Chapter 2 – P20

The relationship between financial leverage and profitability: Pelican Paper, Inc., and Timberland Forest, Inc., is rivals in the manufacture of craft papers. Some financial statement values for each company follow: Use them in a ratio analysis that compares the firm’s financial leverage and profitability.

Item Pelican Paper, Inc. Timberland Forest, Inc.

Total assets $10,000,000 $10,000,000

Total Equity $9,000,000 $5,000,000

Total debt $1,000,000 $5,000,000

Annual interest $100,000 $500,000

Total sales $25,000,000 $25,000,000

EBIT $6,250,000 $6,250,000

Earnings available for

Common stockholders $3,690,000 $3, 450, 00

1. Calculate the following debt and coverage ratios for the two companies. Discuss their financial risk and ability to cover the costs in relation to each other.
2. Debt ratio
3. Times interest earned ratio
4. Calculate the following profitability ratios for the two companies. Discuss their profitability relative to each other.
5. Operating profit margin
6. Net profit margin
7. Return on total assets
8. Return on common equity
9. In what way has the larger debt of Timberland Forest made it more profitability than Pelican Paper? What are the risks that Timberland’s investors undertake when they choose to purchase its stock instead of Pelican’s?

P2 – 24

Integrative – Complete ratio analysis. Given the following financial statements below, historical ratios, and industry averages, calculate Sterling Company’s financial ratios for the most recent year. Assume a 365 day year. Analyze its overall financial situations from both a cross-sectional and a time series view point. Break your analysis into evaluation of the firm’s liquidity, activity, debt, profitability, and market.

**Sterling Company Income Statement for the year Ended December 31, 2009**

Sales revenue $10,000,000

Less: Cost of goods sold $7,500,000

Gross profits $2,500,000

Less: Operating expenses

 Selling expense $300,000

 General and administrative expenses $650,000

 Lease Expense $50,000

 Depreciation expense $200,000

 Total operating expense 1,200,000

Operating profits 1,300,000

Less: Interest expense 200,000

Net profits before taxes 1,100,000

Less: Taxes (rate = 40%) 440,000

Net profits after taxes 660,000

Less: preferred stock dividends 50,000

Earnings available for common stockholders 610,000

Earnings per share (EPS) 3.05

**Sterling Company Balance Sheet – December 31, 2009**

Assets Liabilities and Stockholders’ Equity

Current assets Current Liabilities

Cash $200,000 AP $900,000

Market Sec 50,000 Note Payables 200,000

A/R 800,000 Accruals 100,000

Inventories 950,000 Total current liabilities $1,200,000

 Total current assets $2,000,000 Long term debt include financial leases $3,000,000

Gross fixed assets (at cost) $12,000,000 Stockholders’ Equity

Less: Accumulated depreciation 3,000,000 Preferred stock (25,000 shares, $2 dividend

 $1,000,000

Net fixed $9,000,000 Common stock (200,000 shares at $3 dividend) 600,000

Other fixed assets $1,000,000 Paid in capital in excess of par value 5,200,000

Total assets $12,000,000 Retained earnings $1,000,000

 Total stockholders’ equity $7,800,000

 Total Liabilities and stockholders’ equity $12,000,000

The firm has an 8 year financial lease requiring annual beginning of year payments of $50,000. Five years of the lease have yet to run.

Annual credit purchases of $6,200,000 were made during the year.

The annual principal payments on the long term debt are $100,000.

On December 31, 2009, the firm’s common stock closed at $39.50 per share