

- b. Outline the specific GAAPs that provide a guide to reporting the correct amounts for part a of this question. (hint: not all of the GAAP!— only the select ones that apply to part a)

REVENUE RECOGNITION

- REALIZABLE REVENUE
- ADJUST AIR, INV, UNEARNED R.

3 MATCHING COSTS - MATCH COST WITH REALIZABLE REVENUE TO REVIEW TRUE COST OF PRODUCTION OF UNITS

QUESTION 2

What is the more appropriate tax rate for taxpayers to use when assessing their tax burden? Marginal tax rate or Average tax rate? Be sure to outline each of these terms in your answer.

3 - $Avg\ Tax\ Rate = \frac{Total\ Tax\ Pd}{Taxable\ Income}$

- $Marginal\ Tax = Tax\ Pd\ on\ next\ dollar\ earned$

EITHER - BUT GENERALLY DUE TO PROGRESSIVE TAX RATE USE MARGINAL

QUESTION 3

Distinguish among the types of cash flows resulting from operating, financing and investing activities. In your brief description, provide at least one example of each of these activities as a way to illustrate the differences.

3 OPERATING CF - ASSOCIATED WITH ACTIVITIES/FLOWS WITH BUSINESS GOODS/SERVICES (CASH)

PRODUCTION + SALE
- EX: INTEREST PD, AID PD, SALES

INVESTING (CASH)

- ↑ ↓ OF LONG TERM ASSETS/CAPITAL ASSETS

- EX: SALE OF ASSET
PURCHASE OF PATENT

FINANCING (CASH)

- ↑ ↓ OF LT LIABILITIES & OWNER EQUITY

OR COMMON STOCK SALE/NEW LOAN

QUESTION 4

Listed below in random order are the items to be included in the balance sheet of ZZZZ Lodge, Inc. at December 31, 2002:

Equipment Original Cost	\$48,100	Buildings Original Cost	\$447,200
Land Original Cost	510,000	Common Shares/Stock	100,000
Accounts Payable	40,100	Cash	10,300
Accounts Receivable	19,400	Salaries Payable	21,000
Utilities Payable	8,000	Retained Earnings	?
Land Loan	405,000 (Of which 15,000 is to be paid within one year)		
Accumulated Depreciation for Equipment			40,000
Accumulated Depreciation for Building.. ..			100,000

Additional information:

Accrued Net Income (year ending 2002) \$100,000

Interest expense (adjusted for tax) (for the year 2002) \$18,000

You are quite certain the market value of land and buildings has not changed since the original purchase date.

Please use the information above to answer the following parts a to d.

b. Use TWO ratios or equations to test each of the following financial terms for ZZZZ Lodge, Inc. In addition, provide a brief explanation of the term and result of your ratio/value.

LIQUIDITY

$$CA > CL$$

1.

$$CA/CL = \frac{29700}{84100} = .35$$

< 1 NOT LIQUID

2.

$$CA - CL = \underline{\underline{\langle 54,400 \rangle}}$$

SHORT 54,400 -
THESE LIAB. OF THIS
AMT WILL NOT BE
COVERED

4

PROFITABILITY

TR > TE USING ACCR. NET INCOME

1.)

ACCR NI > 0 SO
PROFITABLE

$$3.) ROE = NI/OE$$

$$= 23.75\%$$

23.75%
\$0.2375 EARNED / V. GOOD

2.)

$$\cancel{RDA} = NI + int / TA$$

$$RDA = 118000 / 895000$$

$$= \underline{\underline{13.18\%}}$$

EARN 13% ON EVERY 1\$
OF ASSET.
V. GOOD.

4

SOLVENCY

$$TA > TL$$

1.

TA > TL SO SOLVENT

2.

$$D/E = 474,100 / 420,900$$

$$= 1.13 \text{ \$ for } 1 \text{ \$ EQUITY}$$

2.

$$D/A = 474,100 / 895,000$$

$$= .53 \text{ \$ DEBT FOR } 1 \text{ \$ ASSET}$$

4. % EQUITY

$$= 420,900 / 895,000$$

$$= \underline{\underline{47\%}} \text{ OWNERSHIP}$$

4

- a. Prepare a balance sheet at December 31, 2002. Include a proper heading and organize your balance sheet. You will need to compute the amount to be shown for retained earnings.

ZZZZ Lodge Balance Sheet: Dec 31, 2002	
Assets	Liabilities
<p>CA/ CASH 10,300</p> <p>A/R 19,400</p> <p>TOTAL <u>29,700</u></p> <p>LTA/ EQ WP</p> <p>PP 48,100 8,100</p> <p>DEP ACC 40,000</p> <p>BLDG</p> <p>PP 447,200 347,200</p> <p>DEP ACC 100,000</p> <p>LAND 510,000</p> <p>TOTAL <u>865,300</u></p>	<p>CL/ A/P 40,100</p> <p>W/P 8,000</p> <p>S/P 21,000</p> <p>LOAN PNT</p> <p>DUE WIL 1YR 15,000</p> <p>TOTAL <u>84,100</u></p> <p>LTL/ LAND</p> <p>LOAN <u>390,000</u></p> <p>TOTAL <u>390,000</u></p> <p>TOTAL LIABILITIES <u>474,100</u></p>
	Shareholders' Equity
<p>TOTAL ASSETS > \$ 895,000</p>	<p>COMMON STOCK 100,000</p> <p>RETAINED EARNINGS 320,900</p> <p><u>420,900</u></p> <p>TOTAL EQUITY \$ <u>895,000</u></p>

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c. Assess and comment on the use of financial leverage by ZZZZ Lodge, Inc. Be sure to define the concept and impact of financial leverage in your explanations and use the appropriate ratios in your assessment.

FINANCIAL LEV - USE OF BANK'S MONEY (DEBT)
 - TO BUY ASSETS, EARN NI & ↑ ROE
 - ↑ RISK (FIXED DEBT PMT) & ↑ RTN (RISK)

6
 FIRM LEVERAGE RATIOS {
 D/E = 10/3 / 1[#] EQUITY MINIMAL
 ROA = 13.18% GOOD RATE
 ROE = 28% V. GOOD RATE

- USE OF V. LOW INTEREST (3.8%) FROM BANK & ROA OF 13% LEVERAGES ROE TO 28%

d. A banker friend has suggested to ZZZZ Lodge, Inc. owners that they should try to eliminate all risk from their business. Briefly describe the two types of risk facing the firm and how each of these risk types can be measured and minimized.

6
 FINANCIAL RISK - OCCURS DUE TO FIXED DEBT PMT NO MATTER WHAT LEVEL OF NI.
 - MEASURE D/E, ROA, ROE
 - ELIMINATE ∅ DEBT

BUSINESS RISK - PRICE & QUANTITY / PRODUCTION / SALE VARIABILITY EXTERNAL TO FIRM
 - MEASURES OPERATING LEVERAGE SENSITIVITY & B/E ANALYSIS
 - CAN BE MITIGATED - NOT ELIMINATED

QUESTION 4

- a. Your colleague is considering changing her business structure to a public corporation. Outline three major reasons why she would want to change to this type of structure.

- 3
- * CAN RAISE FUNDS VIA LOANS + SHARES
 - LIMITED LIABILITY FOR SHAREHOLDERS
 - NO PROGRESSIVE TAX RATE
 - CONTINUITY OF BUSINESS
 - USE SHARES AS EMPLOYEE INCENTIVE

- b. Your colleague has decided to stay as a sole proprietor business structure. Outline three major reasons why she would want to stay in this type of structure.

- 4
- SIMPLE + EASY TO SETUP/MAINTAIN
 - * MAINTAIN DECISION MAKING CONTROL
 - LOSS DEDUCTIBLE FROM OTHER INCOME
 - CAN DRAW MONEY AS REQ'D FROM BUSINESS.

- c. Describe the term "limited liability" and explain how it applies to each of the business structures from parts a and b?

LIMITED LIABILITY IMPLIES THE INVESTOR LOSS OR AMOUNT THEY ARE LIABLE FOR IS LIMITED TO THEIR INVESTMENT.

4

SOLE P. — UNLIMITED LIABILITY. IF BUSINESS CANNOT PAY LIABILITIES UPON BANKRUPTCY THEN OWNER IS RESPONSIBLE (7 THEIR ASSETS)

CORP — SHAREHOLDERS HAVE LIMITED LIABILITY

QUESTION 6

Use the accounting equation to assess the owner equity of this firm and use Debt/Equity ratio and Percent Ownership ratio to assess this firm's financial position. Please show your work!

Data: A brand new company has a building costing \$10,000, machinery costing \$5,000, cash of \$700, and a bank loan of \$10,850.

5

A	=	L	+	OE	
				\$	10850
BLDG	\$	10,000		LOAN	
MACHINE		5000			
CASH		700			
A	\$	15,700		L	\$ 10,850
				OE	\$ 4,850

- $D/E = 10850 / 4850 = 2.2$ \$ DEBT FOR 1\$ EQUITY
MAY INDICATE FINANCIAL RISK

- % OWNERSHIP = $4850 / 15700 = 30\%$ BANK OWNS MORE THAN OWNER.

FINANCIAL POSITION - NOT GREAT - RISK

QUESTION 7

Cooking the Books. You found out today that you do not have to follow GAAP! List THREE ways of ignoring GAAP that would result in a higher net income for your firm. Your answers should be based upon GAAP and accounting rules as opposed to using any illegal or odd sales/services.

3 MANY WAYS TO ↑ NI

AIR	}	CHANGE TIMING OF INCLUSION ON NI AS ↑ R ↓ VE
INV		
A/P		
PRINC VS DEPRECIATION		
PREPAID EXP		

QUESTION 8

	Firm A	Firm B	Firm C
Debt	\$2	\$40	\$15
Equity	\$8	\$60	\$35
Total Assets	\$10	\$100	\$50

- a. Given the above balance sheets of three firms, which firm appears to have greater financial leverage? What will be the effect of this financial leverage on each of the firms. Be specific!

$$\frac{D}{E} \quad .25 \quad .66 \quad .43$$

FIRM B > LEVERAGE

EFFECT - > ROE (MAGNIFY)

- > FINANCIAL RISK (FIXED PMT)

concepts

- b. Outline the difference between operating and financial leverage for the firm. Be sure to define each term in your explanation.

OPERATING = SALES + EBIT RELATIONSHIP

VIA PROP. OF FIXED VS V.

VARIABLE EXPENSE & ↑ UNIT OF SALE ⇒

FINANCE - FIXED PMT ASSOCIATED WITH

FINANCING VIA DEBT ↑ RISK

↓ ↑ RTN POTENTIAL

QUESTION 9

ABCD Corp, Balance Sheet Values	Dec 31, 2012	Dec 31, 2013
Total Assets	200,000	250,000
Total Liabilities	162,000	183,000

If the owners of ABCD Corp had invested \$30,000 in the business during September and made no withdrawals, ABCD's income (loss) for September was:

- a. \$29,000
- b. \$67,000
- c. \$1,000
- d. (\$1,000)
- e. none of the above

D

Show your work if possible.

3

$OE_{2012} \quad 38,000 \quad [200,000 - 162,000]$
 $NI \quad ? \quad < \underline{1,000} >$
 $OC \quad 30,000$
 $OE_{2013} \quad 69,000 \quad [250,000 - 183,000]$

QUESTION 10

A goal for all firms is to make their Return on Equity (ROE) as high as possible over the long term. Outline at least two ways that managers can make ROE high (as discussed in class).

4

$\uparrow ROE \quad \text{VIA} \quad ROA \uparrow$
 $\text{PROFIT MARGIN} \uparrow$
 $\uparrow SALES$
 $\text{FINANCIAL LEVERAGE CHANGE}$
 $\text{OPERATING LEVERAGE CHANGE}$

QUESTION 11

Janet Smith is the owner of her own business. All accounts at the beginning of the year were zero. On December 31, Smith's assets, liabilities, revenue and expense were:

Insurance Expense	\$3,000
Accounts Payable	4,000
Depreciation Expenses	900
Accounts Receivable	5,000
Rent Expenses	2,500
Cash	14,000
Salaries Expense	19,000
Equipment	11,000
Supplies Expense	1,200
Equipment loan (not due this year)	4,600
Revenue for Services Performed	45,000
Inventory	700

<u>A</u>		<u>L</u>	
A/R	5000	A/P	4000
Cash	14000	LOAN	
INV	700	EQUIP	4600
EQUIP	11000		
TA 30700		TL 8600	

a. On December 31, total assets are equal to:

- a. \$25,700
- b. \$19,700
- c. \$22,100
- d. \$30,700
- e. none of the above

2

D 30700

b. On December 31, ACCRUED net income is equal to: (be sure you are using accrued values)

- a. \$18,400
- b. \$45,000
- c. \$17,400
- d. \$20,100
- e. none of the above,

4

D 20100

<u>R</u>		<u>E</u>	
REN	45000	INS	3000
A/R (NET)	5000	Dep	900
INV (NET)	700	Rent	2500
50,700		Sal.	19000
		Supplies	1200
		A/P	4000
		30,600	

c. On December 31, current assets equal:

- a. \$9,000
- b. \$19,700
- c. \$19,000
- d. \$23,000
- e. none of the above

2

B 19700

d. On December 31, owner equity was equal to:

- a. \$16,000
- b. \$67,100
- c. \$22,100
- d. \$9,700
- e. none of the above

4

C 22100

NI = 20,100
ACCRUED.

100