Financial Integrative Case for Track Software, Inc.

Seven years ago, after 15 years in public accounting, Stanley Booker, CPA,

resigned his position as manager of cost systems for Davis, Cohen, and O’Brien

Public Accountants and started Track Software, Inc. In the 2 years preceding his

departure from Davis, Cohen, and O’Brien, Stanley had spent nights and weekends

developing a sophisticated cost-accounting software program that became Track’s

initial product offering. As the firm grew, Stanley planned to develop and expand

the software product offerings, all of which would be related to streamlining the

accounting processes of medium- to large-sized manufacturers.

Although Track experienced losses during its first 2 years of operation—2009

and 2010—its profit has increased steadily from 2011 to the present (2015). The

firm’s profit history, including dividend payments and contributions to retained

earnings, is summarized in Table 1.

Stanley started the firm with a $100,000 investment: his savings of $50,000 as

equity and a $50,000 long-term loan from the bank. He had hoped to maintain his

initial 100 percent ownership in the corporation, but after experiencing a $50,000

loss during the first year of operation (2009), he sold 60 percent of the stock to a

group of investors to obtain needed funds. Since then, no other stock transactions

have taken place. Although he owns only 40 percent of the firm, Stanley actively

manages all aspects of its activities; the other stockholders are not active in management

of the firm. The firm’s stock was valued at $4.50 per share in 2014 and at

$5.28 per share in 2015.



Stanley has just prepared the firm’s 2015 income statement, balance sheet, and

statement of retained earnings, shown in Tables 2, 3, and 4, along with the 2014

balance sheet. In addition, he has compiled the 2014 ratio values and industry

average ratio values for 2015, which are applicable to both 2014 and 2015 and

are summarized in Table 5. He is quite pleased to have achieved record earnings of

$48,000 in 2015, but he is concerned about the firm’s cash flows. Specifically, he

is finding it more and more difficult to pay the firm’s bills in a timely manner and

generate cash flows to investors, both creditors and owners. To gain insight into

these cash flow problems, Stanley is planning to determine the firm’s 2015 operating

cash flow (OCF) and free cash flow (FCF).

Stanley is further frustrated by the firm’s inability to afford to hire a software

developer to complete development of a cost estimation package that is believed

to have “blockbuster” sales potential. Stanley began development of this package

2 years ago, but the firm’s growing complexity has forced him to devote more of

his time to administrative duties, thereby halting the development of this product.

Stanley’s reluctance to fill this position stems from his concern that the added

$80,000 per year in salary and benefits for the position would certainly lower the

firm’s earnings per share (EPS) over the next couple of years. Although the project’s

success is in no way guaranteed, Stanley believes that if the money were spent to hire

the software developer, the firm’s sales and earnings would significantly rise once

the 2- to 3-year development, production, and marketing process was completed.

With all these concerns in mind, Stanley set out to review the various data to

develop strategies that would help ensure a bright future for Track Software. Stanley

believed that as part of this process, a thorough ratio analysis of the firm’s 2015

results would provide important additional insights.









**Questions**

**a.** (1) On what financial goal does Stanley seem to be focusing? Is it the correct

goal? Why or why not?

(2) Could a potential agency problem exist in this firm? Explain.

**b.** Calculate the firm’s earnings per share (EPS) for each year, recognizing that the

number of shares of common stock outstanding has remained unchanged since

the firm’s inception. Comment on the EPS performance in view of your response

in part a.

**c.** Use the financial data presented to determine Track’s operating cash flow (OCF)

and free cash flow (FCF) in 2015. Evaluate your findings in light of Track’s current

cash flow difficulties.

**d.** Analyze the firm’s financial condition in 2015 as it relates to (1) liquidity, (2) activity,

(3) debt, (4) profitability, and (5) market, using the financial statements

provided in Tables 2 and 3 and the ratio data included in Table 5. Be sure to

evaluate the firm on both a cross-sectional and a time-series basis.

**e.** What recommendation would you make to Stanley regarding hiring a new software

developer? Relate your recommendation here to your responses in part a.

**f.** Track Software paid $5,000 in dividends in 2015. Suppose that an investor approached

Stanley about buying 100% of his firm. If this investor believed that by

owning the company he could extract $5,000 per year in cash from the company

in perpetuity, what do you think the investor would be willing to pay for the firm

if the required return on this investment is 10%?

**g.** Suppose that you believed that the FCF generated by Track Software in 2015

could continue forever. You are willing to buy the company in order to receive

this perpetual stream of free cash flow. What are you willing to pay if you require

a 10% return on your investment?