000.00
Notes receivable	= 324,000.00
Accounts receivable (net)	= 513,000.00
Total Quick Assets	**1,478,000.00**

Current assets are cash, marketable securities, notes receivable, accounts receivable, inventory, and prepaid expenses.

Cash	= 425,000.00
Marketable securities	= 216,000.00
Notes receivable	= 324,000.00
Accounts receivable (net)	= 513,000.00
Inventory	= 432,000.00
Prepaid expenses	= 64,000.00
Assets	**1,974,000.00**

Current liabilities are notes payable (one year), accounts payable, unearned revenue, and accrued expenses (income tax, salary payable, interest payable).

Notes payable	= 165,000.00
Accounts payable	= 445,500.00
Accrued liability	= 42,500.00
Total Current Liabilities	**653,000.00**

b) Ratios

1. Current ratio = $\frac{\text{Current assets}}{\text{Current liabilities}}$ = $\frac{1,974,000.00}{653,000.00}$ = **3.02: 1**

2. Quick ratio = $\frac{\text{Quick assets}}{\text{Current liabilities}}$ = $\frac{1,478,000.00}{653,000.00}$ = **2.26: 1**

3. Working capital = Current assets – Current liabilities

   = 1,9741,000.00-653,000.00 = **1,321,000.00**

c) Indication of effects on Current ratio, Quick ratio, Working Capital and Net cash flow from operating activities.

Item	Current ratio	Quick ratio	Working capital	Net cash flow from operations activities
0	Decrease	Increase	Decrease	No effect
1	Decrease	Decrease	Decrease	Increase
2	Decrease	Decrease	Decrease	Increase
3	No effect	No effect	Decrease	Decrease
4	Decrease	Decrease	Decrease	No effect
5	Increase	Decrease	Increase	No effect
6	Decrease	Decrease	Decrease	Decrease
7	No effect	No effect	No effect	No effect
8	No effect	No effect	No effect	No effect
9	No effect	No effect	Decrease	Decrease
10	No effect	No effect	Decrease	No effect
11	No effect	No effect	Increase	Increase
12	No effect	No effect	No effect	Increase

Solutions to Problem 14 -8

Valesko Department Store

Balance Sheet

December 31, 2002

A) 1.

Assets

Current Assets	$. 4,000.00
Plant and Equipment	2,600.00
Other Assets	200.00
Total Assets	**6,800.00**
Current Liabilities	2,000.00
Long term liabilities	1,600.00
Total liabilirties	**3,600.00**
Stock holder's equity	3.200.00
Total liabilities and Stockholders' equity	**6,800.00**

Velasco Department Store
Income Statement
For the year Ended December 31,2002

Net Sales		$..10,000.00
Less: Cost of goods sold		7,000.00
Gross Profit		**3,000.00**
Less: Operating expenses:		
Selling expenses:	1,000.00	
General and administrative expense	980.00	
Total operating expenses		1,980.00
Operating Income		1,020.00
Income tax expense and other non operating expenses		220.00
Net Income		**800.00**

B) 1) Compute at year-end the company's:

Current ratio = $\frac{\text{Current asset}}{\text{Current liabilities}}$ $\frac{\$4,000.00}{\$2,000.00}$ = **2:1**

2) Working capital = Current asset – Current liability
$ 4,000.00 – 2,000.00 = **2,000**

c) Compute the company's 2002:

1) Gross profit rate = $\frac{\text{Gross profit}}{\text{Net sales}} = \frac{3,000.00}{10,000.00}$ = **30%**

2) Return on assets = $\frac{\text{operating Income}}{\text{Average Investment in total assets}} = \frac{1,020.00}{6,800.00}$ = **15%**

3) Return on total stockholders' equity = $\frac{\text{Net sales}}{\text{Average total stockholders' equity}}$

$= \frac{800.00}{3,200.00}$ = **25%**

d) 1) The company may pay its short-term obligations and its ratio may change dramatically. The major reasons could be:

2) the company may pay its long-term liabilities;

3) the Company declares and pays dividends to its stockholders;

4) the company may purchase equipment by its own cash.

Solutions to Problem 14.10

A)

1. Inventory turnover = $\frac{\text{Cost of goods sold}}{\text{Average Inventory}} = \frac{1,755.00}{351.00}$ = **5**

2. Accounts Receivable turnover = $\frac{\text{Net sales}}{\text{Average accounts receivable}}$

= $\frac{2,750.00}{300,000.00}$ = **9.17**

3. Total operations expense = $\frac{\text{Operating expenses}}{\text{Net sales}}$

$\frac{707,000.00}{2,750,000.00}$ = **0.257**

4. Gross profit percentage = $\frac{\text{Gross profit}}{\text{Net sales}}$

= $\frac{995,000.00}{2,750,000.00}$ = **0.3618**

5. Return on average stockholder's equity = $\frac{\text{Net Income}}{\text{Average total stockholders' equity}}$

$\frac{159,000.00}{95,000.00}$ = **0.178**

Return on average assets = $\frac{\text{operating income}}{\text{Average total assets}}$ =

= $\frac{288,000.00}{1,800,000.00}$ = **0.16**

A) Obtaining the loan would not be desirable from the point of view of the stockholders. use from the data given;

Gross profit percentage	36%
Less: Operating expenses	26%
	10%

Therefore, this 10% Net income will not cover the interest ratio of **12%.**

Solutions to Case 14.3

A) Analysis whether current ratio is favorable or not.

1. **Paying some of the center's current liabilities**

This measure might show that the current position of the company is better by paying some of its liabilities. However, this as it is called WINDOW DRESSING, by simply rearranging the asset and liability accounts it doesn't tell that the company is in a stronger position.

2. Purchase large amounts of inventory on account

Jenkins retail store is engaged in building materials, hard ware, and garden supplies. These products are consumed rarely. That is unless there is a need or a replacement of an item already had. So buying more inventories on account will not make the firm stronger as it is increasing both the asset and liability accounts. However, if the Jenkins know that there is a high demand in the coming future and as a result there will be a possibility these items be converted into cash, probably, this could make a difference. Otherwise high inventory will tie up cash to be used for other operations.

3) Offering credit customers as a special discount

This option could normally accelerate the turnover of inventory. The fast turnover of inventory shortens the operating cycle time and inventories are converted into cash faster. Besides the introduction of special discount will invite for more customers and at the same time there will be high volume of sales. This will lead to high profitability, liquidity and best credit terms if there are also policies for discount and collection of receivables.

B) Jekins current problem is to make its current ratio sound . To raise the liquidity of the
center, Jekins has :

1. To increase cash and cash equivalents,
2. To increase the turnover for accounts receivables,
3. To increase the turnover of inventory,
4. To manage the expense.

Some of the ethical strategies Jenkins has to follow to improve its cash flows could be:

1. Peak Pricing
2. Develop an Effective Product Mix
3. Differing Income Taxes.

Peak Pricing: Jenkins can raise the prices when there is high demand and lower prices during off peaks periods. This will help the firm to increase the revenue during the periods of high demand and shifts some of the demand to off peak periods.

Develop an Effective Product Mix :

Jenkins cash receipts and revenue could be improved if it introduces Product mix. Complementary products such as clearing materials, computer appliances flowers, and other related items may add their sales and this may also satisfy customers who would purchase such items in different shops.

Differing Income Taxes:
differing income taxes mean using accounting methods for income tax purposes that legally post pone the payment of income taxes. Differing taxes may benefit a growing business every year. Thus it is an effective and popular cash management strategy.

Solutions to Case 14.5

Kelsay MicroLabs develop and manufacture pharmaceutical products. The company has been growing rapidly during the past ten years, due to primarily to having discovered, patented and successfully marketed dozens of new products; profits have increased annually by 30% or more. The company pays no dividends but has a very high price-earnings ratio.

Due to its rapid growth and large expenditures for research and development, the company has experienced occasional cash shortages. To solve this problem, Kelsay has decided to improve its cash position by:

1. Requiring customers to pay for products purchased on account from the company in 30 days instead of 60 days and
2. Reducing expenditures for research and development by 25%.

Herewith we evaluated the situation from the perspective of:

3. Short term creditors
4. Common stock holders.

a) **<u>From the perspective of short term creditors</u>**

Bankers and other short-term creditors share the interest of stockholders and bold holders in the profitability and long-run stability of a business. Their primary interest, however, is in the current position of the company. Its ability to generate sufficient funds (working capital) to meet current operating needs and pay current debts promptly.

Thus the analysis of financial statements by a banker considering a short-term loan, or by a trade creditor investigating the credit status of a customer, is likely to center on the working capital position of the prospective debtors.

Working capital is the excess of current assets over current liabilities. It represents the cash and near cash assets that are expected to convert into cash within a relatively short period of time and that current liabilities require a prompt cash payment.

Kelsay Microlabs Company is a company, which has been growing rapidly during the past ten years due to primarily to having discovered, patented, and successfully marketed dozens of new products. Profits have increased by 30% or more but due to its rapid growth and large expenditures for research and development the company has experienced occasional cash shortages. The company may not be too attractive for the short-term creditors.

Because of the prevailing condition of its cash shortage its working capital position is low and its ability to pay its current obligations may be low.

The decision of Kelsay Company seems reasonable in improving its cash position, for the short run, by shortening its credit periods and by reducing expenditures for research and development by 25%.

The management of the company has to think not only of the long-term creditors but also of the short-term creditors as well.

b) <u>From the perspective of common stock-holders</u>

Common stock holders and potential investors in common stock look first at a company's earning record. Their investment is in shares of stock, so earnings per share and dividends per share are of particular interest.

Earnings per share of common stock are computed by dividing the income applicable to the common stock by the weighted average number of shares of common stock outstanding during the year. Any preferred dividend requirements must be subtracted from the net income to determine net income applicable to common stock.

Common stockholders consider an increase in earnings per share to be a favorable development. An increase in earning per share generally represents an increase in the profitability of the company and creates certainty as to the company's prospects for future growth.

The Kelsay company profits have increased annually by 30% or more and earnings per share increases definitely. This is the most attractive part to the common stock holders.

Price earning ratio (p/e ratio) expresses the relationship between the market price of a company's stock and the underlying earnings per share. It is computed by dividing the current market price per share of the company's stock by annual earnings per share.

The price earnings ratio of the Kelsay Company is very high. This is also very attractive in the perspective of common stock holders' situation.

Dividends are of prime importance to some stockholders, but a secondary factor to the others. Some stockholders invest primarily to receive regular cash income, while others invest in stocks principally with the expectation of rising market prices. If a corporation is profitable and retains its earnings for expansion of the business, the expanded operations should produce an increase in the net income of the company and thus tend to make each share of stock more valuable. In comparing the advantages of alternative investment opportunities, one should relate earnings and dividends per share to the market value of the stock.

Dividends per share divided by the market price per share determine the yield rate of the company's stock. Dividend yield is especially important to those investors whose objective is to maximize the dividend revenue from their investment.

The Kelsay Company, though, profits increase annually by 30% or more, and has a very high price-earnings ratio, which is very attractive for both investment opportunities; paying no dividends may not be encouraging for the common stock holders whose prime importance is dividends. These stock holders invest primarily to receive regular cash income and Kelsay company management have to take into consideration of such investors' objective also and it is good that it decides to improve its cash position so that its liquidity position will be improved and it will try to satisfy all its investors.

<u>Solutions to case 14 – 6</u>

a) **Evaluating the situation from the 5.5% -bond holder.**

When Metro Utilities calls the 5.5% bondholder at 103 they Benefit accordingly:

1. Since the management has declared the calling price of the 5.5% bond by 103 the holders do benefit.

2. The 5.5% bondholders have the opportunity of benefiting by investing their bonds at 8%.

b)Evaluating the situation from the 14 % bondholders.

When metro utilities calls the 14 % bonds at 103 they are gaining, but in the end they loose. This is because the 14% bondholders would have benefited to get the 14% interest bond maturing in 23 years. But if the Metro utilities call them at 103 they are going to invest their bonds in 8 %. Overall, they are loosing 6%.

C) In view of the Common stockholders

The Common Stockholders as owners of the business enterprise, they are gaining when they get 12% return on assets, while current market value of the bonds is assumed at 8%. Secondly, when the common stockholders call the 5.5% bondholders at 103 callable prices as owners they are loosing; but when they call the 14% bond holders at 103 they are gaining in the long run.

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