INTEGRATED CASE

D’LEON INC., PART II

4-25

FINANCIAL STATEMENT ANALYSIS Part I of this case, presented in Chapter 3, discussed the situation of D’Leon Inc., a regional snack foods producer, after an expansion program. D’Leon had increased plant capac- ity and undertaken a major marketing campaign in an attempt to “go national.” Thus far, sales have not been up to the forecasted level, costs have been higher than were projected, and a large loss occurred in 2008 rather than the expected profit. As a result, its managers, directors, and investors are concerned about the firm’s survival.

Donna Jamison was brought in as assistant to Fred Campo, D’Leon’s chairman, who had the task of getting the company back into a sound financial position. D’Leon’s 2007 and 2008 balance sheets and income statements, together with projections for 2009, are given in Tables IC4-1 and IC4-2. In addition, Table IC4-3 gives the

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company’s 2007 and 2008 financial ratios, together with industry average data. The 2009 projected financial state- ment data represent Jamison’s and Campo’s best guess for 2009 results, assuming that some new financing is ar- ranged to get the company “over the hump.”

Jamison examined monthly data for 2008 (not given in the case), and she detected an improving pattern dur- ing the year. Monthly sales were rising, costs were falling, and large losses in the early months had turned to a small profit by December. Thus, the annual data look somewhat worse than final monthly data. Also, it appears to be taking longer for the advertising program to get the message out, for the new sales offices to generate sales, and for the new manufacturing facilities to operate efficiently. In other words, the lags between spending money and deriving benefits were longer than D’Leon’s managers had anticipated. For these reasons, Jamison and Campo see hope for the company—provided it can survive in the short run.

Jamison must prepare an analysis of where the company is now, what it must do to regain its financial health, and what actions should be taken. Your assignment is to help her answer the following questions. Pro- vide clear explanations, not yes or no answers.

a. Why are ratios useful? What are the five major categories of ratios? b. Calculate D’Leon’s 2009 current and quick ratios based on the projected balance sheet and income statement

data. What can you say about the company’s liquidity positions in 2007, in 2008, and as projected for 2009? We often think of ratios as being useful (1) to managers to help run the business, (2) to bankers for credit analysis, and (3) to stockholders for stock valuation. Would these different types of analysts have an equal interest in the company’s liquidity ratios?

c. Calculate the 2009 inventory turnover, days sales outstanding (DSO), fixed assets turnover, and total assets turnover. How does D’Leon’s utilization of assets stack up against other firms in the industry?

d. Calculate the 2009 debt and times-interest-earned ratios. How does D’Leon compare with the industry with respect to financial leverage? What can you conclude from these ratios?

e. Calculate the 2009 operating margin, profit margin, basic earning power (BEP), return on assets (ROA), and return on equity (ROE). What can you say about these ratios?

f. Calculate the 2009 price/earnings ratio and market/book ratio. Do these ratios indicate that investors are expected to have a high or low opinion of the company?

g. Use the DuPont equation to provide a summary and overview of D’Leon’s financial condition as projected for 2009. What are the firm’s major strengths and weaknesses?

h. Use the following simplified 2009 balance sheet to show, in general terms, how an improvement in the DSO would tend to affect the stock price. For example, if the company could improve its collection procedures and thereby lower its DSO from 45.6 days to the 32-day industry average without affecting sales, how would that change “ripple through” the financial statements (shown in thousands below) and influence the stock price?

Accounts receivable Other current assets Net fixed assets

Total assets

$ 878 Debt 1,802

817 Equity

$3,497 Liabilities plus equity

$1,545 1,952

$3,497

i. Does it appear that inventories could be adjusted? If so, how should that adjustment affect D’Leon’s profit- ability and stock price?

j. In 2008, the company paid its suppliers much later than the due dates; also, it was not maintaining financial ratios at levels called for in its bank loan agreements. Therefore, suppliers could cut the company off, and its bank could refuse to renew the loan when it comes due in 90 days. On the basis of data provided, would you, as a credit manager, continue to sell to D’Leon on credit? (You could demand cash on delivery—that is, sell on terms of COD—but that might cause D’Leon to stop buying from your company.) Similarly, if you were the bank loan officer, would you recommend renewing the loan or demand its repayment? Would your ac- tions be influenced if in early 2009 D’Leon showed you its 2009 projections along with proof that it was going to raise more than $1.2 million of new equity?

k. In hindsight, what should D’Leon have done in 2007? l. What are some potential problems and limitations of financial ratio analysis? m. What are some qualitative factors that analysts should consider when evaluating a company’s likely future

financial performance?

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Table IC 4-1

Balance Sheets

2009E

2008

2007

57,600 351,200 715,200

Assets

Cash $ 85,632 Accounts receivable 878,000 Inventories 1,716,480

$ 1,287,360

$

7,282 632,160

Total current assets Gross fixed assets Less accumulated depreciation

Net fixed assets Total assets

Liabilities and Equity

Accounts payable Notes payable Accruals

Total current liabilities Long-term debt Common stock Retained earnings

Total equity Total liabilities and equity

$2,680,112 1,197,160 380,120

$ 817,040

$3,497,152

$ 436,800 300,000 408,000

$1,144,800 400,000 1,721,176 231,176

$1,952,352

$3,497,152

$1,926,802 1,202,950 263,160

$ 939,790

$2,866,592

$ 524,160 636,808 489,600

$1,650,568 723,432 460,000 32,592

$ 492,592

$2,866,592

2008

$6,034,000 5,528,000 519,988

$6,047,988

($ 13,988) 116,960

($ 130,948) 136,012

($ 266,960) (106,784)a

($ 160,176)

($1.602) $0.110 $4.926

$2.25 100,000 40.00% $40,000 0

$1,124,000 491,000 146,200

$ 344,800

$1,468,800

$

$

$

145,600 200,000 136,000

481,600 323,432 460,000 203,768

663,768

Note: E indicates estimated. The 2009 data are forecasts.

$1,468,800

2007

$3,432,000 2,864,000 358,672

$3,222,672

Table IC 4-2

Income Statements

Sales Cost of goods sold Other expenses Total operating costs excluding

depreciation & amortization EBITDA

Depreciation & amortization EBIT

Interest expense EBT

Taxes (40%) Net income

EPS DPS Book value per share Stock price Shares outstanding Tax rate Lease payments Sinking fund payments

2009E

$7,035,600 5,875,992 550,000

$6,425,992

$

$

$

609,608 116,960

492,648 70,008

422,640 169,056

$

$

$

209,328 18,900

190,428 43,828

146,600 58,640

$ 253,584

$1.014 $0.220 $7.809 $12.17

250,000 40.00% $40,000 0

$ 87,960

$0.880 $0.220 $6.638

$8.50 100,000 40.00% $40,000 0

Note: E indicates estimated. The 2009 data are forecasts. aThe firm had sufficient taxable income in 2006 and 2007 to obtain its full tax refund in 2008.

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Table IC 4-3

Ratio Analysis

2009E 2008

Current 1.2􏰄 Quick 0.4􏰄

4.7􏰄 38.2

6.4􏰄

2007

Industry Average

Inventory turnover Days sales outstanding (DSO)a Fixed assets turnover Total assets turnover Debt ratio TIE Operating margin Profit margin Basic earning power ROA ROE 􏰃32.5% Price/earnings 􏰃1.4􏰄 Market/book 0.5􏰄 Book value per share $4.93

Note: E indicates estimated. The 2009 data are forecasts. aCalculation is based on a 365-day year.

(Fundamentals of Financial Management. South-Western/CourseSmart, 10/02/2008. pp. 118 - 121).

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