Chapter 2
Review of Accounting

Discussion Questions

2-1. Discuss some financial variables that affect the price-earnings ratio.

The price-earnings ratio will be influenced by the earnings and sales growth of the firm, the risk or volatility in performance, the debt-equity structure of the firm, the dividend payment policy, the quality of management, and a number of other factors. The ratio tends to be future-oriented, and the more positive the outlook, the higher it will be.

2-2. What is the difference between book value per share of common stock and market value per share? Why does this disparity occur?

Book value per share is arrived at by taking the cost of the assets and subtracting out liabilities and preferred stock and dividing by the number of common shares outstanding. It is based on the historical cost of the assets. Market value per share is based on current assessed value of the firm in the marketplace and may bear little relationship to original cost. Besides the disparity between book and market value caused by the historical cost approach, other contributing factors are the growth prospects for the firm, the quality of management, and the industry outlook. To the extent these are quite negative or positive; market value may differ widely from book value.

2-3. Explain how depreciation generates actual cash flows for the company.

The only way depreciation generates cash flows for the company is by serving as a tax shield against reported income. This non-cash deduction may provide cash flow equal to the tax rate times the depreciation charged. This much in taxes will be saved, while no cash payments occur.

2-4. What is the difference between accumulated depreciation and depreciation expense? How are they related?

Accumulated depreciation is the sum of all past and present depreciation charges, while depreciation expense is the current year’s charge. They are related in that the sum of all prior depreciation expense should be equal to accumulated depreciation (subject to some differential related to asset write-offs).

2-5. How is the income statement related to the balance sheet?

The earnings (less dividends) reported in the income statement is transferred to the ownership section of the balance sheet as retained earnings. Thus, what we earn in the income statement becomes part of the ownership interest in the balance sheet.

2-6. Comment on why inflation may restrict the usefulness of the balance sheet as normally presented.

The balance sheet is based on historical costs. When prices are rising rapidly, historical cost data may lose much of their meaning–particularly for plant and equipment and inventory.

2-7. Explain why the statement of cash flows provides useful information that goes beyond income statement and balance sheet data.

The income statement and balance sheet are based on the accrual method of accounting, which attempts to match revenues and expenses in the period in which they occur. However, accrual accounting does not attempt to properly assess the cash flow position of the firm. The statement of cash flows fulfills this need.

2-8. What are the three primary sections of the statement of cash flows? In what section would the payment of a cash dividend be shown?

The sections of the statement of cash flows are:

Cash flows from operating activities
Cash flows from investing activities
Cash flows from financing activities

The payment of cash dividends falls into the financing activities category.

2-9. What is free cash flow? Why is it important to leveraged buyouts?

Free cash flow is equal to cash flow from operating activities:

Minus: Capital expenditures required to maintain the productive capacity of the firm.

Minus: Dividends (required to maintain the payout on common stock and to cover any preferred stock obligation).

The analyst or banker normally looks at free cash flow to determine whether there are sufficient excess funds to pay back the loan associated with the leveraged buy-out.

2-10. Why is interest expense said to cost the firm substantially less than the actual expense, while dividends cost it 100 percent of the outlay?

Interest expense is a tax deductible item to the corporation, while dividend payments are not. The net cost to the corporation of interest expense is the amount paid multiplied by the difference of one minus the applicable tax rate.

For example, \$100 of interest expense costs the company \$65 after taxes when the corporate tax rate is 35 percent; for example, $\$100 \times (1 - .35) = \$65$.

Chapter 2

Problems

1. **Income Statement (LO1)** Frantic Fast Foods had earnings after taxes of \$390,000 in the year 2009 with 300,000 shares outstanding. On January 1, 2010, the firm issued 25,000 new shares. Because of the proceeds from these new shares and other operating improvements, earnings after taxes increased by 20 percent.
   a. Compute earnings per share for the year 2009.
   b. Compute earnings per share for the year 2010.

2-1. Solution:

Frantic Fast Foods

a. Year 2009

$$\text{Earnings per share} = \frac{\text{Earnings after taxes}}{\text{Shares outstanding}}$$

$$= \frac{\$390{,}000}{300{,}000} = \$1.30$$

b. Year 2010

$$\text{Earnings after taxes} = \$390{,}000 \times 1.20 = \$468{,}000$$
$$\text{Shares outstanding} = 300{,}000 + 25{,}000 = 325{,}000$$

$$\text{Earnings per share} = \frac{\$468{,}000}{325{,}000} = \$1.44$$

2. **Income Statement (LO1)** Bettis Bus Company had earnings after taxes of $600,000 in the year 2009 with 300,000 shares of stock outstanding. On January 1, 2010, the firm issued 40,000 new shares. Because of the proceeds from these new shares and other operating improvements, earnings after taxes increased by 25 percent.
   a. Compute earnings per share for the year 2009.
   b. Compute earnings per share for the year 2010.

2-2. Solution:

Bettis Bus Company

a. Year 2009

$$\text{Earnings per share} = \frac{\text{Earnings after taxes}}{\text{Shares outstanding}}$$

$$= \frac{\$600{,}000}{300{,}000} = \$2.00$$

b. Year 2010

$$\text{Earnings after taxes} = \$600{,}000 \times 1.25 = \$750{,}000$$
$$\text{Shares outstanding} = 300{,}000 + 40{,}000 = 340{,}000$$
$$\text{Earning per share} = \frac{\$750{,}000}{340{,}000} = \$2.21$$

3. *a.* **Gross profit (LO1)** Hillary Swank Clothiers had sales of $360,000 and cost of goods sold of $244,800. What is the gross profit margin (ratio of gross profit to sales)?

   b. If the average firm in the clothing industry had a gross profit of 35 percent, how is the firm doing?

2-3. Solution:

Hillary Swank Clothiers

a. Sales	$360,000
Cost of goods sold.................................	244,800
Gross Profit	$115,200

$$\text{Gross Profit Margin} = \frac{\text{Gross Profit}}{\text{Sales}} \quad \frac{\$115{,}200}{\$360{,}000} = 32\%$$

b. With a gross profit 32 percent, the firm is under-performing the industry average of 35 percent.

4. **Operating Profit (LO1)** A-Rod Fishing Supplies had sales of $2,000,000 and cost of goods sold of $1,250,000. Selling and administrative expenses represented 8 percent of sales. Depreciation was 5 percent of the total assets of $4,000,000. What was the firm’s operating profit?

2-4. Solution:

A-Rod Fishing Supplies

Sales	$2,000,000
Cost of goods sold	1,250,000
Gross Profit	750,000
Selling and administrative expense*	160,000
Depreciation expense**	200,000
Operating profit	$ 390,000

* 8% × $2,000,000 = $160,000

** 5% × $4,000,000 = $200,000

5. **Income statement (LO1)** Arrange the following income statement items so they are in the proper order of an income statement:

Taxes
Shares outstanding
Interest expense
Depreciation expense
Preferred stock dividends
Operating profit
Sales
Gross profit
Earnings per share
Earnings before taxes
Cost of goods sold
Earnings after taxes
Earnings available to common stockholders
Selling and administrative expense

2-5. Solution:

Sales
-Cost of goods sold
Gross profit
-Selling and administrative expense
-Depreciation expense
Operating profit
-Interest expense
Earnings before taxes
-Taxes
Earnings after taxes
-Preferred stock dividends

Earnings available to common stockholders
Shares outstanding
Earnings per share

6. **Income statement (LO1)** Given the following information prepare in good form an income statement for the Dental Drilling Company.

Selling and administrative expense	$ 60,000
Depreciation expense	70,000
Sales	470,000
Interest expense	40,000
Cost of goods sold	140,000
Taxes	45,000

2-6. Solution:

Dental Drilling Company

Income Statement

Sales	$ 470,000
Cost of goods sold	$ 140,000
Gross Profit	$ 330,000
Selling and administrative expense	$ 60,000
Depreciation expense	$ 70,000
Operating profit	$ 200,000
Interest expense	$ 40,000
Earnings before taxes	$ 160,000
Taxes	$ 45,000
Earnings after taxes	$ 115,000

7. **Income Statement (LO1)** Given the following information, prepare in good form an income statement for Jonas Brothers Cough Drops.

Selling and administrative expense	$250,000
Depreciation expense	190,000
Sales	1,600,000
Interest expense	120,000
Cost of goods sold	480,000
Taxes	165,000

2-7. Solution:

Jonas Brothers Cough Drops
Income Statement

Sales	$1,600,000
Cost of goods sold	480,000
Gross profit	1,120,000
Selling and administrative expense	250,000
Depreciation expense	190,000
Operating profit	680,000
Interest expense	120,000
Earnings before taxes	560,000
Taxes	165,000
Earnings after taxes	$395,000

8. **Determination of profitability (LO1)** Prepare in good form an income statement for ATM Cards, Inc. Take your calculations all the way to computing earnings per share.

Sales	$800,000
Shares outstanding	100,000
Cost of goods sold	300,000
Interest expense	20,000
Selling and administrative expense	40,000
Depreciation expense	30,000
Preferred stock dividends	80,000
Taxes	110,000

2-8. Solution:

ATM Cards, Inc.
Income Statement

Sales	$ 800,000
Cost of goods sold	300,000
Gross profit	$ 500,000
Selling and administrative expense	40,000
Depreciation expense	30,000
Operating profit	$ 430,000
Interest expense	20,000
Earnings before taxes	$ 410,000
Taxes	110,000
Earnings after taxes	$ 300,000
Preferred stock dividends	80,000
Earnings available to common stockholders	220,000
Shares outstanding	100,000
Earnings per share	$2.20

9. **Determination of profitability (LO1)** Prepare in good form an income statement for Virginia Slim Wear. Take your calculations all the way to computing earnings per share.

Sales	$600,000
Shares outstanding	100,000
Cost of goods sold	200,000
Interest expense	30,000
Selling and administrative expense	40,000
Depreciation expense	20,000
Preferred stock dividends	80,000
Taxes	100,000

2-9. Solution:

Virginia Slim Wear
Income Statement

Sales	$600,000
Cost of goods sold	200,000
Gross profit	400,000
Selling and administrative expense	40,000
Depreciation expense	20,000
Operating profit	340,000
Interest expense	30,000
Earnings before taxes	310,000
Taxes	100,000
Earnings after taxes	210,000
Preferred stock dividends	80,000
Earnings available to common stockholders	130,000
Shares outstanding	100,000
Earnings per share	$ 1.30

10. **Income Statement (LO1)** Precision Systems had sales of $800,000, cost of goods of $500,000, selling and administrative expense of $60,000 and operating profit of $100,000.

What was the value of depreciation expense? Set this problem up as a partial income statement, and determine depreciation expense as the plug figure.

2-10. Solution:

Precision Systems

Sales	$800,000
Cost of goods sold	500,000
Gross Profit...	300,000
Selling and administrative expense................	60,000
Depreciation (plug figure)..............................	**140,000**
Operating profit	$100,000

11. **Depreciation and earnings (LO1)** Stein Books, Inc. sold 1,400 finance textbooks for $195 each to High Tuition University in 2010. These books cost $150 to produce. Stein Books spent $12,000 (selling expense) to convince the university to buy its books.

Depreciation expense for the year was $15,000. In addition, Stein Books borrowed $100,000 on January 1, 2010, on which the company paid 10 percent interest. Both the interest and principal of the loan were paid on December 31, 2010. The publishing firm's tax rate is 30 percent.

Did Stein Books make a profit in 2010? Please verify with an income statement presented in good form.

2-11. Solution:

Stein Books, Inc.

Income Statement

For the Year Ending December 31, 2010

Sales (1,400 books at $195 each)..................................	$273,000
Cost of goods sold (1,400 books at $150 each)	210,000
Gross Profit..	63,000
Selling expense	12,000
Depreciation expense	15,000
Operating profit……	$36,000
Interest expense ($100,000 × 10%)	10,000
Earnings before taxes	26,000

Taxes @ 30%	7,800
Earnings after taxes	$18,200

12. **Determination of profitability (LO1)** Lemon Auto Wholesalers had sales of $700,000 in 2010 and cost of goods sold represented 70 percent of sales. Selling and administrative expenses were 12 percent of sales. Depreciation expense was $10,000 and interest expense for the year was $8,000. The firm's tax rate is 30 percent.
    a. Compute earnings after taxes.
    b. Assume the firm hires Ms. Carr, an efficiency expert, as a consultant. She suggests that by increasing selling and administrative expenses to 14 percent of sales, sales can be increased to $750,000. The extra sales effort will also reduce cost of goods sold to 66 percent of sales (There will be a larger markup in prices as a result of more aggressive selling). Depreciation expense will remain at $10,000. However, more automobiles will have to be carried in inventory to satisfy customers, and interest expense will go up to $15,000. The firm's tax rate will remain at 30 percent. Compute revised earnings after taxes based on Ms. Carr's suggestions for Lemon Auto Wholesalers. Will her ideas increase or decrease profitability?

2-12. Solution:

Lemon Auto Wholesalers
Income Statement

a.	Sales	$700,000
	Cost of goods sold (70% of sales)	$490,000
	Gross Profit	$210,000
	Selling and administrative expense (12% of sales)	$ 84,000
	Depreciation	$ 10,000
	Operating profit	$116,000
	Interest expense	$ 8,000
	Earnings before taxes	$108,000
	Taxes @ 30%	$ 32,400
	Earnings after taxes	$ 75,600

2-12. (Continued)

b.

Sales	$750,000
Cost of goods sold (66% of sales)	$495,000
Gross profit	$255,000
Selling and administrative expense (14% of sales)	$105,000
Depreciation	$ 10,000
Operating profit	$140,000
Interest expense	$ 15,000
Earnings before taxes	$125,000
Taxes @ 30%	$ 37,500
Earnings after taxes	$ 87,500

Ms. Carr's ideas will increase profitability.

13. **Balance sheet (LO3)** Classify the following balance sheet items as current or noncurrent:

Retained earnings	Bonds payable
Accounts payable	Accrued wages payable
Prepaid expenses	Accounts receivable
Plant and equipment	Capital in excess of par
Inventory	Preferred stock
Common stock	Marketable securities

2-13. Solution:

Retained earnings – noncurrent
Accounts payable – current
Prepaid expense – current
Plant and equipment – noncurrent
Inventory – current
Common stock – noncurrent
Bonds payable – noncurrent
Accrued wages payable – current
Accounts receivable – current
Capital in excess of par – noncurrent

Preferred stock – noncurrent
Marketable securities – current

14. **Balance sheet and income statement classification (LO1 & 3)** Fill in the blank spaces with categories 1 through 7:

1. Balance sheet (BS)
2. Income statement (IS)
3. Current assets (CA)
4. Fixed assets (FA)
5. Current liabilities (CL)
6. Long-term liabilities (LL)
7. Stockholders' equity (SE)

Indicate Whether Item Is on Balance Sheet (BS) or Income Statement (IS)	If on Balance Sheet, Designate Which Category	Item
_____	_____	Accounts receivable
_____	_____	Retained earnings
_____	_____	Income tax expense
_____	_____	Accrued expenses
_____	_____	Cash
_____	_____	Selling and administrative expenses
_____	_____	Plant and equipment
_____	_____	Operating expenses
_____	_____	Marketable securities
_____	_____	Interest expense
_____	_____	Sales
_____	_____	Notes payable (6 months)
_____	_____	Bonds payable, maturity 2019
_____	_____	Common stock
_____	_____	Depreciation expense
_____	_____	Inventories
_____	_____	Capital in excess of par value
_____	_____	Net income (earnings after taxes)
_____	_____	Income tax payable

2-14. Solution:

1. Balance Sheet (BS)
2. Income Statement (IS)
3. Current Assets (CA)

4. Fixed Assets (FA)
5. Current Liabilities (CL)
6. Long-Term Liabilities (LL)
7. Stockholders Equity (SE)

2-14. (Continued)

Indicate Whether the item is on Income Statement or Balance Sheet	***If the Item is on Balance Sheet, Designate Which Category***	***Item***
BS	CA	Accounts Receivable
BS	SE	Retained Earnings
IS		Income Tax Expense
BS	CL	Accrued Expenses
BS	CA	Cash
IS		Selling and Administrative expenses
BS	FA	Plant & Equipment
IS		Operating Expenses
BS	CA	Marketable Securities
IS		Interest Expense
IS		Sales
BS	CL	Notes Payable (6 months)
BS	LL	Bonds payable (Maturity 2019)
BS	SE	Common Stock
IS		Depreciation Expense
BS	CA	Inventories

BS	SE	Capital in excess of par value
IS		Net Income (Earnings after Taxes)
BS	CL	Income tax payable

15. **Development of balance sheet (LO3)** Arrange the following items in proper balance sheet presentation:

Accumulated depreciation..	$300,000
Retained earnings..	96,000
Cash..	10,000
Bonds payable..	136,000
Accounts receivable..	48,000
Plant and equipment—original cost....................................	680,000
Accounts payable..	35,000
Allowance for bad debts...	6,000
Common stock, $1 par, 100,000 shares outstanding.....	100,000
Inventory..	66,000
Preferred stock, $50 par, 1,000 shares outstanding...	50,000
Marketable securities..	20,000
Investments..	20,000
Notes payable...	33,000
Capital paid in excess of par (common stock).........	88,000

2-15. Solution:

Assets

Current Assets:		
Cash		$ 10,000
Marketable securities		20,000
Accounts receivable	$ 48,000	
Less: Allowance for bad debts	6,000	42,000
Inventory		66,000
Total Current Assets		$138,000
Other Assets:		
Investments..................................		20,000
Fixed Assets:		

Plant and equipment	$680,000	
Less: Accumulated depreciation	300,000	
Net plant and equipment		380,000
Total Assets.............................		$ 538,000

2-15. (Continued)

Liabilities and Stockholders' Equity

Current Liabilities:	
Accounts payable	$ 35,000
Notes payable	33,000
Total current liabilities	$ 68,000
Long-term Liabilities	
Bonds payable	136,000
Total Liabilities	$204,000
Stockholders' Equity:	
Preferred stock, $50 par, 1,000 shares outstanding..	50,000
Common stock, $1 par, 100,000 shares outstanding	100,000
Capital paid in excess of par (common stock)	88,000
Retained earnings	96,000
Total Stockholders' Equity	$334,000
Total Liabilities and Stockholders' Equity	$538,000

16. **Earnings per share and retained earnings (LO1 & 3)** Okra Snack Delights, Inc., has an operating profit of $210,000. Interest expense for the year was $30,000; preferred dividends paid were $24,700; and common dividends paid were $36,000. The tax was $59,300. The firm has 16,000 shares of common stock outstanding.

    a. Calculate the earnings per share and the common dividends per share.
    b. What was the increase in retained earnings for the year?

2-16. Solution:

Okra Snack Delights, Inc.

a.

Operating profit (EBIT)	$210,000
Interest expense	30,000
Earnings before taxes (EBT)	$180,000
Taxes	59,300
Earnings after taxes (EAT)	$120,700
Preferred dividends	24,700
Available to common stockholders	$ 96,000
Common dividends	36,000
Increase in retained earnings	$ 60,000

$$\text{Earnings per Share} = \frac{\text{Earnings Available to Common Stockholders}}{\text{Number of Shares of Com. Stock Outstanding}}$$

$$= \$96{,}000/16{,}000 \text{ shares}$$

$$= \$6.00 \text{ per share}$$

Dividends per Share = $36,000/16,000 shares

= $2.25 per share

b. Increase in retained earnings = $60,000

17. **Earnings per share and retained earnings (LO1 & 3)** Quantum Technology had $640,000 of retained earnings on December 31, 2010. The company paid common dividends of $30,000 in 2010 and had retained earnings of $500,000 on December 31, 2009. How much did Quantum Technology earn during 2010, and what would earnings per share be if 40,000 shares of common stock were outstanding?

2-17. Solution:

Quantum Technology

Retained earnings, December 31, 2010	$640,000
Less: Retained earnings, December 31, 2009................	500,000
Change in retained earnings..................................	$140,000
Add: Common stock dividends......................................	30,000
Earnings available to common stockholders	$170,000

Earnings per share

$$= \frac{\$170{,}000}{40{,}000 \text{ shares}} = \$4.25 \text{ per share}$$

18. **Price/earning ratio (LO2)** Botox Facial Care had earnings after taxes of $280,000 in 2009 with 200,000 shares of stock outstanding. The stock price was $30.80. In 2010, earnings after taxes increased to $320,000 with the same 200,000 shares outstanding. The stock price was $40.00

a. Compute earnings per share and the P/E ratio for 2009.
The P/E ratio equals the stock price divided by earnings per share.
b. Compute earnings per share and the P/E ratio for 2010.
c. Give a general explanation of why the P/E ratio changed

2-18. Solution:

Botox Facial Care

a. EPS (2009) $= \frac{\$280{,}000}{200{,}000} = \$1.40$

P/E ratio (2009) = Price/EPS $= \frac{30.80}{\$1.40} = 22x$

b. EPS (2010) $= \frac{\$320{,}000}{200{,}000} = \$1.60$

$$\text{P/E ratio (2010)} = \text{Price/EPS} = \frac{\$40.00}{\$1.60} = 25x$$

c. The stock price increased by 29.9% while EPS only increased 14.3%.

19. **Price/earning ratio (LO2)** Assume for Botox Facial Care discussed in Problem 18 that in 2011, earnings after taxes declined to $140,000 with the same 200,000 shares outstanding. The stock price declined to $24.50.

a. Compute earnings per share and the P/E ratio for 2011.
b. Give a general explanation of why the P/E changed. You might want to consult the textbook to explain this surprising result.

2-19. Solution:

Botox Facial Care (continued)

a. $$\text{EPS (2011)} = \frac{\$140{,}000}{200{,}000} = \$.70$$

$$\text{P/E ratio (2011)} = \text{Price/EPS} = \frac{\$24.50}{\$.70} = 35x$$

b. As explained in the text, when EPS drops rapidly, the stock price might not decline as much, and the P/E ratio rises.
A higher P/E ratio under adverse conditions is not a positive.

20. **Cash flow (LO4)** Identify whether each of the following items increases or decreases cash flow:

Increase in accounts receivable	Decrease in prepaid expenses
Increase in notes payable	Increase in inventory
Depreciation expense	Dividend payment
Increase in investments	Increase in accrued expenses
Decrease in accounts payable	

2-20. Solution:

Increase in accounts receivable – decreases cash flow (use)
Increase in notes payable – increases cash flow (source)
Depreciation expense – increases cash flow (source)
Increase in investments – decreases cash flow (use)

Decrease in accounts payable – decreases cash flow (use)
Decrease in prepaid expense – increases cash flow (source)
Increase in inventory – decreases cash flow (use)
Dividend payment – decreases cash flow (use)
Increase in accrued expenses – increases cash flow (source)

21. **Depreciation and Cash flow (LO5)** The Jupiter Corporation has a gross profit of $700,000 and $240,000 in depreciation expense. The Saturn Corporation also has $700,000 in gross profit, with $40,000 in depreciation expense. Selling and administrative expense is $160,000 for each company.

    Given that the tax rate is 40 percent, compute the cash flow for both companies. Explain the difference in cash flow between the two firms.

2-21. Solution:

Jupiter Corporation – Saturn Corporation

	Jupiter	Saturn
Gross profit	$700,000	$700,000
Selling and adm. expense	160,000	160,000
Depreciation	240,000	40,000
Operating profit	$300,000	$500,000
Taxes (40%)	120,000	200,000
Earnings after taxes	$180,000	$300,000
Plus depreciation expense	$240,000	$40,000
Cash Flow	$420,000	$340,000

Jupiter had $200,000 more in depreciation which provided $80,000 (0.40 × $200,000) more in cash flow.

22. **Free cash flow (LO4)** Coastal Pipeline, Inc., anticipated cash flow from operating activities of $8 million in 2010. It will need to spend $1.5 million on capital investments in order to remain competitive within the industry. Common stock dividends are projected at $.6 million and preferred stock dividends at $.25 million.

    a. What is the firm's projected free cash flow for the year 2010?
    b. What does the concept of free cash flow represent?

2-22. Solution:

Coastal Pipeline, Inc.

a.

Cash flow from operations activities	$8.00 million
- Capital Expenditures	1.50
- Common stock dividends	.60
- Preferred stock dividends	.25
Free cash flow	$5.65 million

b. Free cash flow represents the funds that are available for special financial activities, such as a leveraged buyout.

23. **Book value (LO3)** Landers Nursery and Garden Stores has current assets of $220,000 and fixed assets of $170,000. Current liabilities are $80,000 and long-term liabilities are $140,000. There is $40,000 in preferred stock outstanding and the firm has issued 25,000 shares of common stock. Compute book value (net worth) per share.

2-23. Solution:

Landers Nursery and Garden Stores

Current assets	$220,000
Fixed assets	170,000
Total assets	$390,000
–Current liabilities	80,000
–Long-term liabilities	140,000
Stockholders' equity	$170,000
–Preferred stock obligation	40,000
Net worth assigned to common	$130,000
Common shares outstanding	25,000
Book value (net worth) per share	$ 5.20

24. **Book value and market value (LO2 & 3)** The Rockford Corporation has assets of $380,000, current liabilities of $40,000, and long-term liabilities of $70,000. There is $30,000 in preferred stock outstanding; 20,000 shares of common stock have been issued.

a. Compute book value (net worth) per share.
b. If there is $25,000 in earnings available to common stockholders and Rockford's stock has a P/E of 15 times earnings per share, what is the current price of the stock?
c. What is the ratio of market value per share to book value per share?

2-24. Solution:

Rockford Corporation

a.

Total assets	$380,000
–Current liabilities	40,000
–Long-term liabilities	70,000
Stockholders' equity	270,000
–Preferred stock	30,000
Net worth assigned to common	$240,000
Common shares outstanding	20,000
Book value (net worth) per share	$ 12.00

b.

Earnings available to common	$ 25,000
Shares outstanding	20,000
Earnings per share	$ 1.25

P/E ratio	×	earnings per share	=	price
15	×	$1.25	=	$18.75

c. Market value per share (price) to book value per share $18.75/$12.00 = 1.56

25. **Book value and market value (LO2 & 3)** Amigo Software, Inc., has total assets of $800,000, current liabilities of $150,000, and long-term liabilities of $120,000. There is $65,000 in preferred stock outstanding. Thirty thousand shares of common stock have been issued.

a. Compute book value (net worth) per share.
b. If there is $48,000 in earnings available to common stockholders and the firm's stock has a P/E of 20 times earnings per share, what is the current price of the stock?
c. What is the ratio of market value per share to book value per share? (Round to two places to the right of the decimal point.)

2-25. Solution:

Amigo Software, Inc.

a.	Total assets	$800,000
	–Current liabilities	150,000
	–Long-term liabilities	120,000
	Stockholders' equity	$530,000
	–Preferred stock	65,000
	Net worth assigned to common	$465,000
	Common shares outstanding	30,000
	Book value (net worth) per share	$ 15.50
b.	Earnings available to common	$ 48,000
	Shares outstanding	30,000
	Earnings per share	$ 1.60

P/E ratio	×	earnings per share	=	price
20	×	$1.60	=	$32.00

c. Market value per share (price) to book value per share
$32.00/$15.50 = 2.06

26. **Book value and P/E ratio (LO2 & 3)** In problem 25, if the firm sells at 2.5 times book value per share, what will the P/E ratio be? (Round to the nearest whole number.)

2-26. Solution:

Amigo Software, Inc. (continued)

$$2.5 \times \text{book value per share} = \text{price}$$

$$2.5 \times \$15.4 = \$38.75$$

$$\frac{\text{Price}}{\text{Earnings per share}} = \text{P/E}$$

$$\frac{\$38.75}{\$1.60} = 24.22 \quad \text{P/E ratio} \qquad \text{round to 24x}$$

27. **Construction of income statement and balance sheet (LO1 & 3)** For December 31, 2009, the balance sheet of Baxter Corporation was as follows:

Current Assets		**Liabilities**	
Cash	$ 10,000	Accounts payable	$ 12,000
Accounts receivable	15,000	Notes payable	20,000
Inventory	25,000	Bonds payable	50,000
Prepaid expenses	12,000		
Fixed Assets		**Stockholders' Equity**	
Plant and equipment (gross)	$250,000	Preferred stock	20,000
Less: Accumulated depreciation	50,000	Common stock	55,000
		Paid-in capital	25,000
Net plant and equipment	200,000	Retained earnings	80,000
Total Assets	$262,000	Total liabilities and stockholders' equity	$262,000

Sales for 2010 were $220,000, and the cost of goods sold was 60 percent of sales. Selling and administrative expense was $22,000. Depreciation expense was 8 percent of plant and equipment (gross) at the beginning of the year. Interest expense for the notes payable was 10 percent, while the interest rate on the bonds payable was 12 percent. This interest expense is based on December 31, 2009 balances. The tax rate averaged 20 percent.

Two thousand dollars in preferred stock dividends were paid and $8,400 in dividends were paid to common stockholders. There were 10,000 shares of common stock outstanding.

During 2010, the cash balance and prepaid expenses balances were unchanged. Accounts receivable and inventory increased by 10 percent. A new machine was purchased on December 31, 2010, at a cost of $35,000.

Accounts payable increased by 25 percent. Notes payable increased by $6,000 and bonds payable decreased by $10,000, both at the end of the year. The preferred stock, common stock, and paid-in capital in excess of par accounts did not change.

a. Prepare an income statement for 2010.
b. Prepare a statement of retained earnings for 2010.
c. Prepare a balance sheet as of December 31, 2010.

2-27. Solution:

Baxter Corporation

2010 Income Statement

a.	Sales	$220,000
	Cost of good sold (60%)	132,000
	Gross profit	$ 88,000
	Selling and administrative expense	22,000
	Depreciation expense (8%)	20,000[1]
	Operating profit (EBIT)	$ 46,000
	Interest expense	8,000[2]
	Earnings before taxes	$ 38,000
	Taxes (20%)	7,600
	Earnings after taxes (EAT)	$ 30,400
	Preferred stock dividends	2,000
	Earnings available to common stockholder	$ 28,400
	Shares outstanding	10,000
	Earnings per share	$ 2.84
b.	2010 Statement of Retained Earnings	
	Retained earnings balance, January 1, 2010	$ 80,000
	Add: Earnings available to common stockholders, 2010	28,400
	Deduct: Cash dividend declared in 2010	8,400

[1] 8% × $250,000 = $20,000
[2] (10% × $20,000) + (12% × $50,000) = $8,000

Retained earnings balance,
December 31, 2010...................................... $100,000

2-27. (Continued)

c. **2010 Balance Sheet**

Current Assets		Liabilities	
Cash…………..	$ 10,000	Accounts payable	$15,000
Accounts receivable……..	16,500	Notes payable….	26,000
Inventory………	27,500	Bonds payable…	40,000
Prepaid expenses	12,000		
	$66,000		$81,000

Fixed Assets		Stockholders' Equity	
Gross plant…...	$285,000	Preferred stock... Common stock...	$ 20,000 55,000
Accumulated depr…………	(70,000)[3]	Paid in capital in excess of par…	25,000
Net plant……..	215,000	Retained earnings	100,000
Total assets…..	$281,000	Total Liability & Equity………..	$281,000

[3] $50,000 + $20,000 = $70,000

28. **Statement of cash flows (LO4)** Prepare a statement of cash flows for the Jeter Corporation. Follow the general procedures indicated in Table 2–10.

JETER CORPORATION
Income Statement
For the Year Ended December 31, 2010

Sales	$ 3,300,000
Cost of goods sold	1,950,000
Gross profits	1,350,000
Selling and administrative expense	650,000
Depreciation expense	230,000
Operating income	470,000
Interest expense	80,000
Earnings before taxes	390,000
Taxes	140,000
Earnings after taxes	250,000
Preferred stock dividends	10,000
Earnings available to common stockholders	$ 240,000
Shares outstanding	150,000
Earnings per share	$ 1.60

Statement of Retained Earnings
For the Year Ended December 31, 2010

Retained earnings, balance, January 1, 2010	$800,000
Add: Earnings available to common stockholders, 2010	240,000
Deduct: Cash dividends declared and paid in 2010	140,000
Retained earnings, balance, December 31, 2010	$900,000

Comparative Balance Sheets
For 2009 and 2010

Assets	**Year-End 2009**	**Year-End 2010**
Current assets:		
Cash	$ 100,000	$120,000
Accounts receivable (net)	500,000	510,000
Inventory	610,000	640,000
Prepaid expenses	60,000	30,000
Total current assets	1,270,000	1,300,000
Investments (long-term securities)	90,000	80,000
Plant and equipment	2,000,000	2,600,000
Less: Accumulated depreciation	1,000,000	1,230,000
Net plant and equipment	1,000,000	1,370,000
Total assets	$2,360,000	$2,750,000

Liabilities and Stockholders' Equity	**Year-End 2009**	**Year-End 2010**
Current liabilities:		
Accounts payable	$ 300,000	$ 550,000
Notes payable	500,000	500,000
Accrued expenses	70,000	50,000
Total current liabilities	870,000	1,100,000
Long-term liabilities:		
Bonds payable, 2015	100,000	160,000
Total liabilities	970,000	1,260,000
Stockholders' equity:		
Preferred stock, $100 par value	90,000	90,000
Common stock, $1 par value	150,000	150,000
Capital paid in excess of par	350,000	350,000
Retained earnings	800,000	900,000
Total stockholders' equity	1,390,000	1,490,000
Total liabilities and stockholders' equity	$2,360,000	$2,750,000

2-28. Solution:

Jeter Corporation
Statement of Cash Flows
For the Year Ended December 31, 2010

Cash flows from operating activities:		
Net income (earnings after taxes)		$250,000
Adjustments to determine cash flow from operating activities:		
Add back depreciation	$230,000	
Increase in accounts receivable	(10,000)	
Increase in inventory	(30,000)	
Decrease in prepaid expenses	30,000	
Increase in accounts payable	250,000	
Decrease in accrued expenses	(20,000)	
Total adjustments		450,000
Net cash flows from operating activities		**$700,000**
Cash flows from investing activities:		
Decrease in investments	10,000	
Increase in plant and equipment	(600,000)	
Net cash flows from investing activities		**(590,000)**
Cash flows from financing activities:		
Increase in bonds payable	60,000	
Preferred stock dividends paid	(10,000)	
Common stock dividends paid	(140,000)	
Net cash flows from financing		**(90,000)**
Net increase (decrease) in cash flows		**$ 20,000**

The student should observe that the increase in cash flows of $20,000 equals the $20,000 change in the cash account on the balance sheet. This indicates the statement is correct.

(The following questions apply to the Jeter Corporation, as presented in Problem 28.)

29. **Net income and cash flows (LO1 & 3)** Describe the general relationship between net income and net cash flows from operating activities for the firm.

2-29. Solution:

Cash flows from operating activities far exceed net income. This occurs primarily because we add back depreciation of $230,000 and accounts payable increase by $250,000. Thus, the reader of the cash flow statement gets important insights as to how much cash flow was developed from daily operations.

30. **Financing of assets (LO3)** Has the buildup in plant and equipment been financed in a satisfactory manner? Briefly discuss.

2-30. Solution:

The buildup in plant and equipment of $600,000 (gross) and $370,000 (net) has been financed, in part, by the large increase in accounts payable (250,000). This is not a very satisfactory situation. Short-term sources of funds can always dry up, while fixed asset needs are permanent in nature. This firm may wish to consider more long-term financing, such as a mortgage, to go along with profits, the increase in bonds payable, and the add-back of depreciation.

31. **Book value (LO3)** Compute the book value per common share for both 2009 and 2010 for the Jeter Corporation.

2-31. Solution:

$$\text{Book value Per share} = \frac{\text{Stockholders' equity} - \text{Preferred stock}}{\text{Common shares outstanding}}$$

$$\text{Book value Per share (2009)} = \frac{(\$1,390,000 - \$90,000)}{150,000} = \frac{\$1,300,000}{150,000} = \$8.67$$

$$\text{Book value Per share (2010)} = \frac{(\$1,490,000 - \$90,000)}{150,000} = \frac{\$1,400,000}{150,000} = \$9.33$$

32. **P/E ratio (LO2)** If the market value of a share of common stock is 3.1 times book value for 2010, what is the firm's P/E ratio for 2010? (Round to the nearest whole number.)

2-32. Solution:

$$\text{Market value} = 3.1 \times \$9.33 = \$28.92$$

$$\text{P/E ratio} = \$28.92/\$1.60 = 18.07 \text{ or } 18\times$$

W E B E X E R C I S E

1. PepsiCo, at the top of Table 2 in the chapter, is a company that provides comprehensive financial statements. Go to finance.yahoo.com. In the box next to "Get Quotes" type in its ticker symbol PEP and click.
2. Scroll all the way down to "Financials" and click on "Income Statement." Compute the annual percentage change between the three years for the following:
   a. Total Revenue
   b. Net Income Applicable to Common Shares
3. Now click on the "Balance Sheet" and compute the annual percentage change between the three years for the following:

   a. Total Assets
   b. Total Liabilities

4. Write a one paragraph summary of how the company is doing.

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