| TANNER CORPORATION<br>Balance Sheet<br>December 31 | |
|---|---|
| Current assets: | |
| Cash | $ ? |
| Accounts receivable, net | ? |
| Inventory | ? |
| Total current assets | ? |
| Plant and equipment, net | ? |
| Total assets | $ ? |
| Current liabilities | $250,000 |
| Bonds payable, 10% | ? |
| Total liabilities | ? |
| Stockholders' equity: | |
| Common stock, $2.50 par value | ? |
| Retained earnings | ? |
| Total stockholders' equity | ? |
| Total liabilities and stockholders' equity | $ ? |

The following additional information is available about the company:

a. Selected financial ratios computed from the statements above are given below:

| | |
|---|---|
| Current ratio | 2.40 to 1 |
| Acid-test (quick) ratio | 1.12 to 1 |
| Accounts receivable turnover | 15.0 times |
| Inventory turnover | 6.0 times |
| Debt-to-equity ratio | 0.875 to 1 |
| Times interest earned | 7.0 times |
| Earnings per share | $4.05 |
| Return on total assets | 14% |

b. All sales during the year were on account.

c. The interest expense on the income statement relates to the bonds payable; the amount of bonds outstanding did not change throughout the year.

d. There were no changes in the number of shares of common stock outstanding during the year.

e. Selected balances at the *beginning* of the current year (January 1) were as follows:

| | |
|---|---|
| Accounts receivable | $160,000 |
| Inventory | $280,000 |
| Total assets | $1,200,000 |

**Required:**

Compute the missing amounts on the company's financial statements. (Hint: You may find it helpful to think about the difference between the current ratio and the acid-test ratio.)

START!

**ETHICS CHALLENGE (LO3)**

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 from his own savings and from retained profits. However, Jurgen now faces a cash crisis. In the year just ended, an acute shortage of a vital tungsten steel alloy had 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 to become 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 accounts 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 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.

**MOUNTAIN AEROSPORT**
**Comparative Balance Sheet**
**As of December 31, This Year and Last Year**
**(in thousands of dollars)**

| | This Year | Last Year |
|---|---|---|
| **Assets** | | |
| Current assets: | | |
| Cash | $105 | $225 |
| Accounts receivable, net | 75 | 60 |
| Inventory | 240 | 150 |
| Prepaid expenses | 15 | 18 |
| Total current assets | 435 | 453 |
| Property and equipment | 405 | 270 |
| Total assets | $840 | $723 |
| **Liabilities and Stockholders' Equity** | | |
| Current liabilities: | | |
| 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 stockholders' equity | 594 | 573 |
| Total liabilities and stockholders' equity | $840 | $723 |

**MOUNTAIN AEROSPORT**
**Income Statement**
**For the Year Ended December 31, This Year**
**(in thousands of dollars)**

| | |
|---|---|
| Sales (all on account) | $630 |
| Cost of goods sold | 435 |
| Gross margin | 195 |
| Operating expenses: | |
| Selling expenses | 63 |
| Administrative expenses | 102 |
| Total operating expenses | 165 |
| Net operating income | 30 |
| Interest expense | 0 |
| Net income before taxes | 30 |
| Less income taxes (30%) | 9 |
| Net income | $ 21 |

**Required:**

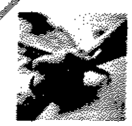
1. Based on the above unaudited financial statements and the statement made by the loan officer, would the company qualify for the loan?
2. Last year Jurgen purchased and installed new, more efficient equipment to replace an older heat-treating furnace. Jurgen had originally planned to sell the old equipment 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?

Finish

## TEAMWORK IN ACTION (LO1, LO2, LO3, LO4)

Obtain the most recent annual report or SEC filing 10-K of a publicly traded company that interests you. It may be a local company or it may be a company in an industry that you would like to know more about. Using the annual report, compute as many of the financial ratios covered in this chapter as you can for at least the past two years. This may pose some difficulties—particularly since companies often use different terms for many income statement and balance sheet items than were shown in the chapter. Nevertheless, do the best that you can. After you have computed the financial ratios, summarize the company's performance for the current year. Has it improved, gotten worse, or remained about the same? Do the ratios indicate any potential problems or any areas that have shown significant improvement? What recommendations, if any, would you make to a bank about extending short-term credit to this company? What recommendations, if any, would you make to an insurance company about extending long-term credit to this company? What recommendations, if any, would you make to an investor about buying or selling this company's stock?

## COMMUNICATING IN PRACTICE (LO1, LO2, LO3, LO4)



Typically, the market price of shares of a company's stock takes a beating when the company announces that it has not met analysts' expectations. As a result, many companies are under a lot of pressure to meet analysts' revenue and earnings projections. To manage (that is, to inflate or smooth) earnings, managers sometimes record revenue that has not yet been earned by the company, delay the recognition of expenses that have been incurred or employ other accounting tricks.

A wave of accounting scandals related to earnings management swept over the capital markets in the wake of the collapse of Enron in 2002. Some earlier examples illustrate how companies have attempted to manage their earnings. On March 20, 2000, MicroStrategy announced that it was forced to restate its 1999 earnings; revenue from multiyear contracts had been recorded in the first year instead of being spread over the lives of the related contracts as required by GAAP. On April 3, 2000, Legato Systems Inc. announced that it had restated its earnings; $7 million of revenue had been improperly recorded because customers had been promised that they could return the products purchased. As further discussed in this chapter, America Online overstated its net income during 1994, 1995, and 1996. In May 2000, upon completing its review of the company's accounting practices, the SEC levied a fine of $3.5 million against AOL. Just prior to the announcement of the fine levied on AOL, Helane Morrison, head of the SEC's San Francisco office, reemphasized that the investigation of misleading financial statements is a top priority for the agency. [Sources: Jeff Shuttleworth, "Investors Beware: Dot.Coms Often Use Accounting Tricks," *Business Journal Serving San Jose & Silicon Valley*, April 14, 2000, p. 16; David Henry, "AOL Pays $3.5M to Settle SEC Case," *USA Today*, May 16, 2000, p. 3B.]

**Required:**

Write a memorandum to your instructor that answers the following questions. Use headings to organize the information presented in the memorandum. Include computations to support your answers, when appropriate.

1. Why would companies be tempted to manage earnings?
2. If the earnings that are reported by a company are misstated, how might this impact business decisions made about that company (such as the acquisition of the company by another business)?
3. What ethical issues, if any, arise when a company manages its earnings?
4. How would investors and financial analysts tend to view the financial statements of a company that has been known to manage its earnings in the past?

## TAKING IT TO THE NET

As you know, the World Wide Web is a medium that is constantly evolving. Sites come and go and change without notice. To enable periodic update of site addresses, this problem has been posted to the textbook website (www.mhhe.com/bgn2e). After accessing the site, enter the Student Center and select this chapter. Select and complete the Taking It to the Net problem.