Ethics Challenge:

Mountain Aerosport was founded by Jurgen Prinz to produce a ski he had designed for doing aerial tricks. Up to this point, Jurgen has financed the company with his own savings and with cash generated by his business. However, Jurgen now faces a cash crisis. In the year just ended, an acute shortage of vital tungsten steel alloy developed just as the company was beginning production for the Christmas season. Jurgen had been assured by his suppliers that the steel would be delivered in time to make Christmas shipments, but the suppliers had been unable to fully deliver on this promise. As a consequence, Mountain Aerosport had large stocks of unfinished skis at the end of the year and had been unable to fill all of the orders that had come in from retailers for the Christmas season. Consequently, sales were below expectations for the year, and Jurgen does not have enough cash to pay his creditors.

Well before the accounts payable were due, Jurgen visited a local bank and inquired about obtaining a loan. The loan officer at the bank assured Jurgen that there should not be any problem getting a loan to pay off his account payable – providing that on his most recent financial statements the current ratio was above 2.0, the acid-test ratio was above 1.0, and the net operating income was at least four times the interest on the proposed loan. Jurgen promised to return later with a copy of his financial statements.

Jurgen would like to apply for a $120 thousand six-month loan bearing an interest rate of 10% per year. The unaudited financial reports of the company appear below.

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| **Mountain Aerosport** |
| **Comparative Balance Sheet** |
| **As of December 31** |
| **(in thousands of dollars)** |

|  |  |  |
| --- | --- | --- |
| Assets: | This Year | Last Year |
| Current Asset: |  |  |
| Cash | 105 | 225 |
| Account recievable, net | 75 | 60 |
| Inventory | 240 | 150 |
| Prepaid expenses | 15 | 18 |
| Total current assests | 435 | 453 |
| Property and equipment | 405 | 270 |
| Total assests | 840 | 723 |
|  |  |  |
| Liabilities and Stockholder's Equity |  |  |
| Current Liability |  |  |
| Accounts payable | 231 | 135 |
| Accrued payables | 15 | 15 |
| Total current liabilities | 246 | 150 |
| Long-term liabilities | 0 | 0 |
| Total Liabilities | 246 | 150 |
|  |  |  |
| Stockholders' equity |  |  |
| Common stock and additional paid in capital | 150 | 150 |
| Retained Earnings | 444 | 423 |
| Total Stockholder's equity | 594 | 573 |
| Total liabilities and stockholders' equity | 840 | 723 |

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| **Mountain Aerosport** |
| **Income statement** |
| **For the year ended Decemeber 31, This year** |
| **(in thousands of dollars)** |

|  |  |
| --- | --- |
| Sales (all on account) | 630 |
| Cost of goods Sold | 435 |
| Gross Margin | 195 |
| Selling and administrative expenses |  |
| Selling expense | 63 |
| Administrative expense | 102 |
| Total Selling and administrative expense | 165 |
| Net Operating income | 30 |
| Interest expense | 0 |
| Net income before taxes | 30 |
| Income Taxes (30%) | 9 |
| Net income before taxes | 21 |

Required:

1. On the basis of the above unaudited financial statements and the statement made by the loan officer, would the company qualify for the loan.
2. Last year Jurgen purchased and installed new, more efficient equipment to replace an older heat treating furnace. Jurgen had originally planned to sell the old equipment but found that it is still needed whenever the heat-treating process is a bottleneck. When Jurgen discussed his cash flow problems with his brother-in-law, he suggested to Jurgen that the old equipment be sold or at least reclassified as inventory on the balance sheet since it could be readily sold. At present, the equipment is carried in the property and equipment account and could be sold for its net book value of $68 thousand. The bank does not require audited financial statements. What advice would you give to Jurgen concerning the machine?