**Problem 12-15 Income Statement, Statement of Cash Flows (Direct Method) and Balance Sheet**

The following events occurred at Handsome Hounds Grooming Company during its first year of business:

1. To establish the company, the two owners contributed a total of $50,000 in exchange for common stock.
2. Grooming service revenue for the first year amounted to $150,000, of which $40,000 was on account.
3. Customers owe $10,000 at the end of the year from the services provided on account.
4. At the beginning of the year, a storage building was rented. The company was required to sign a three-year lease for $12,000 per year and make a $2,000 refundable security deposit. The first year’s lease payment and the security deposit were paid at the beginning of the year.
5. At the beginning of the year, the company purchased a patient at a cost of $100,000 for a revolutionary system to be used for dog grooming. The patent is expected to be useful for 10 years. The company paid 20% down in cash and signed a four-year note at the bank for the remainder.
6. Operating expenses, including amortization of the patent and rent on the storage building, totaled $80,000 for the first year. No expenses were accrued or unpaid at the end of the year.
7. The company declared and paid a $20,000 cash dividend at the end of the first-year.

Required:

1. Prepare an income statement for the first year.
2. Prepare a statement of cash flows for the first year using the direct method in the Operating Activities section.
3. Did the company generate more or less cash flow from operations than it earned in net income? Explain why there is a difference.
4. Prepare a balance a sheet as of the end of the first year.

**Problem 12-1** **Comparing Tow Companies in the Same Industry: Kellogg’s and General**

Refer to the statement of cash flows for both Kellogg’s and General Mills for the most recent year and any other pertinent information.

Statement of Cash Flow for Kellogg

|  |  |  |  |
| --- | --- | --- | --- |
| Million | 2006 | 2005 | 2004 |
| Operating activities |  |  |  |
| Net earnings  Adjustments to reconcile earnings to operating cash flows  Depreciation and amortization  Deferred income taxes  Other (a)  Pension and other postretirement benefit plan contribution  Changes in operating assets and liabilities | **$1,004.1**  **352.7**  **(43.7)**  **235.2**  **(98.3)**  **(38.5)** | $980.4  391.8  (59.2)  199.3  (397.3)  28.3 | $890.6  410.0  57.7  104.5  (204.0)  (29.8) |
| **Net cash provided by operating activities** | **$1,410.5** | $1,143.3 | $1,229.0 |
| **Investing activities** |  |  |  |
| Additions to properties  Acquisitions of businesses  Property disposals  Investment in joint venture and other | **$(453.1)**  **-**  **9.4**  **(1.7)** | $(374.2)  (50.4)  9.8  (.2) | $(278.6)  -  7.9  .3 |
| **Net cash used in investing activities** | **$(445.4)** | $(415.0) | $(270.4) |
| **Financing activities** |  |  |  |
| Net increase (reduction) of notes payable, with maturities  Less than or equal to 90 days  Issuance of notes payable, with maturities greater than 90 days  Reductions of notes payable, with maturities greater than 90 days  Issuances of long term debt  Reductions of long-term debt  Issuances of common stock  Common stock repurchases  Cash dividends  Other | **$(344.2)**  **1,065.4**  **(565.2)**  **-**  **(84.7)**  **217.5**  **(648.9)**  **(449.9)**  **21.9** | $360.2  42.6  (42.3)  647.3  (1,041.3)  221.7  (664.2)  (435.2)  5.9 | $388.3  142.3  (141.7)  7.0  (682.2)  291.8  (297.5)  (417.2)  (6.7) |
| **Net cash used in financing activities** | **$(789.0)** | $(905.3) | $(716.3) |
| Effect of exchange rate changes on cash | **15.4** | (21.3) | 33.9 |
| Increase (decrease) in cash and cash equivalents  Cash and cash equivalents at beginning of year | **$191.5**  **219.1** | $(198.3)  417.4 | $276.2  141.2 |
| Cash and cash equivalents at end of year | $410.6 | $219.1 | $417.4 |

Statement of Cash Flow for General Mills

|  |  |  |  |
| --- | --- | --- | --- |
| Million | 2006 | 2005 | 2004 |
| Operating activities |  |  |  |
| Net earnings  Adjustments to reconcile earnings to operating cash flows  Depreciation and amortization  Deferred income taxes  Changes in current assets and liabilities  Tax benefit on exercised options  Pension and other postretirement costs  Restructuring and other exit costs  Divestitures (gain)  Debt repurchase costs  Other, net | $1,090  424  26  184  41  (74)  30  -  -  50 | $1,240  443  9  258  62  (70)  84  (499)  137  47 | $1,055  399  109  (186)  63  (21)  26  -  -  16 |
| Net cash provided by operating activities | 1,771 | 1,711 | 1,461 |
| **Investing activities** |  |  |  |
| Purchases of land, buildings and equipment  Investments of businesses  Investments in affiliates, net of investment returns and dividends  Purchases of marketable securities  Proceeds from sale of marketable securities  Proceeds from disposal of land, buildings and equipment  Proceeds from disposition of businesses  Other, net | (360)  (26)  78  -  1  11  -  4 | (434)  -  84  (1)  33  24  799  (9) | (653)  (10)  32  (7)  129  36  -  2 |
| Net cash used by investing activities | (292) | 496 | (470) |
| **Financing activities** |  |  |  |
| Changes in notes payable  Issuances of long term debt  Payment of long-term debt  Proceeds from issuance of preferred membership interests of subsidiary  Common stock issued  Purchases of common stock for treasury  Dividends paid  Other, net | 1,197  -  (1,386)  -  157  (885)  (485))  (3) | (1,05.7)  2  (1,115)  (42.3)  835  195-  (771)  (461)  (13) | (1,023)  576  (248)  (141.7)  -  192  (24)  (413)  (3) |
| **Net cash used by financing activities** | (1,405) | (2385) | (943) |
| Increase (decrease) in cash and cash equivalents  Cash and cash equivalents - beginning of year | 74  $73 | (178)  751 | 48  703 |
| Cash and cash equivalents - end of year | $647 | $573 | $751 |
| **Cash Flow from Changes in Current Assets and Liabilities**  Receivables  Inventories  Prepaid expenses and other current assets  Accounts payable  Other current liabilities | $ (18)  (6)  (7)  14  201 | $ (9)  30  9  (19)  247 | $ (22)  24  (15)  (161)  (12) |
| Changes in Current Assets and Liabilities | $ 184 | $ 258 | $ (186) |

Required:

1. Which method, direct or indirect, does each company use in preparing the Operating Activities section of their statements of cash flow? Explain.
2. By what amount did net cash provided by operating activities increase or decrease from the prior year for each company? What is the largest adjustment to reconcile net income to net cash provided by operating activities for each company?
3. What amount died each company spend during the most recent year to acquire property and equipment? How does this amount compare with the amount that each company spent in the prior year?
4. What is the primary source of financing for each of the two companies? Did either or both companies buy back some of their own shares during the most recent year? If so, what might be some reasons for doing this?

**Problem 10-3 Amortization of Premium**

Stacy Company issued five-year 10% bonds with a face value of $10,000 on January 1, 2008. Interest is paid annually on December 31. The market rate of interest on this date is 8%, and Stacy Company receives proceeds of $10,803 on the bond issuance.

Required:

1. Prepare a five year table to amortize the premium using the effective interest method.
2. What is the total interest expense over the life of the bonds? Cash interest payment? Premium amortization?
3. Identify and analyze the effect of the payment of interest and the amortization of premium on December 3, 2010 (the third year), and determine the balance sheet presentation of the bonds on that date.

**Problem 11-5 Dividends and Stock Splits**

On January 1, 2008, Fredericksen Inc’s.Stockholders’ Equity category appeared as follows:

|  |  |
| --- | --- |
| Preferred stock, $80 par value, 7%,  3,000 shares issued and outstanding | $240,000 |
| Common stock, $10 par value,  15,000 shares issued and outstanding | 150,000 |
| Additional paid-in capital – Preferred | 60,000 |
| Additional paid-in capital – Common | 225,000 |
| Total contributed capital | $675,000 |
| Retained earnings | 2,100,000 |
| Total stockholders’ equity | $2,775,000 |

The preferred stock is noncumulative and nonparticipating. During 2008, the following transactions occurred:

1. On March 1, declared a cash dividend of $16,800 on preferred stock. Paid the dividend on April 1.
2. On June 1, declared a 5% stock dividend on common stock. The current market prior of the common stock was $18. The stock was issued on July 1.
3. On September 1, declared a cash dividend of $0.50 per share on the common stock, paid the dividend on October 1.
4. On December 1, issued a 2-for-2 stock split of common stock when the stock was selling for $50 per share.

Required:

1. Explain each transaction’s effect on the Stockholders’ Equity accounts and the total stockholders’ equity.
2. Develop the Stockholders’ Equity category of the December 31, 2008, balance sheet. Assume that the net income for the year was $650,000.
3. Explain the difference between a stock dividend and a stock split.

**Problem 13-7 Comparison with Industry Averages**

Heartland Inc. is a medium-size company that has been in business for 20 years. The industry has become very competitive in the last few years, and Heartland Inc. decides that it must grow if it is going to survive. It has approached the bank for a sizable five-year loan and the bank has requested Heartland’s most recent financial statements as part of the loan package.

The industry in which Heartland operates consists of approximately 20 companies relatively equal in size. The trade association to which all of the companies belong publishes an annual survey of the industry, including industry averages for selected ratios for the competitors. All companies voluntarily submit their financial statements to the association for this purpose.

Heartland’s controller is aware the bank has access to this survey and is very concerned with how the company fared this past year compared to the rest of the industry. The ratios included in the publication this past year are as follows:

|  |  |
| --- | --- |
| Ratio | Industry Average |
| Current ratio | 1.23 |
| Acid test (quick) ratio | 0.75 |
| Accounts receivables turnover | 33 times |
| Inventory turnover | 29 times |
| Debt-to- equity ratio | 0.53 times |
| Interest earned | 8.65 times |
| Return on sales | 6.57% |
| Assets turnover | 1.95 times |
| Return on assets | 12.81% |
| Return on common stockholder’s equity | 17.67% |

The financial statements to be submitted to the bank in connection with the loan follow:

Heartland Inc.

Statement of Income and Retained Earnings

For the Year Ended December 31, 2008

(thousands omitted)

Sales revenue $542,750

Cost of goods sold (435,650)

Gross profit $107,100

Selling, general and administrative expenses $(65,780)

Loss on sales and securities (220)

Income before interest and taxes $41,100

Interest expense (9,275)

Income before taxes $31,825

Income tax expense (12,730)

Net income $19,095

Retained earnings, January 1, 2008 58,485

$77,580

Dividends paid on common stock (12,000)

Retained earnings December 31, 2008 $65,580

Heartland Inc.

Comparative Statements of Financial Position

(thousands omitted)

|  |  |  |
| --- | --- | --- |
|  | 2008 | 2007 |
| **Assets** |  |  |
| Current assets:  Cash  Marketable securities  Accounts receivable, net of allowances  Inventories  Prepaid items  Total current assets  Long term investments  Property, plant, and equipment:  Land  Buildings and equipment, net of accumulated depreciation  Total property, plant, and equipment  Total assets | $ 1,135  1,250  15,650  12,680  385  $ 31,100  $ 425  $ 32,000  216,000  $248,000  $279,525 | $ 750  2,250  12,380  15,870  420  $ 31,670  $ 425  $ 32,000  206,000  $238,000  $270,095 |
|  |  |  |
| **Liabilities and Stockholder’s Equity** |  |  |
| Current liabilities:  Short term notes  Accounts payables  Salaries and wages payable  Income taxes payable  Total current liabilities  Long term bonds payable  Stockholders’ equity:  Common stock, no par  Retained earnings  Total stockholders’ equity  Total liabilities and stockholders’ equity | $ 8,750  20,090  1,975  3,130  $ 33,945  $ 80,000  $100,000  65,580  $165,580  $278,525 | $ 12,750  14,380  2,430  2,050  $ 31,610  $ 80,000  $100,000  58,485  $158,485  $270,095 |

Required:

1. Prepare a columnar report for the controller of Heartland Inc. comparing the industry averages for the ratios published by the trade association with the comparable ratios for Heartland. For Heartland, compute the ratios as of December 31, 2008, or for the year ending December 31, 2008, whichever is appropriate.
2. Briefly evaluate Heartland’s ratios relative to the industry averages.
3. Do you think that the bank will approve the loan? Explain your answer.