SOLUTIONS MANUAL

Interpreting and Analyzing Financial Statements

A Project-Based Approach

Fifth Edition

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ACTIVITY 11 THE CLASSIFIED BALANCE SHEET

Purpose: • Identify account classifications typically used on the balance sheet

STARBUCKS (SBUX) 9/28/2008 BALANCE SHEET ($ in millions)			
ASSETS		**LIABILITIES**	
Cash and cash equivalents	$ 269.8	Accounts payable	$ 324.9
Short-term investments	52.5	Short-term debt	713.0
Accounts receivable	329.5	Other current liabilities	1151.8
Inventories	692.8	Long-term debt	549.6
Other current assets	403.4	Other noncurrent liabilities	442.4
PPE, net	2,956.4	**STOCKHOLDERS' EQUITY**	
Goodwill and intangibles	333.1	Contributed capital	40.1
Long-term investments	374.0	Retained earnings	2,402.4
Other noncurrent assets	261.1	Other stockholders' equity	48.4
TOTAL ASSETS	**$5,672.6**	**TOTAL L & SE**	**$5,672.6**

A classified balance sheet breaks the three major account types (assets, liabilities, and stockholders' equity) into smaller classifications to help decision makers better understand the information presented. Typical classifications and a brief description follow.

- **Current assets** (CA) are those assets expected to be converted into cash, sold, or consumed within 12 months.
- **Property, plant, and equipment** (PPE) summarize amounts for equipment, buildings, and land. These are long-term assets that are expected to benefit more than one accounting period. **Depreciation expense** is the cost allocated to each year of the asset's useful life. **Accumulated depreciation** is the total amount of depreciation expensed since the asset's date of purchase. Acquisition cost – accumulated depreciation = the **book value** of PPE, which is the amount added to compute total assets on the balance sheet. Land is not depreciated.
- **Goodwill** is created when acquiring a company for an amount greater than its net assets; amounts paid for the value its management team, customer base, and overall reputation. **Other intangible assets** include amounts paid for patents, copyrights, and brand names.
- **Other assets** are noncurrent asset (NCA) accounts such as long-term investments, which are not included in any other asset classification.
- **Current liabilities** (CL) are amounts owed to creditors that are expected to be repaid within 12 months. Examples include accounts payable and short-term debt.
- **Noncurrent liabilities** (NCL) are amounts owed to creditors that are expected to be repaid in more than 12 months. Examples include bonds payable and long-term debt.
- **Contributed capital** (CC) includes amounts paid (contributed) by stockholders to purchase common stock and preferred stock. Accounts include common stock and additional-paid-in capital (APIC).
- **Retained earnings** (RE) is net income earned by the company since its incorporation and not yet distributed as dividends.
- **Other stockholders' equity** includes treasury stock and adjustments to stockholders' equity such as the change in value of long-term investments.

To answer the following questions refer to the balance sheet presented above.

Q1 How many accounts listed are Current Assets? (1 / 3 / **5**) Property, Plant, and Equipment? (**1** / 3 / 5)

Goodwill and Intangibles? (**1** / 3 / 5) Other Assets? (1 / 3 / 5) **2** **Ooops**

Q2 What is the total amount reported for Current Liabilities? **$2,189.7** million

Noncurrent Liabilities? **$992.0** million Total Stockholders' Equity? **$2,490.9** million

ACTIVITY 12 UNDERSTANDING THE BALANCE SHEET

Purpose: • Identify the value at which amounts are reported on the balance sheet

Use Starbucks' balance sheet dated 9/28/2008 (on the opposite page) to answer the following questions.

a. How much do customers owe this company? **$324.9** million

b. For *inventories*, $692.8 million is the (**acquisition cost** / current market value / can't tell).

c. For *property, plant, and equipment, net*, $2,956.4 million is the (acquisition cost / current market value / **book value** / can't tell). ~~On average, these assets (are brand new / **have been used about half of their useful life** / are ready to be replaced).~~ **Ooops**

d. What amount of investments does this company intend to hold for more than a year? **$374.0** million

e. (PPE / **Goodwill** / LT Investments) is created when a company is acquired.

f. How much does this company owe to suppliers? **$324.9** million

g. Current assets total **$1,748.0** million and current liabilities total **$2,189.7** million. Current assets are used to pay off (**current** / noncurrent) liabilities. This company has (sufficient / **insufficient**) current assets to pay off its current liabilities.

h. Noncurrent assets total **$2,176.6** million and noncurrent liabilities total **$992.0** million. Noncurrent liabilities are used to finance (current / **noncurrent**) assets.

i. Contributed capital represent (amounts borrowed / **amounts paid-in by shareholders** / net income earned by the company).

j. This company is relying primarily on (long-term debt / contributed capital / **retained earnings**) to finance assets, which is an (external / **internal**) source of financing.

k. The balance sheet reports a company's financial position (**as of a certain date** / over a period of time).

l. Assets and liabilities are recorded on the balance sheet in order (of magnitude / alphabetically / **of liquidity**), which means that (PPE / **cash**) will always be listed before (**PPE** / cash).

m. U.S. GAAP and IFRS treat (**cash** / PPE) essentially the same. However, for (cash / **PPE**), IFRS allows valuation at fair value, whereas U.S. GAAP requires (**historical cost** / fair value).

ACTIVITY 13 UNDERSTANDING THE BALANCE SHEET

Purpose:
- Identify the value at which amounts are reported on the balance sheet
- Understand what an increase or a decrease in an account indicates
- Develop strategies for analyzing the balance sheet

STARBUCKS (SBUX) BALANCE SHEET ($ in millions)				
ASSETS	**9/28/2008**	**9/30/2007**	**10/01/2006**	**10/02/2005**
Cash and cash equivalents	$ 269.8	$ 281.3	$ 312.6	$ 173.8
Short-term investments	52.5	157.4	141.0	133.2
Accounts receivable	329.5	287.9	224.3	190.8
Inventories	692.8	691.7	636.2	546.3
Other current assets	403.4	278.2	215.7	165.2
Property, plant, and equipment	5,717.3	5,306.5	4,082.7	3,322.1
Accumulated depreciation	(2,760.9)	(2,416.1)	(1,794.8)	(1,480.1)
PPE, net	2,956.4	2,890.4	2,287.9	1,842.0
Goodwill and other intangibles	333.1	257.7	199.4	127.9
Long-term investments	374.0	279.9	224.9	261.6
Other noncurrent assets	261.1	219.4	186.9	(L)
TOTAL ASSETS	**$ 5,672.6**	**$ 5,343.9**	**$ 4,428.9**	**$ 3,513.7**
LIABILITIES				
Accounts payable	$ 324.9	$ 390.8	$ 341.0	$ 221.0
Short-term debt	713.0	710.3	700.0	277.0
Other current liabilities	1,151.8	1,054.5	894.7	729.0
Long-term debt	549.6	550.1	2.0	2.9
Other noncurrent liabilities	442.4	354.1	262.7	193.5
STOCKHOLDERS' EQUITY				
Contributed capital	40.1	40.1	40.1	130.4
Retained earnings	2,402.4	2,189.4	2,151.1	1,939.0
Other stockholders' equity	48.4	54.6	37.3	20.9
TOTAL L & SE	**$ 5,672.6**	**$ 5,343.9**	**$ 4,428.9**	**$ (Z)**

Q1 Use all four years of balance sheet amounts above to answer the following questions.

a. Calculate the amounts that should be reported for (Z) and (L) on the 10/02/2005 balance sheet: (Z) = **$3,513.7** million (L) = **$72.9** million

b. What was the beginning balance of the inventories account for the fiscal year ended on 9/28/2008? **$691.7** million 9/30/2007? **$636.2** million 10/01/2006? **$546.3** million

c. What amount of property, plant, and equipment was purchased during fiscal year ended 9/28/2008? **$410.8** million 9/30/2007? **$1,223.8** million 10/01/2006? **$760.6** million

d. From 10/2/2005 to 9/28/2008, long-term debt (**increased** / decreased), indicating (**more** / less) financial risk. This company paid off long-term debt during fiscal years ended in (**2008** / 2007 / **2006**). As of 9/28/2008 this company owes long-term debt of **$549.6** million to creditors.

Q2 Use all four years of balance sheet amounts on the previous page to answer the following questions.

a. Total Assets are (**increasing** / decreasing), indicating that this company is (**expanding** / shrinking).

b. From 10/2/2005 to 9/28/2008, Contributed Capital (increased / **decreased**), indicating the company (sold assets / **repurchased common stock** / reported a net loss) during this accounting period.

c. Retained Earnings is (**increasing** / decreasing), indicating this company (issued more stock / purchased more assets / **reported net income**). Assuming no dividends were issued, how much net income (loss) was reported for the fiscal year ended on…

9/28/2008? **$213.0** million 9/30/2007? **$38.3** million 10/01/2006? **$212.1** million

The most profitable year was during the fiscal year ending in (**2008** / 2007 / 2006).

d. Develop a strategy to analyze the balance sheet. Which line would you look at first? Second? Third? *Why*?

Answers will vary…but one possible method of analyzing the balance sheet is to first review the trend in total assets, and then study how those assets are financed by examining liabilities, contributed capital, and retained earnings.

e. Review the series of balance sheets. This company appears to report a (**strong** / weak) financial position. *Why*? Support your response with at least two observations.

Answers will vary, but should include two if the following

- ***Total assets increased, indicating the company is expanding.***
- ***Property, plant, and equipment increased, indicating the company is updating assets on a regular basis.***
- ***Retained earnings increased, indicating the company is profitable.***

ACTIVITY 14 DEBT VS. EQUITY

Purpose:
- Identify the characteristics of debt and equity
- Assess financial risk

Corporations externally finance the purchase of assets with debt (liabilities) or equity (common stock).

Assets = Liabilities + Stockholders' Equity

Large amounts of **debt** are usually issued in the form of bonds. The borrowing corporation records a bond payable and is referred to as the *debtor* and the entity loaning the money records a bond receivable and is referred to as the *creditor*. The debtor must pay back the amount borrowed plus interest to the creditor. The interest paid by the borrowing corporation is an expense that reduces taxable income. The return to creditors is the interest received. Creditors are not owners of the corporation and, therefore, have no ownership rights.

Equity refers to the issuance of stock, which may be common stock or preferred stock. Entities owning shares of stock are the owners of the corporation and are referred to as *stockholders* or shareholders. Stockholders' primary ownership rights include a right to vote at annual meetings and a right to a portion of the profits (net income). *Dividends* are the distribution of profits to stockholders. The corporate board of directors decides whether to pay dividends or not and has no obligation to purchase the shares of stock back from the stockholders. If stockholders sell their shares of stock, they usually sell to another investor using a stockbroker, who in turn executes the trade on a stock exchange such as the New York Stock Exchange or NASDAQ. Stockholders earn a return on their investment by receiving dividends or selling the stock for a greater amount than the purchase price.

The balance sheet helps investors, both creditors and stockholders, assess the degree of financial risk a corporation is assuming. In general, the more a corporation relies on debt to finance assets, the greater the financial risk of the corporation.

($ in millions)	Google (GOOG) 12/31/2008	General Mills (GIS) 12/31/2008
Assets	$ 20,178	$ **19,042** (Y)
Liabilities	$ 3,529	$ 12,826
Stockholders' equity	$ **16,649** (B)	$ 6,216
Debt ratio	**17.5%**	**67.4%**

Q1 Compute the values for (B) and (Y) in the above chart. Compute the **Debt Ratio** and record in the above chart. This ratio quantifies the proportion of assets financed with debt. *Debt ratio = Liabilities / Assets* (Google / **GIS**) is financing assets primarily with debt; therefore, (Google / **GIS**) is assuming the greater financial risk. Based only on the information presented above, which company would you choose as an investment? (**Google** / GIS) *Why*?

Google, because it has the lower debt ratio, indicating lower financial risk.

Q2 For each item circle the correct response when comparing the issuance of debt and equity.

a. The corporation (**does** / does not) have to pay interest to creditors, but (does / **does not**) have to pay dividends to shareholders.

b. The corporation (**must** / never has to) repay amounts borrowed from creditors, but (must / **never has to**) repay amounts invested by shareholders, thus the title, "contributed" capital.

c. The interest expense of debt (**reduces** / does not reduce) taxable income, but dividends paid to shareholders (reduce / **do not reduce**) taxable income.

d. Issuing additional debt (does / **does not**) dilute current shareholders' ownership, but issuing additional shares of common stock (**does** / does not) dilute current shareholders' ownership.

e. If you were the CFO of a company, how would you recommend financing assets?
Primarily with (**debt** / **equity**). Why?

Either choice may be correct if supported with good reasons.

If debt was chosen, correct responses include…

- ***Debt does not dilute current shareholder's ownership rights.***
- ***Interest expense on debt is tax deductable.***

If equity was chosen, correct responses include…

- ***equity is risk free to the company because…***
  - ***Amounts paid-in by shareholders for capital stock never have to be paid back.***
  - ***Dividend payments are not required.***

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ACTIVITY 15 ANALYSIS: RATIOS

Purpose: • Understand the information provided by the current ratio and the debt ratio

Liquidity and Solvency Ratios measure the ability to meet financial obligations and the level of financial risk.

The **Current Ratio** measures the ability to pay current payables as they come due by comparing current assets to current liabilities. It is a measure of short-term liquidity. A higher ratio indicates a stronger ability to pay current debts.

$$\text{Current Ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

The **Debt Ratio** measures the proportion of assets financed by debt by comparing total liabilities to total assets. It is a measure of long-term solvency. A higher ratio indicates greater financial risk.

$$\text{Debt Ratio} = \frac{\text{Total liabilities}}{\text{Total assets}}$$

For the year 2008	*Industry Average for Restaurants*	DineEquity (DIN)	Darden Restaurants (DRI)	Chipotle Mexican Grill (CMG)
Current Ratio	*1.2*	1.4	0.4	2.7
Debt Ratio	*0.46*	0.91	0.61	0.46
Debt-to-Equity Ratio*	*0.85*	10.22	1.55	0.86

Use the chart above to answer the following questions. Stock symbols are shown in parentheses.

Q1 Of the above three restaurant chains, which is your favorite? (**DIN** / **DRI** / **CMG**) ***Any response is correct***

- *DIN* operates Applebee's Neighborhood Grill & Bar and IHOP.
- *DRI* operates Red Lobster, Olive Garden, Bahama Breeze, and Smokey Bones Barbeque and Grill.
- *CMG* operates Chipotle Mexican Grill.

Q2 (**DIN** / DRI / **CMG**) have sufficient current assets to pay off current liabilities and, therefore, have a current ratio (**greater** / less) than 1.0. A current ratio that is (**lower** / higher) than the industry average may indicate a lack of short-term liquidity, which includes (DIN / **DRI** / CMG). Does this indicate that this corporation is insolvent or unable to pay its bills? (Yes / **No**) *Explain*.

Not necessarily. By definition, current liabilities become due within one year, therefore, do not all have to be paid at this time. However, they do need to be paid when due. Comparing a company ratio to the industry average gives a sense of how this company ranks when compared to other restaurants. If a company's ratio is significantly below the industry average, this is a warning sign and may warrant further investigation.

Q3 (**DIN** / **DRI** / CMG) are relying more on debt to finance assets and have a debt ratio (**greater** / less) than 0.50. Darden Restaurants is financing **61%** of assets with debt. For a company wanting to be lower risk and less dependent on debt, a(n) (increasing / **decreasing**) trend in the debt ratio is considered favorable. A company that has higher financial risk will, in general, be required to pay (**higher** / lower) interest rates when borrowing money.

Q4 *Why* does a company with a higher debt ratio tend to have greater financial risk?

A higher debt ratio indicates greater debt. Debt is a legal liability that must be repaid plus interest. If the principle or interest cannot be repaid, then a company can be forced into bankruptcy and creditors may not get fully repaid. Therefore, creditors are at financial risk of not receiving the full amount due to them. As the amount of company debt increases, so does the financial risk of not being able to pay back that debt plus interest when due.

Q5 Does a high debt ratio indicate a weak corporation? (Yes / **No**) *Explain* your answer.

The answer is no, not necessarily. Even though DineEquity has a higher debt ratio, it would not be considered a weak corporation. Companies use different strategies to finance assets. Companies within a stable industry have the ability to use more debt than companies within a volatile industry. Companies with a high percentage of PPE can use that PPE as collateral for debt financing. Also, some corporations make the decision to accept higher financial risk.

* *Instead of reporting the Debt Ratio, some financial sources report the Debt-to-Equity ratio, computed as liabilities divided by stockholders' equity. Debt ratio = Debt-to-equity ratio/(1 + debt-to-equity ratio). For DineEquity 0.91=10.22/11.22*

ACTIVITY 16 ANALYSIS: TREND

Purpose: • Prepare a trend analysis and understand the information provided

A **Trend Analysis** compares amounts of a more recent year to a base year. The base year is the earliest year being studied. The analysis measures the percentage of change from the base year.

Q1 For Starbucks, use the amounts listed below to compute the trend indexes for noncurrent liabilities (NCL), common stock (CS), and retained earnings (RE) by dividing each amount by the amount for the base year. Record the resulting *trend index* in the shaded area. Use 10/02/2005 as the base year.

STARBUCKS	9/28/2008		9/30/2007		10/01/2006		10/02/2005	
($ in millions)	$	Trend	$	Trend	$	Trend	BASE YEAR	
Current assets	1,748.0	145	1,696.5	140	1,529.8	127	1,209.3	100
PPE, net	2,956.4	160	2,890.4	157	2,287.9	124	1,842.0	100
Goodwill + Intang.	333.1	260	257.7	201	199.4	156	127.9	100
Other assets	635.1	190	499.3	149	411.8	123	334.5	100
TOTAL ASSETS	**5,672.6**	**161**	**5,343.9**	**152**	**4,428.9**	**126**	**3,513.7**	**100**
Current liabilities	2,189.7	178	2,155.6	176	1,935.6	158	1,227.0	100
NC liabilities	992.0	**505**	904.2	**460**	264.8	**135**	196.4	**100**
Common stock	40.1	**31**	40.1	**31**	40.1	**31**	130.4	**100**
Retained earnings	2,402.4	**124**	2,189.4	**113**	2,151.1	**111**	1,939.0	**100**
Other SE	48.4	232	54.6	261	37.3	178	20.9	100
TOTAL L and SE	**5,672.6**	**161**	**5,343.9**	**152**	**4,428.9**	**126**	**3,513.7**	**100**

Refer to the series of balance sheets and the trend analysis above to answer the following questions.

Q2 A trend index of 161 (total assets) indicates that the dollar amount is (**greater** / less) than the (previous / **base**) year, while a trend index of 31 (common stock) indicates the dollar amount is (greater / **less**) than the (previous / **base**) year. For *total assets*, the trend index of 161 is computed by dividing $5,672.6 (total assets on 9/28/2008) by **$3,513.7** million (total assets of the base year). A trend index of 161 indicates *total assets* (**increased** / decreased) by **61%** (from an index of 100 to 161) from 10/02/2005 to 9/28/2008.

Q3 From 10/02/2005 to 9/28/2008, which of the following accounts increased at a greater rate than total assets? (**Noncurrent liabilities** / Common stock / Retained earnings). This indicates that in the latter years the company is relying more on (**Noncurrent liabilities** / Common stock / Retained earnings) to finance assets and less on (Noncurrent liabilities / **Common stock** / **Retained earnings**) to finance assets.

Q4 The annual total asset growth rate can be compared between companies.

Assume less than 5% is low, 5-15% is moderate, and over 15% is high.

The three-year average total asset growth rate of this company is considered (low / moderate / **high**). (61% / 3 years ~ 20% > 15%)

Q5 Examine the financial information reported above and *comment* on at least two items of significance that the trend analysis helps to reveal.

Answers will varyand may include two of the following…

- ***Assets increased 61%, while noncurrent liabilities increased 405%, indicating increased reliance on debt financing.***
- ***Current assets, PPE net, and other assets increased about the same rate as total assets.***
- ***Goodwill and intangibles increased at a rate greater than that of total assets.***
- ***Retained earnings increased, but at a rate slower than that of total assets.***

ACTIVITY 17 ANALYSIS: COMMON-SIZE STATEMENTS

Purpose: • Prepare common-size statements and understand the information provided

The **Common-Size Balance Sheet** compares all amounts to total assets of that same year. The analysis measures each item as a percentage of total assets.

Q1 For DineEquity and Chipotle Mexican Grill listed below, complete the common-size statements by dividing each item on the balance sheet by the amount of total assets. Record the resulting common-size percentage in the shaded area provided.

(*Hint*: Percentages for CA + PPE, net + Goodwill + Other = 100% and CL + LTD + Other NCL + CS + RE + Other = 100 %.)

2008	DineEquity (DIN)		Darden Restaurants (DRI)		Chipotle Mexican Grill (CMG)	
($ in millions)	$	CS%	$	CS%	$	CS%
Current assets	339.1	**10.1%**	467.9	9.9%	211.1	**25.6%**
PPE, net	824.5	**24.5%**	3,066.0	64.8%	585.9	**71.0%**
Goodwill + intangibles	1,653.5	**49.2%**	1,002.4	21.2	21.9	**2.7%**
Other assets	544.1	**16.2%**	194.3	4.1%	6.1	**.7%**
TOTAL ASSETS	**3,361.2**	**100%**	**4,730.6**	**100.0%**	**825.0**	**100%**
Current liabilities	282.7	**8.4%**	1,136.2	24.0%	76.8	**9.3%**
Long-term debt	2,333.3	**69.4%**	1,694.2	35.8%	0	**0.0%**
Other NC liabilities	515.4	**15.3%**	491.1	10.4%	125.6	**15.2%**
Contributed capital	389.9	**11.6%**	2,074.8	43.9%	502.3	**60.9%**
Retained earnings	145.8	**4.3%**	2,096.0	44.3%	150.7	**18.3%**
Other SE	(305.9)	**(9.1)%**	(2,761.7)	(58.4)%	(30.4)	**(3.7)%**
TOTAL L and SE	**3,361.2**	***100.0%***	**4,730.6**	**100.0%**	**825.0**	**100.0%**

* *Note*: The percentages may not sum to 100% due to rounding error.

Refer to the series of balance sheets and the common-size statements above to answer the following questions.

Q2 The debt ratio (Total liabilities / Total assets) for Darden Restaurants is **70.2%** or **0.702** (decimal form).

Q3 Which company finances assets primarily with amounts *borrowed long term*? (**DIN** / DRI / CMG)

Q4 Which company finances assets primarily with amounts *invested by shareholders*? (DIN/DRI/**CMG**)

Q5 Which company finances assets primarily with *past profits*? (DIN / **DRI** / CMG)

Q6 Review the balance sheet information presented above for the three restaurant chains and comment on at least two items of significance that the common-size statements help to reveal.

Answers will vary and may include two of the following…

- ***The majority of assets for DRI and CMG are committed to PPE, while DIN is invested in Goodwill and Intangibles.***
- ***Each company relies on different forms of primary financing.***

Q7 These companies were easier to compare (**before / after**) you prepared the common-size statements. *Why*?

Because these companies vary in size it is easier to compare the amounts as common-size amounts (percentages). Also, the percentages offer more detailed information regarding the proportion of resources committed to various types of assets and the financing of those assets.

ACTIVITY 18 ANALYSIS OF YUM! BRANDS

Purpose: • Understand and interpret amounts reported on the balance sheet

YUM! BRANDS (YUM) BALANCE SHEET ($ in millions)								
ASSETS	**12/27/2008**		**12/29/2007**		**12/30/2006**		**12/31/2005**	
Cash and cash equivalents		$ 216		$ 789		$ 319		$ 201
Accounts receivable		229		225		220		236
Inventories		143		128		93		85
Other current assets		363		339		269		333
Property, plant, and equipment	6,897		7,132		6,777		6,186	
Accumulated depreciation	(3,187)		(3,283)		(3,146)		(2,830)	
PPE, net		3,710		3,849		3,631		3,356
Goodwill and other intangibles		940		1,026		1,009		868
Long-term investments		65		153		138		173
Other noncurrent assets		861		679		689		545
TOTAL ASSETS		**$6,527**		**$7,188**		**$6,368.0**		**$5,797**
LIABILITIES								
Accounts payable		$ 508		$ 519		$ 554		$ 473
Short-term debt		25		288		211		211
Other current liabilities		1,189		1,255		959		939
Long-term debt		3,564		2,924		2,045		1,649
Other noncurrent liabilities		1,349		1,063		1,147		1,076
STOCKHOLDERS' EQUITY								
Contributed capital		7		0		0		0
Retained earnings		303		1,119		1,608		1,619
Other stockholders' equity		(418)		20		(156)		(170)
TOTAL L & SE		**$6,527**		**$7,188**		**$6,368**		**$5,797**

YUM! BRANDS (YUM) Classified Balance Sheet / Common-size Statements ($ in millions)								
	12/27/2008		**12/29/2007**		**12/30/2006**		**12/31/2005**	
	$	CS%	$	CS%	$	CS%	$	CS%
Current assets	**951**	**14.6%**	**1,481**	**20.6%**	901	14.2%	855	14.7%
PPE, net	**3,710**	**56.8%**	**3,849**	**53.5%**	3,631	57.0%	3,356	57.9%
Goodwill + Intang.	**940**	**14.4%**	**1,026**	**14.3%**	1,009	15.8%	868	15.0%
Other assets	**926**	**14.2%**	**832**	**11.6%**	827	13.0%	718	12.4%
TOTAL ASSETS	**6,527**	**100.0%**	**7,188**	**100.0%**	**6,368**	**100.0%**	**5,797.0**	**100.0%**
C liabilities	**1,722**	**26.4%**	**2,062**	**28.7%**	1,724	27.1%	1,623	28.0%
NC liabilities	**4,913**	**75.3%**	**3,987**	**55.5%**	3,192	50.1%	2,725	47.0%
TOTAL LIAB	**6,635**	**101.7%**	**6,049**	**84.2%**	**4,916**	**77.2%**	**4,348**	**75.0%**
Cont. capital	**7**	**0.1%**	**0**	**0.0%**	0	0%	0	0%
Retained earnings	**303**	**4.6%**	**1,119**	***15.6%**	1,608	25.3%	1,619	27.9%
Other SE	**(418)**	**(6.4)%**	**20**	*** 0.3%**	(156)	(2.5)%	(170)	(2.9)%
TOTAL SE	**(108)**	**(1.7)%**	**1,139**	**15.8%**	**1,452**	**22.8%**	**1,449**	**25.0%**

* *Rounding error*

YUM! BRANDS (YUM) RATIOS					
	Industry Norm	12/27/2008	12/29/2007	12/30/2006	12/31/2005
Current ratio	*1.2*	**0.55**	**0.72**	0.52	0.53
Debt ratio	*46%*	**102%**	**84%**	77%	75%

Refer to the series of balance sheets for Yum! Brands (on the previous page) to answer the following questions.

Q1 YUM! Brands is the largest restaurant chain (larger than McDonald's) when measured by (sales / **# of units**) and operates more than 36,000 restaurants in more than 110 countries. (*Hint: Refer to company descriptions in Appendix A – Featured Corporations*).

Which is your favorite YUM! Brands restaurant? (**KFC / Pizza Hut / Taco Bell / Long John Silver's / A&W**) ***Any response is correct.***

Q2 *Total Assets* increased by **$730** million since 12/31/2005, an increase of **12.6%**, which is the result of (**purchasing additional assets** / issuing more common stock / increasing net income). This company has a major investment in (inventory / **PPE** / financial securities), which (**is** / is not) expected.

Q3 On 12/31/2005, the retained earnings account reports a (**positive** / negative) amount, which is most likely the result of previously (selling assets / purchasing treasury stock / **reporting net income**).

Q4 This company distributed dividends and other amounts to shareholders of $835 million in 2006, $1,398 million in 2007, and $1,780 million in 2008. Use this information to compute net income for:

2008 **$964** million; 2007 **$909** million; 2006 **$824** million

2006 (Beg RE $1,619 + NI - Div $ 835 = Ending RE $1,608)

2007 (Beg RE $1,608 + NI - Div $1,398 = Ending RE $1,119)

2008 (Beg RE $1,119 + NI - Div $1,780 = Ending RE $ 303)

Q5 For 12/29/2007 and 12/27/2008 complete the classified balance sheet by adding the items within each classification. Record your results in the area provided on the previous page. Classified balance sheets for 12/31/2005 and 12/30/2006 have already been completed.

(*Remember* CA + PPE, net + Goodwill + Other = Total Assets and CL + NCL + CS + RE + Other = Total L + SE)

Q6 For 12/29/2007 and 12/27/2008 complete the common-size statements by dividing each item on the classified balance sheet by the amount of total assets for the same year. Record your results in the area provided on the previous page. Common-size statements for 12/31/2005 and 12/30/2006 have already been completed. *Comment* on the trends in Total Liabilities and Total Stockholders' Equity and what this indicates.

Reliance on debt financing increased to 102% of total assets from 75%, while reliance on equity financing has dwindled to a negative 2% from 25%of total assets, revealing the company is significantly increasing its reliance on debt financing, and therefore, significantly raising its financial risk.

Q7 For 12/29/2007 and 12/27/2008 compute the current ratio and the debt ratio. Record your results in the area provided above. Ratios for 12/31/2005 and 12/30/2006 have already been computed. *Comment* on the results.

The current ratio remained relatively steady except for 2007; steadiness is a favorable indication. However, the company's current ratio remains approximately half the industry norm, which indicates this company may have liquidity problems.

The debt ratio increased from 75% on 12/31/2005 to 102% on 12/27/2008, revealing the company's increasing reliance on debt financing, and therefore, increased financial risk. The company's reliance on debt financing is significantly above the industry norm, which may signal major solvency problems.

Q8 If you had $10,000, would you consider investing in this company? (Yes / **No**) *Why*?
Support you response with at least three good reasons.

Answers will vary and may include three of the following…

- ***Total assets have remained relatively flat, indicating a slow growth rate.***
- ***Long-term debt has more than doubled, indicating heavier reliance on debt financing.***
- ***Noncurrent liabilities have increased from 47% of total assets to 75% of total assets, indicating heavy reliance on liabilities to finance assets.***
- ***Retained earnings has decreased significantly, from 27.9% of assets down to only 4.6% of assets, resulting from increased dividend payouts.***
- ***The current ratio is significantly below the industry norm, signaling potential liquidity problems.***
- ***The debt ratio increased from 75% to 102%, signaling an alarming increase in debt financing.***
- ***The debt ratio is significantly higher than the industry norm, signaling potential solvency problems.***

A student may answer "yes" if they feel confident the downturn is due to the recession, and that a recovering economy will result in this restaurant company recovering also.

ACTIVITY 19 ANALYSIS OF MCDONALD'S

Purpose: • Understand and interpret amounts reported on the balance sheet

McDONALD's (MCD) BALANCE SHEET ($ in millions)				
ASSETS	**12/31/2008**	**12/31/2007**	**12/31/2006**	**12/31/2005**
Cash and cash equivalents	$ 2,063.4	$ 1,981.3	$ 2,128.1	$ 4,260.6
Accounts receivable	931.2	1,053.8	806.9	793.9
Inventories	111.5	125.3	112.4	144.3
Other current assets	411.5	421.5	2,144.8	1,020.2
Property, plant, and equipment	$31,152.4	$32,203.7	$29,722.9	$29,482.5
Accumulated depreciation	(10,897.9)	(11,219.0)	(10,284.8)	(9,909.2)
PPE, net	20,254.5	20,984.7	19,438.1	19,573.3
Goodwill	2,237.4	2,301.3	2,073.6	1,924.4
Long-term investments	1,222.3	1,156.4	1,035.4	1,035.4
Other noncurrent assets	1,229.7	1,367.4	1,235.2	1,236.7
TOTAL ASSETS	**$28,461.5**	**$29,391.7**	**$28,974.5**	**$29,988.8**
LIABILITIES				
Accounts payable	$ 620.4	$ 624.1	$ 668.7	$ 678.0
Short-term debt	0.0	1,126.6	0.0	544.0
Other current liabilities	1,917.5	2,747.8	2,282.9	2,885.7
Long-term debt	10,186.0	7,310.0	8,389.9	8,934.3
Other noncurrent liabilities	2,355.0	2,303.4	2,174.7	1,800.7
STOCKHOLDERS' EQUITY				
Common stock, par	16.6	16.6	16.6	16.6
Additional paid-in capital	4,600.2	4,226.7	3,445.0	2,720.2
Retained earnings	28,953.9	26,461.5	25,845.6	23,516.0
Treasury stock	(20,289.4)	(16,762.4)	(13,552.2)	(10,373.6)
Other stockholders' equity	101.3	1,337.4	(296.7)	(733.1)
TOTAL L & SE	**$28,461.5**	**$29,391.7**	**$28,974.5**	**$29,988.8**

McDONALD's Classified Balance Sheet / Trend Analysis ($ in millions)								
	12/31/2008		**12/31/2007**		**12/31/2006**		**12/31/2005**	
	$	Trend	$	Trend	$	Trend	**BASE YEAR**	
Current assets	**3,517.6**	**57**	**3,581.9**	**58**	5,192.2	83	6,219.0	100
PPE, net	**20,254.5**	**103**	**20,984.7**	**107**	19,438.1	99	19,573.3	100
Goodwill	**2,237.4**	**116**	**2,301.3**	**120**	2,073.6	108	1,924.4	100
Other assets	**2,452.0**	**108**	**2,523.8**	**111**	2,270.6	100	2,272.1	100
TOTAL Assets	**28,461.5**	**95**	**29,391.7**	**98**	**28,974.5**	**97**	**29,988.8**	**100**
Current liabilities	**2,537.9**	**62**	**4,498.5**	**110**	2,951.6	72	4,107.7	100
NC Liabilities	**12,541.0**	**117**	**9,613.4**	**90**	10,564.6	98	10,735.0	100
TOTAL Liab	**15,078.9**	**102**	**14,111.9**	**95**	**13,516.2**	**91**	**14,842.7**	**100**
Contributed capital	**4,616.8**	**169**	**4,243.3**	**155**	3,461.6	126	2,736.8	100
Retained earnings	**28,953.9**	**123**	**26,461.5**	**113**	25,845.6	110	23,516.0	100
Other SE	**(20,188.1)**	**182**	**(15,425.0)**	**139**	(13,848.9)	125	(11,106.7)	100
TOTAL SE	**13,382.6**	**88**	**15,279.8**	**101**	**15,458.3**	**102**	**15,146.1**	**100**

McDONALD's (MCD) RATIOS					
	Industry Norm	**12/31/2008**	**12/31/2007**	**12/31/2006**	**12/31/2005**
Current ratio	*1.2*	**1.39**	**0.80**	1.76	1.51
Debt ratio	*46%*	**53%**	**48%**	47%	49%

Refer to the series of balance sheets for McDonald's on the previous page to answer the following questions.

Q1 McDonald's is the world's (**#1** / #2) restaurant chain when measured by (**sales** / # of units) and has over 32,000 restaurants in more than 120 countries. *Hint: Refer to company descriptions in Appendix A – Featured Corporations*

Q2 In regard to assets, this company has a major investment in (inventory / **PPE** / financial securities). On average, the PPE has been used for (more / **less**) than half of its useful life.

Q3 *Long-term debt* was paid back during (2008 / **2007** / **2006**).

Q4 This company was able to attract new shareholders during (**2008** / **2007** / **2006**). As of 12/31/2008 shareholders have contributed a total of **$4,616.8** million to this corporation.

Q5 This company distributed dividends of $1,216.5 million in 2006, $1,765.6 million in 2007, and $1,823.4 million in 2008. Use this information to compute net income for:

2008 **$4,315.8** million; 2007 **$2,381.5** million; 2006 **$3,546.1** million

2006 (Beg RE $23,516.0 + NI - Div $1,216.5 = Ending RE $25,845.6)

2007 (Beg RE $25,845.6 + NI - Div $1,765.6 = Ending RE $26,461.5)

2008 (Beg RE $26,461.5 + NI - Div $1,823.4 = Ending RE $28,953.9)

Q6 Treasury stock results from (selling assets / refinancing debt / **repurchasing common stock**). Additional *treasury stock* was acquired during (**2008** / **2007** / **2006**).

Q7 For 12/31/2007 and 12/31/2008 complete the classified balance sheet by adding the accounts within each classification. Record your results in the area provided on the previous page. Classified balance sheets for 12/31/2005 and 12/31/2006 have already been completed.

(Remember CA + PPE, net + Goodwill + Other = Total Assets and CL + NCL + CS + RE + Other = Total L + SE)

Q8 *Refer to the Classified Balance Sheet.* The assets of this company are primarily financed with (liabilities / contributed capital / **retained earnings**). This is referred to as (**internal** / external) financing since these funds are generated by operations. Issuing stocks and bonds are forms of (internal / **external**) financing since these funds come from investors outside of the firm.

Q9 For 12/31/2007 and 12/31/2008 complete the trend analysis by dividing each amount by the amount for the base year of 12/31/2005, and then multiply by 100. Record the resulting *trend index* in the area provided on the previous page. For 12/31/2005 and 12/31/2006 the trend indexes have already been computed.

Q10 *Refer to the trend index.* Since the base year, total assets (increased **/** **decreased**) by **5%**, which is primarily the result of (increased / **decreased**) (**CA** / PPE / Goodwill).
Total liabilities (increased / **stayed about the same** / decreased), while contributed capital (**increased** / decreased) by **69%** and retained earnings (**increased** / decreased) by **23%**, which is the result of (purchasing additional assets / acquiring other companies / **increasing net income**).

Q11 For 12/31/2007 and 12/31/2008 compute the current ratio and the debt ratio. Record your results in the area provided above. Ratios for 12/31/2005 and 12/31/2006 have already been computed.

Q12 Review the financial information of this company and *comment* on

a. signs of financial strength.

Over this three year period…

- ***Current assets decreased 43% while current liabilities decreased 38%, indicating potential efficiencies in the use of working capital.***
- ***Contributed capital increased by 69%, indicating the company is able to attract investors.***
- ***Retained earnings increased each year, indicating three years of profitability.***
- ***Treasury stock increased, indicating fewer common shares outstanding, resulting in a possible increase in EPS.***
- ***The current ratio fluctuated, but in 2008 is higher than the industry norm, indicating adequate liquidity.***

b. warning signs or signs of financial weakness.

Over this three year period…

- ***Assets decreased by 5%, indicating a stable, but not a growing company.***
- ***PPE remained flat, indicating a lack of expansion.***
- ***Current liabilities decreased by 38%, while noncurrent liabilities increased by 17% and total liabilities remained about the same, indicating a shift toward long-term financing.***
- ***The debt ratio increased slightly from 49% to 53% and remains slightly above the industry norm, indicating slightly more financial risk than average for the industry.***

Q13 If you had $10,000, would you consider investing in this company? (**Yes / No**) Why or why not?

Answers will vary, but should be supported by good reasoning such as…

No, the company appears rather sluggish as assets decreased slightly and there is a shift toward greater reliance on long-term debt.

Yes, the company is stable and continues to produce steady profits.

ACTIVITY 20 TEST YOUR UNDERSTANDING

Purpose: • Understand and interpret amounts reported on the balance sheet

BALANCE SHEETS ($ in millions)								
ASSETS	**CORP A 6/25/2008**		**CORP B 5/31/2008**		**CORP C 12/31/2007**		**CORP D 12/31/2008**	
Cash and cash equivalents		$ 54.7		$ 2,133.9		$ 2,292.3		$ 29,253
Short-term investments		0.0		642.2		1,159.7		988,119
Accounts receivable		52.3		2,795.3		1,060.5		664,600
Inventories		35.5		2,438.4		0.0		0
Other current assets		312.2		829.5		233.0		0
Property, plant, & equipment	2,476.2		4103.0		2,305.5		0.0	
Accumulated depreciation	(945.2)		(2,211.9)		(769.3)		0.0	
PPE, net		1,531.0		1,891.1		1,536.2		0
Goodwill + Intangibles		140.4		1,191.9		3,926.8		46,948
Long-term investments		0.0		0.0		3,177.5		0
Other noncurrent assets		67.0		520.4		303.9		209,550
TOTAL ASSETS		**$2,193.1**		**$12,442.7**		**$13,689.9**		**$1,938,470**
LIABILITIES								
Accounts payable		$ 168.6		$ 1,287.6		$ 151.9		$ 70,916
Short-term debt		0.0		351.0		0.0		331,984
Other current liabilities		357.6		1,682.9		1,553.1		841,585
Long-term debt		901.6		441.1		0.0		292,193
Other noncurrent liabilities		170.2		854.5		733.9		260,162
STOCKHOLDERS' EQUITY								
Contributed capital		482.3		2,501.0		11,550.0		89,886
Retained earnings		1,800.3		5,073.3		4,848.2		86,521
Other stockholders' equity		(1,687.5)		251.3		(5,147.2)		(34,777)
TOTAL L & SE		**$2,193.1**		**$12,442.7**		**$13,689.9**		**$1,938,470**

Classified Balance Sheets / Common-size Statements ($ in millions)								
	A 6/25/2008		**B 5/31/2008**		**C 12/31/2008**		**D 12/31/2008**	
	$	CS%	$	CS%	$	CS%	$	CS%
Current assets	454.7	20.7	8,839.3	71.0	4,745.5	34.7	1,681,972	86.8
PPE, net	1,531.0	69.8	1,891.1	15.2	1,536.2	11.2	-0-	0.0
Goodwill+	140.4	6.4	1,191.1	9.6	3,926.8	28.7	46,948	2.4
Other assets	67.0	3.1	520.4	4.2	3,481.4	25.4	209,550	10.8
TTL Assets	**2,193.1**	**100.0**	**12,442.7**	**100.0**	**13,689.9**	**100.0**	**1,938,470**	**100.0**
C Liabilities	526.2	24.0	3,321.5	26.7	1,705.0	12.4	1,244,485	64.2
NC Liabilities	1,071.8	48.9	1,295.6	10.4	733.9	5.4	552,355	28.5
TTL Liab	**1,598.0**	**72.9**	**4,617.1**	**37.1**	**2,438.9**	**17.8**	**1,796,840**	**92.7**
Cont capital	482.3	22.0	2,501.0	20.1	11,550.0	84.4	89,886	4.6
R/Earnings	1,800.3	82.1	5,073.3	40.8	4,848.2	35.4	86,521	4.5
Other SE	(1,687.5)	(77.0)	251.3	2.0	(5,147.2)	(37.6)	(34,777)	(1.8)
TTL SE	**595.1**	**27.1**	**7,825.6**	**62.9**	**11,251.0**	**82.2**	**141,630**	**7.3**

RATIOS	CORP A 6/25/2008	CORP B 5/31/2008	CORP C 12/31/2008	CORP D 12/31/2008
Current ratio	0.86	2.66	2.78	1.35
Debt ratio	73%	37%	18%	93%

Q1 Analyze the financial attributes of the four corporations on the previous page by placing an X in the box when the company has the characteristics noted below.

Which corporation …	CORP A	CORP B	CORP C	CORP D
Has significant cash and cash equivalents?				**X Cash**
Has significant receivables and inventory?		**X Rec & Inv**		
Has no inventories?			**X No inv**	**X No inv**
Has significant property, plant, and equipment?	**X PPE**			
Has significant short-term and long-term investments?			**X Investments**	
Finances assets primarily with… liabilities?				**X Liab**
contributed capital?			**X CC**	
retained earnings?	**X RE**	**X RE**		**x**
Is the smallest company?	**X Small**			
Is the largest company?				**X Large**

Q2 Use the descriptions below to match each corporation with its corresponding financial information. Then comment on why you selected the match.

BRINKER INTERNATIONAL (EAT) owns, develops, operates, and franchises the Chili's Grill & Bar (Chili's), On The Border Mexican Grill & Cantina (On The Border), Maggiano's Little Italy, (Maggiano's), and Romano's Macaroni Grill (Macaroni Grill) restaurant brands.

Brinker International must be Corporation (**A** / B / C / D). *Why*?

Brinker International is in the restaurant industry, therefore, would have a significant amount of PPE. It also is a smaller company.

CITIGROUP (C) is a diversified global financial services holding company whose businesses provide a range of financial services to consumer and corporate customers. The company operates in five business segments: Global Cards, Consumer Banking, Institutional Clients Group, Global Wealth Management, and Other.

Citigroup must be Corporation (A / B / C / **D**). *Why*?

Citigroup is one of the largest companies in the world with almost 2 trillion in assets. Financial service organizations have large amounts of current assets, which include customer deposits and investments, and large amounts of current liabilities, which include customer's claims against those deposits and investments. Citigroup is a service corporation, and therefore, carries no inventory.

NIKE (NKE) is engaged in the design, development and worldwide marketing of athletic footwear, apparel, equipment, and accessory products. It sells its products to retail accounts, through NIKE-owned retail, including stores and Internet sales, and through a mix of independent distributors and licensees, in over 180 countries around the world.

Nike must be Corporation (A / **B** / C / D). *Why*?

Nike is a manufacturing firm, and therefore, has a significant amount of inventory and accounts receivable, resulting in a high percentage of current assets. The company has been profitable, and therefore, having retained earnings as the primary source of financing makes sense.

YAHOO! (YHOO) is a global Internet brand. The Company's offerings to users fall into six categories: Front Doors, Communities, Search, Communications, Audience, and Connected Life. Yahoo! generates revenues by providing marketing services to advertisers across a majority of Yahoo! Properties and Affiliate sites. The majority of its offerings are available in more than 30 languages.

Yahoo! must be Corporation (A / B / **C** / D). *Why*?

Yahoo! Is a successful technology company with no inventories. Tech companies are typically financed with contributed capital and have excess cash, which they invest long-term.