PROBLEM 14-12A Common-Size Statements and Financial Rations for Creditors (LO1, LO3,LO4)

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| NEWPORT INDUSTRY | |  |  |  |  |
| Comparative Balance Sheet | |  |  |  |  |
| This Year Last Year | |  |  |  |  |
| Assets |  |  |  |  |  |
| Current assets: | |  |  |  |  |
| Cash ……………………………………… $ 60,000 $ 140,000 | | | | | |
| Marketable securities ……………………… 0 30,000 | | | | | |
| Accounts receivable net …………………… 470,000 290,000 | | | | | |
| Inventory ………………………………….. 940,000 590,000 | | | | | |
| Prepaid expenses …………………………. 35,000 40,000 | | | | | |
| Total current assets ……………………….. 1,505,000 1,090,000 | | | | | |
| Plant and equipment, net ………………..… 1,410,000 1,300,000 | | | | | |
| Total assets ……..………………………… $2,915,000 $2,390,000 | | | | | |
|  |  |  |  |  |  |
| Liabilities and Stockholder’s Equity | |  |  |  |  |
| Liabilities: |  |  |  |  |  |
| Current liabilities …………………………… $ 703,000 $ 371,000 | | | | | |
| Bonds payable, 125 ………………………. 500,000 500,000 | | | | | |
| Total liabilities …………………………….. 1,203,000 871,000 | | | | | |
| Stockholder’s equity: | |  |  |  |  |
| Preferred stock, $25 par, 8% ……………… 300,000 300,000 | | | | | |
| Common stock, $10 par …………………… 550,000 550,000 | | | | | |
| Retained earnings …………………………. 862,000 669,000 | | | | | |
| Total stockholder’s equity ………………… 1,712,000 1,519,000 | | | | | |
| Toal liabilities and equity ……………………. $2,915,000 $2,390,000 | | | | | |
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| NEWPORT INDUSTRY | |  |  |  |  |
| Comparative Income Statement | |  |  |  |  |
| This Year Last Year | |  |  |  |  |
| Sales ……………………………………………… $4,960,000 $4,380,000 | | | | | |
| Less cost of goods sold …………………………… 3,839,000 3,470,000 | | | | | |
| Gross margin………………….…………………… 1,121,000 910,000 | | | | | |
| Less operating expenses …………………………… 651,000 550,000 | | | | | |
| Net operating income …….…..……………………. 470,000 360,000 | | | | | |
| Less interest expense…..……. ………… ……….. 60,000 60,000 | | | | | |
| Net income before taxes … ………………………. 410,000 300,000 | | | | | |
| Less income taxes (30%) ….……………………… 123,000 90,000 | | | | | |
| Net income ……………..……………………… 287,000 210,000 | | | | | |
|  |  |  |  |  |  |
| Dividends paid: | |  |  |  |  |
| Preferred dividends ……………………………….. 24,000 24,000 | | | | | |
| Common dividends …….…………………………. 70,000 70,000 | | | | | |
| Total dividends paid ……….……………………… 94,000 84,000 | | | | | |
| Net income retained ………………………………. 193,000 126,000 | | | | | |
| Retained earnings, beginning of year ……..………… 669,000 543,000 | | | | | |
| Retained earnings, end of year ……………………. $ 862,000 $ 669,000 | | | | | |

During the past year, the company introduced several new product lines and raised the selling prices on a number of old product lines in order to improve its profit margin. The company also hired a new sales manager, who has expanded sales into several new in territories. Sales terms are 2/10, n/30. All sales are on account. The following ratios are typical of firms in this industry:

Current ratio ……………………………….. 2.5 to 1

Acid-test (quick) ratio……………………… 1.3 to 1

Average age of receivables ………………… 17 days

Inventory turnover in days ………………….. 60 days

Debt-to-equity ratio ……………….………. 0.90 to 1

Times interest earned ………………………. 6.000 times

Return on total assets ………………………. 13%

Price-earnings ratio ………………………. 12

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| --- | --- | --- | --- | --- |
| NEWPORT INDUSTRY | **Balance sheet in Common Size Format** | | |  |
|  |  |  |  |  |
| Assets |  | This year |  | Last year |
| Current assets: |  |  |  |  |
| Cash |  | 2.06% |  | 5.86% |
| Marketable securities |  | 0.00% |  | 1.26% |
| Accounts receivable net |  | 16.12% |  | 12.13% |
| Inventory |  | 32.25% |  | 24.69% |
| Prepaid expenses |  | 1.20% |  | 1.67% |
| Total current assets |  | 51.63% |  | 45.61% |
| Plant and equipment, net |  | 48.37% |  | 54.39% |
| Total assets |  | 100.00% |  | 100.00% |
|  |  |  |  |  |
| Liabilities and Stockholder’s Equity |  |  |  |  |
| Liabilities: |  |  |  |  |
| Current liabilities |  | 24.12% |  | 15.52% |
| Bonds payable, |  | 17.15% |  | 20.92% |
| Total liabilities |  | 41.27% |  | 36.44% |
| Stockholder’s equity: |  |  |  |  |
| Preferred stock, $25 par, 8% |  | 10.29% |  | 12.55% |
| Common stock, $10 par |  | 18.87% |  | 23.01% |
| Retained earnings |  | 29.57% |  | 27.99% |
| Total stockholder’s equity |  | 58.73% |  | 63.56% |
| Toal liabilities and equity |  | 100.00% |  | 100.00% |

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| --- | --- | --- | --- | --- | --- |
| NEWPORT INDUSTRY | | Income statement in Common size | | | |
| Comparative Income Statement | |  |  |  |  |
|  |  |  | This year |  | Last year |
| Sales |  |  | 100.00% |  | 100.00% |
| Less cost of goods sold | |  | 77.40% |  | 79.22% |
| Gross margin | |  | 22.60% |  | 20.78% |
| Less operating expenses | |  | 13.13% |  | 12.56% |
| Net operating income | |  | 9.48% |  | 8.22% |
| Less interest expense | |  | 1.21% |  | 1.37% |
| Net income before taxes | |  | 8.27% |  | 6.85% |
| Less income taxes (30%) | |  | 2.48% |  | 2.05% |
| Net income | |  | 5.79% |  | 4.79% |

Problem 14-13A

Refer to the financial statements and other data in PROBLEM 14-12B. Assume that you are an account executive for a large brokerage house and that one of your clients has asked for a recommendation about the possible purchase of Newport Industry stock. You are not acquainted with the stock and for this reason wish to do some analytical work before making a recommendation.

Required:

1. You decide first to assess the well-being of the common stockholders. For both this year and last year, compute:

a. The earnings per share. There has been no change in preferred or common stock over the last two years.

b. The dividend yield ratio for common stock. The company’s stock is currently selling for $38 per share; last year it sold for $35 per share.

c. The dividend payout ratio for common stock.

d. The price-earnings ratio. How do investors regard Newport Industry as compared to other companies in the industry? Explain.

e. The book value per share of common stock. Does the difference between market value and book value suggest that the stock is overpriced? Explain.

2. You decide next to assess the company’s rate of return. Compute the following for both this year and last year:

a. The return on total assets. (Total assets at the beginning of last year were $2,230,000.)

b. The return on common stockholders’ equity. (Stockholders’ equity at the beginning of last year was $1,418,000.)

c. Is the company’s financial leverage positive or negative? Explain.

3. Would you recommend that your client purchase shares of Newport Industry stock? Explain.