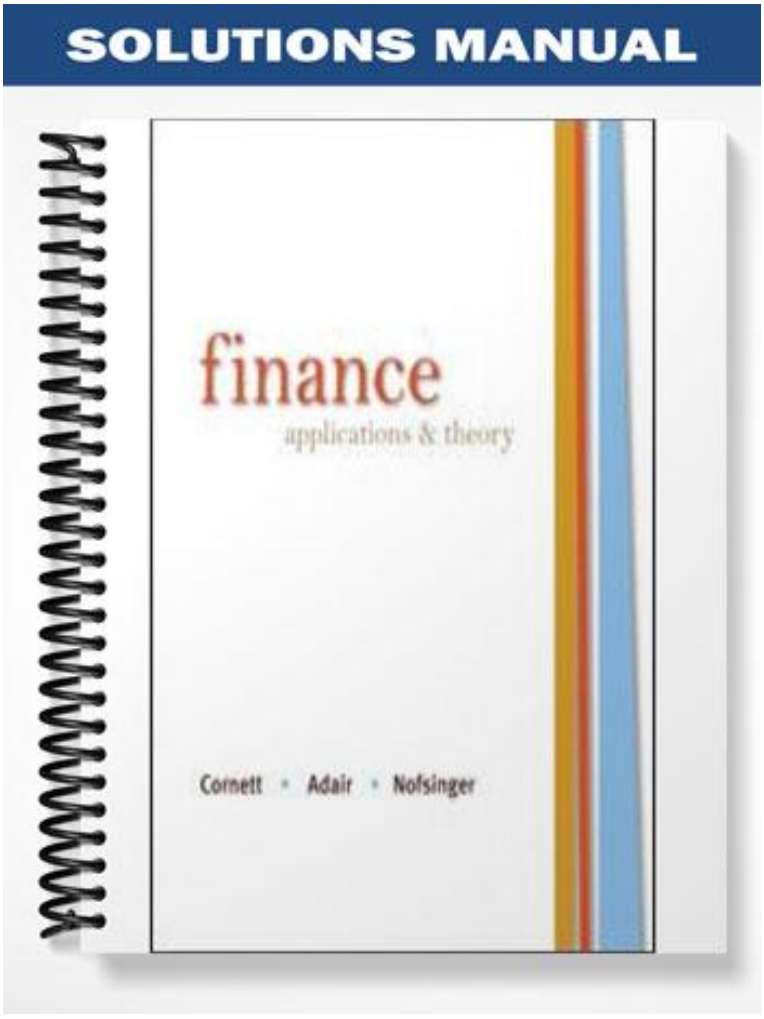
SOLUTIONS MANUAL



CHAPTER 2 – REVIEWING FINANCIAL STATEMENTS

Questions

LG1 1. List and describe the four major financial statements.

The four basic financial statements are:
1. The **balance sheet** reports a firm's assets, liabilities, and equity at a particular point in time.
2. The **income statement** shows the total revenues that a firm earns and the total expenses the firm incurs to generate those revenues over a specific period of time—generally one year.
3. The **statement of cash flows** shows the firm's cash flows over a given period of time. This statement reports the amounts of cash that the firm generated and distributed during a particular time period. The bottom line on the statement of cash flows—the difference between cash sources and uses—equals the change in cash on the firm's balance sheet from the previous year's cash account balance.
4. The **statement of retained earnings** provides additional details about changes in retained earnings during a reporting period. This financial statement reconciles net income earned during a given period and any cash dividends paid within that period on one side with the change in retained earnings between the beginning and ending of the period on the other side.

LG1 2. On which of the four major financial statements (balance sheet, income statement, statement of cash flows, or statement of retained earnings) would you find the following items?

a. earnings before taxes - income statement
b. net plant and equipment - balance sheet
c. increase in fixed assets - statement of cash flows
d. gross profits - income statement
e. balance of retained earnings, December 31, 20xx - statement of retained earnings
f. common stock and paid-in surplus - balance sheet
g. net cash flow from investing activities - statement of cash flows
h. accrued wages and taxes - income statement
i. increase in inventory - statement of cash flows

LG1 3. What is the difference between current liabilities and long-term debt?

Current liabilities constitute the firm's obligations due within one year, including accrued wages and taxes, accounts payable, and notes payable. Long-term debt includes long-term loans and bonds with maturities of more than one year.

LG1 4. How does the choice of accounting method used to record fixed asset depreciation affect management of the balance sheet?

Firm managers can choose the accounting method they use to record depreciation against their fixed assets. Two choices include the straight-line method and the modified accelerated cost recovery system (MACRS). Companies often calculate depreciation using MACRS when they figure the firm's taxes and the straight-line method when reporting income to the firm's stockholders. The MACRS method accelerates deprecation, which results in higher deprecation expenses, lower taxable income, and lower taxes in the early years of a project's life. The straight-line method results in lower depreciation expenses, but also results in higher taxes in the early years of a project's life. Firms seeking to lower their cash outflows from tax payments will favor the MACRS depreciation method.

LG1 5. What are the costs and benefits of holding liquid securities on a firm's balance sheet?

The more liquid assets a firm holds, the less likely the firm will be to experience financial distress. However, liquid assets generate no profits for a firm. For example, cash is the most liquid of all assets, but it earns no return for the firm. In contrast, fixed assets are illiquid, but provide the means to generate revenue. Thus, managers must consider the trade-off between the advantages of liquidity on the balance sheet and the disadvantages of having money sit idle rather than generating profits.

LG2 6. Why can the book value and market value of a firm differ?

A firm's balance sheet shows its book (or historical cost) value based on Generally Accepted Accounting Principles (GAAP). Under GAAP, assets appear on the balance sheet at what the firm paid for them, regardless of what assets might be worth today if the firm were to sell them. Inflation and market forces make many assets worth more now than they were when the firm bought them. So in most cases, book values differ widely from the market values for the same assets—the amount that the assets would fetch if the firm actually sold them. For the firm's current assets—those that mature within a year—the book value and market value of any particular asset will remain very close. For example, the balance sheet lists cash and marketable securities at their market value. Similarly, firms acquire accounts receivable and inventory and then convert these short-term assets into cash fairly quickly, so these assets' book value is generally close to their market value.

LG2 7. From a firm manager's or investor's point of view, which is more important—the book value of a firm or the market value of the firm?

Balance sheet assets are listed at historical cost. Managers would thus see little relation between the total asset value listed on the balance sheet and the current market value of the firm's assets. Similarly, the stockowners' equity listed on the balance sheet generally differs from the true market value of the equity—in this case, the market value may be higher or lower than the value listed on the firm's accounting books. So financial managers and investors often find that balance sheet values are not always the most relevant numbers.

LG3 8. What do we mean by a "progressive" tax structure?

The U.S. tax structure is progressive, meaning that the larger the income, the higher the taxes assessed. However, corporate tax rates do not increase in any kind of linear way based on this progressive nature: They rise from a low of 15 percent to a high of 39 percent, then drop to 34 percent, rise to 38 percent, and finally drop to 35 percent.

LG3 2-9 What's the difference between an average tax rate and a marginal tax rate?

You can figure the average tax rate as the percentage of each dollar of taxable income that the firm pays in taxes. From your economics classes, you can probably guess that the firm's marginal tax rate is the amount of additional taxes a firm must pay out for every additional dollar of taxable income it earns.

LG3 2-10 How does the payment of interest on debt affect the amount of taxes the firm must pay?

Corporate interest payments appear on the balance sheet as an expense item, so we deduct interest payments from operating income when the firm calculates taxable income. But, any dividends paid by corporations to their shareholders are not tax deductible. This is one factor that encourages managers to finance projects with debt financing rather than to sell more stock. Suppose one firm uses mainly debt financing and another firm, with identical operations, uses mainly equity financing. The equity-financed firm will have very little interest expense to deduct for tax purposes. Thus, it will have higher taxable income and pay more taxes than the debt-financed firm. The debt-financed firm will pay fewer taxes and be able to pay more of its operating income to asset funders, i.e., its bondholders and stockholders. So even stockholders prefer that firms finance assets primarily with debt rather than with stock.

LG4 2-11 The income statement is prepared using GAAP. How does this affect the reported revenue and expense measures listed on the balance sheet?

Company accountants must prepare firm income statements following GAAP principles. GAAP procedures require that the firm recognize revenue at the time of sale, but sometimes the company receives the cash before or after the time of sale. Likewise, GAAP counsels the firm to show production and other expenses on the balance sheet as the sales of those goods take place. So production and other expenses associated with a particular product's sale only appear on the income statement (for example, cost of goods sold and depreciation) when that product sells. Of course, just as with the revenue recognition, actual cash outflows incurred with production may occur at a very different point in time—usually much earlier than GAAP principles allow the firm to formally recognize the expenses. Further, income statements contain several non-cash entries; the largest of these non-cash entries is depreciation. Depreciation attempts to capture the non-cash expense incurred as fixed assets deteriorate from the time of purchase to the point when those assets must be replaced. Let's illustrate the effect of depreciation: Suppose a firm purchases a machine for $100,000. The machine has an expected life of five years and at the end of those five years, the machine will have no expected salvage value. The firm lays out a $100,000 cash outflow at the time of purchase. But the entire $100,000

does not appear on the income statement in the year that the firm purchases the machine—in accounting terms, the machine is not *expensed* in the year of purchase. Rather, if the firm's accounting department uses the straight-line depreciation method, it deducts only \$100,000/5 = \$20,000 each year as an expense. This \$20,000 equipment expense is not a cash outflow for the firm. The person in charge of buying the machine knows that the cash flow occurred at the time of purchase—and it totaled \$100,000 rather than \$20,000. So, figures shown on an income statement may not represent the actual cash inflows and outflows for a firm during a particular period.

LG4 2-12 Why do financial managers and investors find cash flow to be more important than accounting profit?

Financial managers and investors are far more interested in actual cash flows than they are in the somewhat artificial, backward-looking accounting profit listed on the income statement. This is a very important distinction between the accounting point of view and the finance point of view. Finance professionals know that the firm needs cash, not accounting profit, to pay the firm's obligations as they come due, to fund the firm's operations and growth, and to compensate the firm's ultimate owners: its shareholders. Thus, the statement of cash flows is a financial statement that shows the firm's cash flows over a given period of time. This statement reports the amounts of cash that the firm generated and distributed during a particular time period.

LG5 2-13 Which of the following activities result in an increase (decrease) in a firm's cash?

a. decrease fixed assets – increase in cash
b. decrease accounts payable - decrease in cash
c. pay dividends - decrease in cash
d. sell common stock – increase in cash
e. decrease accounts receivable - increase in cash
f. increase notes payable – increase in cash

LG5 2-14 What is the difference between net cash flow from operating activities, net cash flow from investing activities, and net cash flow from financing activities?

Cash flows from operations are those cash inflows and outflows that result directly from producing and selling the firm's products. These cash flows include: net income, depreciation, and working capital accounts other than cash and operations-related short-term debt. Cash flows from investing activities are cash flows associated with buying or selling of fixed or other long-term assets. This section of the statement of cash flows shows cash inflows and outflows from long-term investing activities—most significantly the firm's investment in fixed assets. Cash flows from financing activities are cash flows that result from debt and equity financing transactions. These include raising cash by: Issuing short-term debt, issuing long-tern debt, issuing stock, using cash to pay dividends, using cash to pay off debt, and using cash to buy back stock.

LG5 2-15 What are free cash flows for a firm? What does it mean when a firm's free cash flow is negative?

Free cash flows are the cash flows available to pay the firm's stockholders and debtholders after the firm has made the necessary working capital investments, fixed asset investments, and developed the necessary new products to sustain the firm's ongoing operations. If free cash flow is negative, the firm's operations produce no cash flows available for investors.

LG6 2-16 What is earnings management?

Managers and financial analysts have recognized for years that firms use considerable latitude in using accounting rules to manage their reported earnings in a wide variety of contexts. Indeed, within the GAAP framework, firms can "smooth" earnings. That is, firms often take steps to over or understate earnings at various times. Managers may choose to smooth earnings to show investors that firm assets are growing steadily. Similarly, one firm may be using straight line depreciation for its fixed assets, while another is using a modified accelerated cost recovery method (MACRS), which causes depreciation to accrue quickly. If the firm uses MACRS accounting methods, they write fixed asset values down quickly; assets will thus have lower book value than if the firm used straight line depreciation methods. This process of controlling a firm's earnings is called earnings management.

LG6 2-17 What does the Sarbanes-Oxley Act require of firm managers?

Sarbanes-Oxley Act, passed in June 2002, requires public companies to ensure that their corporate boards' audit committees have considerable experience applying generally accepted accounting principles (GAAP) for financial statements. The Act also requires that any firm's senior management must sign off on the financial statements of the firm, certifying the statements as accurate and representative of the firm's financial condition during the period covered. If a firm's board of directors or senior managers fails to comply with Sarbanes-Oxley (SOX), the firm may be delisted from stock exchanges.

Problems

Basic Problems LG1 2-1 **Balance Sheet** You are evaluating the balance sheet for Goodman's Bees Corporation. From the balance sheet you find the following balances: Cash and marketable securities = $400,000, Accounts receivable = $1,200,000, Inventory = $2,100,000, Accrued wages and taxes = $500,000, Accounts payable = $800,000, and Notes payable = $600,000. Calculate Goodman Bee's net working capital.

net working capital = current assets - current liabilities.

Goodman's Bees current assets =

Cash and marketable securities	= $400,000
Accounts receivable	= $1,200,000
Inventory	= $2,100,000

Total current assets	$3,700,000

and current liabilities =

Accrued wages and taxes	=	$500,000
Accounts payable	=	$800,000
Notes payable	=	$600,000
Total current liabilities		$1,900,000

So the firm's net working capital was $1,800,000 ($3,700,000 - $1,900,000).

LG1 2-2 **Balance Sheet** Zoeckler Mowing & Landscaping's year-end 2009 balance sheet lists current assets of $256,000, fixed assets of $324,000, current liabilities of $245,000, and long-term debt of $185,000. Calculate Zoeckler's total stockholders' equity.

Recall the balance sheet identity in Equation 2-1: Assets = Liabilities + Equity. Rearranging this equation: Equity = Assets – Liabilities. Thus, the balance sheets would appear as follows:

	Book value		Book value
Assets		**Liabilities and Equity**	
Current assets	$ 256,000	Current liabilities	$ 245,000
Fixed assets	324,000	Long-term debt	185,000
		Stockholders' equity	150,000
Total	$ 580,000	Total	$ 580,000

LG1 2-3 **Income Statement** Reed's Birdie Shot, Inc.'s 2008 income statement lists the following income and expenses: EBIT = $538,000, Interest expense = $63,000, and Net income = $435,000. Calculate the 2008 Taxes reported on the income statement.

Using the setup of an Income Statement in Table 2.2:

EBIT	$538,000
Interest expense	-63,000
EBT	475,000
Taxes	-40,000
Net income	$435,000

LG1 2-4 **Income Statement** Reed's Birdie Shot, Inc.'s 2009 income statement lists the following income and expenses: EBIT = $455,000, Interest expense = $58,000, and Taxes = $138,000. Reed's has no preferred stock outstanding and 100,000 shares of common stock outstanding. Calculate the 2008 earnings per share.

Using the setup of an Income Statement in Table 2.2:

EBIT	$455,000
Interest expense	-58,000
EBT	397,000
Taxes	-138,000
Net income	$259,000

Thus,

$$\text{Earnings per share (EPS)} = \frac{\$259,000}{100,000} = \$2.59 \text{ per share}$$

LG3 2-5 **Corporate Taxes** Oakdale Fashions Inc. had $245,000 in 2008 taxable income. Using the tax schedule in Table 2-3, calculate the company's 2008 income taxes. What is the average tax rate? What is the marginal tax rate?

From Table 2.3, the $245,000 of taxable income puts Oakdale Fashion in the 39 percent marginal tax bracket. Thus,

Tax liability = Tax on base amount + Tax rate (amount over base):

= $22,250 + .39 ($245,000 - $100,000) = $78,800

Note that the base amount is the maximum dollar value listed in the previous tax bracket. The *average* tax rate for Oakdale Fashions Inc. comes to:

$$\text{Average tax rate} = \frac{\$78,800}{\$245,000}$$

$$= \$78,800/\$245,000 = 32.16\%$$

If Oakdale Fashions earned $1 more of taxable income, it would pay 39 cents (its tax rate of 39 percent) more in taxes. Thus, the firm's marginal tax rate is 39 percent.

LG3 2-6 **Corporate Taxes** Hunt Taxidermy, Inc. is concerned about the taxes paid by the company in 2008. In addition to $26.5 million of taxable income, the firm received $1,750,000 of interest on state-issued bonds and $600,000 of dividends on common stock it owns in Hunt Taxidermy, Inc. Calculate Hunt Taxidermy's tax liability, average tax rate, and marginal tax rate.

In this case, interest on the state-issued bonds is not taxable and should not be included in taxable income. Further, the first 70 percent of the dividends received from Hunt Taxidermy is not taxable. Thus, only 30 percent of the dividends received are taxed, so:

$$\text{Taxable income} = \$26,500,000 + (.3)\$600,000 = \$26,680,000$$

Now Hunt Taxidermy's tax liability will be:

$$\text{Tax liability} = \$6,416,667 + .35 (\$26,680,000 - \$18,333,333) = \$9,338,000$$

The $600,000 of dividend income increased Hunt Taxidermy's tax liability by $63,000 (= (.3) x $600,000 x (.35)). Hunt Taxidermy's resulting average tax rate is now:

Average tax rage = $9,338,000/$26,680,000 = 35.00%

Finally, if Hunt Taxidermy earned $1 more of taxable income, it would still pay 35 cents (based upon its marginal tax rate of 35 percent) more in taxes.

LG4 2-7 **Statement of Cash Flows** Ramakrishnan Inc. reported 2008 net income of $15 million and depreciation of $2,650,000. The top part of Ramakrishnan, Inc.'s 2007 and 2008 balance sheets is listed below (in millions of dollars).

Current assets:	2007	2008	Current liabilities:	2007	2008
Cash and marketable securities	$ 15	$ 20	Accrued wages and taxes	$ 18	$ 19
Accounts receivable	75	84	Accounts payable	45	51
Inventory	110	121	Notes payable	40	45
Total	$200	$225	Total	$103	$115

Calculate the 2008 net cash flow from operating activities for Ramakrishnan, Inc..

Cash Flows from Operating Activities	
Net income	$15,000,000
Additions (sources of cash):	
Depreciation	2,650,000
Increase accrued wages and taxes	1,000,000
Increase in accounts payable	6,000,000
Subtractions (uses of cash):	
Increase in accounts receivable	-9,000,000
Increase in inventory	-11,000,000
Net cash flow from operating activities:	$4,650,000

LG4 2-8 **Statement of Cash Flows** In 2008, Usher Sports Shop had cash flows from investing activities of
-$2,567,000 and cash flows from financing activities of -$3,459,000. The balance in the firm's cash account was $950,000 at the beginning of 2008 and $1,025,000 at the end of the year. Calculate Usher Sports Shop's cash flow from operations for 2008.

Net change in cash and marketable securities = $1,025,000 - $950,000 = $75,000

Cash Flows from Operating Activities	= $6,101,000
Cash Flows from Investing Activities	= - 2,567,000
Cash Flows from Financing Activities	= - 3,459,000
Net Change in Cash and Marketable Securities	= $75,000

LG5 2-9 **Free Cash Flow** You are considering an investment in Fields and Struthers, Inc. and want to evaluate the firm's free cash flow. From the income statement, you see that Fields and Struthers earned an EBIT of $62 million, paid taxes of $17 million, and its depreciation expense was $5 million. Fields and Struthers' gross fixed assets increased by

$32 million from 2007 to 2008. The firm's current assets increased by $20 million and spontaneous current liabilities increased by $12 million. Calculate Fields and Struthers' operating cash flow, investment in operating capital and free cash flow for 2008.

Fields and Struthers' operating cash flow was:

OCF = EBIT – Taxes + Depreciation
= ($62m. – $17m + $5m) = $50m

Investment in operating capital for 2008 was:

IOC = ΔGross fixed assets + ΔNet operating working capital
= $32m. + ($20m. - $12m.) = $40 m.

Accordingly, Fields and Struthers' free cash flow for 2008 was:

FCF = Operating cash flow – Investment in operating capital
= $50m. - $40m. = $10m.

In other words, in 2008, Fields and Struthers had cash flows of $10 million available to pay its stockholders and debtholders.

LG5 2-10 **Free Cash Flow** Tater and Pepper Corp. reported free cash flows for 2008 of $23 million and investment in operating capital of $13 million. Tater and Pepper listed $8 million in depreciation expense and $17 million in taxes on its 2008 income statement. Calculate Tater and Pepper's 2008 EBIT.

Tater and Pepper's free cash flow for 2008 was:

FCF = Operating cash flow – Investment in operating capital
$23m. = Operating cash flow - $13m.

So, operating cash flow = $23m. + $13m. = $36m.

Tater and Pepper's operating cash flow was:

OCF = EBIT – Taxes + Depreciation
$36m. = (EBIT – $17m. + $8m.)

So, EBIT = $36m. + $17m. - $8m. = $45m.

LG1 2-11 **Statement of Retained Earnings** Mr. Husker's Tuxedos, Corp. began the year 2008 with $256 million in retained earnings. The firm earned net income of $33 million in 2008 and paid $5 million to its preferred stockholders and $10 million to its common stockholders. What is the year-end 2008 balance in retained earnings for Mr. Husker's Tuxedos?

The statement of retained earnings for 2008 is as follows:

		2008
Balance of Retained Earnings, December 31, 2007		$256m.
Plus: Net Income for 2008		33m.
Less: Cash Dividends Paid		
Preferred Stock	$5m.	
Common Stock	10m.	
Total Cash Dividends Paid		15m.

Balance of Retained Earnings, December 31, 2008	$274m.

LG1 2-12 **Statement of Retained Earnings** Use the following information to find dividends paid to common stockholders during 2008.

Balance of Retained Earnings, December 31, 2007		$785m.
Plus: Net Income for 2008		25m.
Less: Cash Dividends Paid		
Preferred Stock	$5m.	
Common Stock	7m.	
Total Cash Dividends Paid		12m.
Balance of Retained Earnings, December 31, 2008		$798m.

Total Cash Dividends Paid = $798m. - $25m. - $785m. = -$12m. Thus, common stock dividends paid = $12m. - $5m = $7m.

Intermediate Problems

LG1 2-13 **Balance Sheet** Brenda's Bar and Grill has total assets of $15 million of which $5 million are current assets. Cash makes up 10 percent of the current assets and accounts receivable makes up another 40 percent of current assets. Brenda's gross plant and equipment has a book value of $11.5 million and other long-term assets have a book value of $500,000. Using this information, what is the balance of inventory and the balance of depreciation on Brenda Bar and Grill's balance sheet?

Current assets:			
Cash and marketable Securities (.1 x $5)		$ 0.5	
Accounts receivable (.4 x $5)		2.0	
Inventory	step 1.	2.5	($5 - $0.5 - $2.0)
Total		$5.0	
Fixed assets:			
Gross plant and equipment		$11.5	
Less: Depreciation	step 4.	2.0	($11.5 - $9.5)
Net plant and equipment	step 3.	$9.5	($10.0 - $0.5)
Other long-term assets		0.5	
Total	step 2.	$10.0	($15.0 - $5.0)
Total assets		$15.0	

LG1 2-14 **Balance Sheet** Ed's Tobacco Shop has total assets of $54 million. Fifty percent of these assets are financed with debt of which $17 million is current liabilities. The firm has no preferred stock but the balance in common stock and paid-in surplus is $12 million. Using this information what is the balance for long-term debt and retained earnings on Ed's Tobacco Shop's balance sheet?

Total current liabilities		$17	
Long-term debt:	step 3.	$10	(= $27 - $17)

Total debt:	step 2.	$27	(= .5 x $54)
Stockholders' equity:			
Preferred stock		$ 0	
Common stock and paid-in surplus (20 million shares)		12	
Retained earnings	step 5.	15	(= $27 - $12)
Total	step 4	$27	(= $54 - $27)
Total liabilities and equity	step 1.	$54	(= Total Assets)

LG2 2-15 **Market Value versus Book Value** Muffin's Masonry, Inc. balance sheet lists net fixed asset as $14 million. The fixed assets could currently be sold for $19 million. Muffin's current balance sheet shows current liabilities of $5.5 million and net working capital of $4.5 million. If all the current accounts were liquidated today, the company would receive $7.25 million cash after paying $5.5 million in liabilities. What is the book value of Muffin's Masonry's assets today? What is the market value of these assets?

		Book value		Market value
Assets				
Current assets	step 1.	$10m.	step 3.	$12.75m.
Fixed assets		14m.		19.00m.
Total	step 2.	$24m.		$31.75m.

Step 1. Net working capital (book value) = Current assets (book value) – Current liabilities (book value) = $4.5m. = Current assets (book value) - $5.5m. => Current assets (book value) = $4.5m. + $5.5m. = $10m.
Step 2. Total assets (book value) = $10m. + $14m. = $24m.
Step 3. Net working capital (market value) = Current assets (market value) – Current liabilities (market value) = $7.25m. = Current assets (market value) - $5.5m. => Current assets (market value) = $7.25m. + $5.5m. = $12.75m.
Step 4. Total assets (book value) = $12.75m. + $19m. = $31.75m.

LG1 2-16 **Debt versus Equity Financing** You are considering a stock investment in one of two firms (AllDebt, Inc. and AllEquity, Inc.), both of which operate in the same industry and have identical operating income of $12.5 million. AllDebt, Inc. finances its $25 million in assets with $24 million in debt (on which it pays 10 percent interest annually) and $1 million in equity. AllEquity, Inc. finances its $25 million in assets with no debt and $25 million in equity. Both firms pay a tax rate of 30 percent on their taxable income. Calculate the income available to pay the asset funders (the debtholders and stockholders) and resulting return on assets for the two firms.

		AllDebt	AllEquity
Operating income		$12.50m.	$12.50m.
Less: Interest	($24m. x .1)	2.40m.	0.00m.
Taxable income		10.10m.	12.50m.
Less: Taxes (30%)		3.03m.	3.75m.
Net income		$7.07m.	$8.75m.
Income available for asset funders (= operating income - taxes)		$9.47m.	$8.75m.

Return on assets funders' investment	$9.47m/$25m = 37.88%	$8.75m/$25m = 35.00%

LG1 2-17 **Income Statement** You have been given the following information for Corky's Bedding Corp.:
net sales = $11,250,000
cost of goods sold = $7,750,000;
addition to retained earnings = $1,000,000;
dividends paid to preferred and common stockholders = $495,000;
interest expense = $850,000.
The firm's tax rate is 35 percent. Calculate the depreciation expense for Corky's Bedding Corp.

Net sales (all credit)		$11,250,000
Less: Cost of goods sold		7,750,000
Gross profits	step 4.	$3,500,000
Less: Depreciation	step 5.	$350,000
Earnings before interest and taxes (EBIT)	step 3.	$3,150,000
Less: Interest		850,000
Earnings before taxes (EBT)	step 2.	$2,300,000
Less: Taxes		
Net income	step 1.	$1,495,000
Less: Common and preferred stock dividends		$ 495,000
Addition to retained earnings		$1,000,000

Step 1. Net income = Common and preferred stock dividends + Addition to retained earnings = $495,000 + $1,000,000 = $1,495,000
Step 2. EBT (1 – tax rate) = Net income => EBT = Net income/(1 – tax rate) = $1,495,000/(1-.35) = $2,300,000
Step 3. EBIT – Interest = EBT => EBIT = EBT + Interest = $2,300,000 + $850,000 = $3,150,000
Step 4. Gross profits = Net sales – Cost of goods sold = $11,250,000 – 7,750,000 = $3,500,000
Step 5. Gross profits – Depreciation = EBIT => Depreciation = Gross profits -EBIT = $3,500,000 - $3,150,000 = $350,000

LG1 2-18 **Income Statement** You have been given the following information for Moore's HoneyBee Corp.:
net sales = $54,500,000;
gross profit = $27,500,000;
addition to retained earnings = $8,000,000;
dividends paid to preferred and common stockholders = $5,000,000;
depreciation expense = $5,000,000.
The firm's tax rate is 35 percent. Calculate the cost of goods sold and the interest expense for Moore's HoneyBee Corp.

Net sales (all credit)		$54,500,000
Less: Cost of goods sold		27,500,000
Gross profits	step 3.	$27,000,000
Less: Depreciation		$5,000,000
Earnings before interest and taxes (EBIT)	step 4.	$22,000,000
Less: Interest	step 5.	2,000,000

Earnings before taxes (EBT)	step 2.	$20,000,000
Less: Taxes		
Net income	step 1.	$13,000,000
Less: Common and preferred stock dividends		$5,000,000
Addition to retained earnings		$8,000,000

Step 1. Net income = Common and preferred stock dividends + Addition to retained earnings = $5,000,000 + $8,000,000 = $13,000,000
Step 2. EBT (1 – tax rate) = Net income => EBT = Net income/(1 – tax rate) = $13,000,000/(1-.35) = $20,000,000
Step 3. Gross profits = Net sales – Cost of goods sold = $54,500,000 – 27,500,000 = $27,000,000
Step 4. Gross profits – Depreciation = EBIT = $27,000,000 - $5,000,000 = $22,000,000
Step 5. EBIT – Interest = EBT => Interest = EBIT - EBT = $22,000,000 + $20,000,000 = $2,000,000

LG3 2-19 **Corporate Taxes** The Dakota Corporation had a 2008 taxable income of $33,365,000 from operations after all operating costs but before
1) interest charges of $8,500,000,
2) dividends received of $750,000,
3) dividends paid of $5,250,000, and
4) income taxes.

a. Use the tax schedule in Table 2.3 to calculate Dakota=s income tax liability.

The first 70 percent of the dividends received is not taxable. Thus, only 30 percent of the dividends received are taxed, so:

Taxable income = $33,365,000 - $8,500,000 + (.3)$750,000 = $25,090,000

Now Dakota Corp.'s tax liability will be:

Tax liability = $6,416,667 + .35 ($25,090,000 - $18,333,333) = $8,781,500

b. What are Dakota's average and marginal tax rates on taxable income?

Dakota Corp.'s resulting average tax rate is now:

Average tax rage = $8,781,500/$25,090,000 = 35.00%

Finally, if Dakota Corp earned $1 more of taxable income, it would still pay 35 cents (based upon its marginal tax rate of 35 percent) more in taxes.

LG3 2-20 **Corporate Taxes** Suppose that in addition to the $10.5 million of taxable income, Texas Taco, Inc. received $650,000 of interest on state-issued bonds and $450,000 of dividends on common stock it owns in Texas Taco, Inc.

a. Use the tax schedule in Table 2.3 to calculate Texas Taco=s income tax liability.

Interest on the state-issued bonds is not taxable and should not be included in taxable income. Further, the first 70 percent of the dividends received from Texas Taco is not taxable. Thus, only 30 percent of the dividends received are taxed, so:

Taxable income = $10,500,000 + (.3)$450,000 = $10,635,000

Now Texas Taco's tax liability will be:

Tax liability = $3,400,000 + .35 ($10,635,000 - $10,000,000) = $3,622,250

b. What are Texas Taco's average and marginal tax rates on taxable income?

Texas Taco's resulting average tax rate is now:

Average tax rage = $3,622,250/$10,635,000 = 34.06%

Finally, if Texas Taco earned $1 more of taxable income, it would still pay 35 cents (based upon its marginal tax rate of 35 percent) more in taxes.

LG5 2-21 **Statement of Cash Flows** Use the balance sheet and income statement below to construct a statement of cash flows for Clancy's Dog Biscuit Corp.

Clancy's Dog Biscuit Corporation
Balance Sheet as of December 31, 2007 and 2008
(in millions of dollars)

	2007	2008		2007	2008
Assets			**Liabilities & Equity**		
Current assets:			Current liabilities :		
Cash and marketable securities	$ 5	$ 5	Accrued wages and taxes	$ 6	$ 10
Accounts receivable	19	20	Accounts payable	15	16
Inventory	29	36	Notes payable	13	14
Total	$ 53	$ 61	Total	$ 34	$ 40
Fixed assets:			Long-term debt:	$ 53	$ 57
Gross plant and equipment	$ 88	$106	Stockholders' equity:		
Less: Depreciation	11	15	Preferred stock (2 million shares)	$ 2	$ 2
Net plant and equipment	$ 77	$ 91	Common stock and paid-in surplus (5 million shares)	11	11
Other long-term assets	15	15	Retained earnings	45	57
Total	$ 92	$106	Total	$ 58	$ 70
Total assets	$145	$167	Total liabilities and equity	$145	$167

Clancy's Dog Biscuit Corporation
Income Statement for Years Ending December 31, 2007 and 2008
(in millions of dollars)

	2007	2008
Net sales	$ 80	$ 76
Less: Cost of goods sold	39	44
Gross profits	41	32
Less: Depreciation	4	4
Earnings before interest and taxes (EBIT)	37	28
Less: Interest	5	5
Earnings before taxes (EBT)	32	23
Less: Taxes	10	7
Net income	$22	$16
Less: Preferred stock dividends	$ 1	$ 1
Net income available to common stockholders	$21	$15

Less: Common stock dividends	$ 3	$ 3
Addition to retained earnings	$18	$12
Per (common) share data:		
Earnings per share (EPS)	$4.20	$3.00
Dividends per share (DPS)	$0.60	$0.60
Book value per share (BV)	$11.20	$13.60
Market value (price) per share (MV)	$14.60	$14.25

Statement of Cash Flows for Year Ending December 31, 2008
(in millions of dollars)

	2008
A. Cash Flows from Operating Activities	
Net income	$16
Additions (sources of cash):	
Depreciation	4
Increase accrued wages and taxes	4
Increase in accounts payable	1
Subtractions (uses of cash):	
Increase in accounts receivable	-1
Increase in inventory	-7
Net cash flow from operating activities:	$17
B. Cash Flows from Investing Activities	
Subtractions:	
Increase fixed assets	-$18
Increase in other long-term assets	0
Net cash flow from investing activities:	-$18
C. Cash Flows from Financing Activities	
Additions:	
Increase in notes payable	$ 1
Increase in long-term debt	4
Increase in common and preferred stock	0
Subtractions:	
Pay preferred stock dividends	-1
Pay common stock dividends	-3
Net cash flow from financing activities:	$1
D. Net Change in Cash and Marketable Securities	**-$ 0**

LG5 2-22 **Statement of Cash Flows** Use the balance sheet and income statement below to construct a statement of cash flows for Valium's Medical Supply Corp.

Valium's Medical Supply Corporation
Balance Sheet as of December 31, 2007 and 2008
(in thousands of dollars)

	2007	**2008**		**2007**	**2008**
Assets			**Liabilities & Equity**		
Current assets:			Current liabilities :		

Cash and marketable securities	$ 123	$ 124	Accrued wages and taxes	$ 76	$ 98
Accounts receivable	321	339	Accounts payable	246	271
Inventory	494	548	Notes payable	222	222
Total	$ 938	$1,011	Total	$ 544	$ 591
Fixed assets:			Long-term debt:	$ 937	$963
Gross plant and equipment	$1,507	$1,843	Stockholders' equity:		
Less: Depreciation	197	261	Preferred stock (10 million shares)	$ 10	$ 10
Net plant and equipment	$1,310	$1,582	Common stock and paid-in surplus (100 million shares)	200	200
Other long-term assets	220	220	Retained earnings	777	1,049
Total	$1,530	$1,802	Total	$ 987	$1,259
Total assets	$2,468	$2,813	Total liabilities and equity	$2,468	$2,813

Valium's Medical Supply Corporation
Income Statement for Years Ending December 31, 2007 and 2008
(in thousands of dollars)

	2007	**2008**
Net sales	$1,357	$1,509
Less: Cost of goods sold	666	740
Gross profits	691	769
Less: Depreciation	59	64
Earnings before interest and taxes (EBIT)	632	705
Less: Interest	68	79
Earnings before taxes (EBT)	564	626
Less: Taxes	190	219
Net income	$ 374	$ 407
Less: Preferred stock dividends	$10	$ 10
Net income available to common stockholders	$ 364	$ 397
Less: Common stock dividends	$ 125	$ 125
Addition to retained earnings	$ 239	$ 272
Per (common) share data:		
Earnings per share (EPS)	$3.64	$3.97
Dividends per share (DPS)	$1.25	$1.25
Book value per share (BV)	$9.77	$12.49
Market value (price) per share (MV)	$10.60	$14.25

Statement of Cash Flows for Year Ending December 31, 2008
(in thousands of dollars)

	2008
A. Cash Flows from Operating Activities	
Net income	$407
Additions (sources of cash):	
Depreciation	64
Increase accrued wages and taxes	22
Increase in accounts payable	25
Subtractions (uses of cash):	

Increase in accounts receivable	-18
Increase in inventory	-54
Net cash flow from operating activities:	$446
B. Cash Flows from Investing Activities	
Subtractions:	
Increase fixed assets	-$336
Increase in other long-term assets	0
Net cash flow from investing activities:	-$336
C. Cash Flows from Financing Activities	
Additions:	
Increase in notes payable	$ 0
Increase in long-term debt	26
Increase in common and preferred stock	0
Subtractions:	
Pay preferred stock dividends	-10
Pay common stock dividends	-125
Net cash flow from financing activities:	-$109
D. Net Change in Cash and Marketable Securities	**$ 1**

LG5 2-23 **Statement of Cash Flows** Lane's Outdoor Furniture, Inc. has net cash flows from operating activities for the last year of $340 million. The income statement shows that net income is $315 million and depreciation expense is $46 million. During the year, the change in inventory on the balance sheet was $38 million, change in accrued wages and taxes was $15 million and change in accounts payable was $20 million. At the beginning of the year the balance of accounts receivable was $50 million. Calculate the end of year balance for accounts receivable.

A. Cash Flows from Operating Activities		
Net income	$315m.	
Additions (sources of cash):		
Depreciation	46m.	
Increase accrued wages and taxes	15m.	
Increase in accounts payable	20m.	
Subtractions (uses of cash):		
Increase in accounts receivable	-18m.	(=$340m.-$315m.-$46m.-$15m.-$20m.+$38m.)
Increase in inventory	-38m.	
Net cash flow from operating activities:	$340m.	

Thus, end of year balance of accounts receivable = $50m. + $18m. = $68m.

LG5 2-24 **Statement of Cash Flows** Dogs 4 U Corporation has net cash flow from financing activities for the last year of $20 million. The company paid $105 million in dividends last year. During the year, the change in notes payable on the balance was $23 million, and change in common and preferred stock was $0 million. The end of year balance for

long-term debt was $185 million. Calculate the beginning of year balance for long-term debt.

C. Cash Flows from Financing Activities

Additions:		
Increase in notes payable	$ 23m.	
Increase in long-term debt	102m.	(=$20m.+$105m.-$23m.)
Increase in common and preferred stock	0m.	
Subtractions:		
Pay stock dividends	-105m.	
Net cash flow from financing activities:	$20m.	

Thus, beginning of year balance for long-term debt = $185 - $102m = $83m.

LG5 2-25 **Free Cash Flow** The 2008 income statement for Duffy's Pest Control shows that depreciation expense is $197 million, EBIT is $418 million, EBT is $240 million, and the tax rate is 30 percent. At the beginning of the year, the balance of gross fixed assets was $1,562 million and net operating working capital was $417 million. At the end of the year gross fixed assets was $1,803 million. Duffy's free cash flow for the year was $424 million. Calculate the end of year balance for net operating working capital.

Taxes = $240m. x (.3) = $72m. =>
Duffy's Pest Control's operating cash flow was:

OCF = EBIT – Taxes + Depreciation
= ($418m. – $72m. + $197m.) = $543m.

Duffy's Pest Control's free cash flow for 2008 was:

FCF = Operating cash flow – Investment in operating capital
$424m. = $543m. - Investment in operating capital
=> Investment in operating capital = $543m. - $424m. =$119m.

Accordingly, investment in operating capital for 2008 was:

IOC = ΔGross fixed assets + ΔNet operating working capital
$119m. = ($1,803m. - $1,562m.) + (Ending net operating working capital - $417m.)
=> Ending net operating working capital = $119m. - ($1,803m. - $1,562m.) + $417 m. = $295m.

LG5 2-26 **Free Cash Flow** The 2008 income statement for Egyptian Noise Blasters shows that depreciation expense is $50 million, EBIT is $215 million, and taxes are $70 million. At the end of the year, the balance of gross fixed assets was $385 million. The change in net operating working capital during the year was $43 million. Egyptian's free cash flow for the year was $112 million. Calculate the beginning of year balance for gross fixed assets.

Egyptian Noise Blasters' operating cash flow was:

OCF = EBIT – Taxes + Depreciation
= ($215m. – $70m + $50m) = $195m.

Egyptian Noise Blasters' free cash flow for 2008 was:

FCF = Operating cash flow – Investment in operating capital
$112m. = $195m. - Investment in operating capital
= > Investment in operating capital = $195m. - $112m. = $83m.

Accordingly, investment in operating capital for 2008 was:

IOC = ΔGross fixed assets + ΔNet operating working capital
$83m. = ($385m. – Beginning of year gross fixed assets) + $43m.
=> Beginning of year gross fixed assets = $385m. -$83m. +$43m. = $345m.

LG1 2-27 **Statement of Retained Earnings** Thelma and Louie, Inc. started the year with a balance of retained earnings of $543 million and ended the year with retained earnings of $589 million. The company paid dividends of $35 million to the preferred stock holders and $88 million to common stock holders. Calculate Thelma and Louie's net income for the year.

Statement of Retained Earnings as of December 31, 2008
(in millions of dollars)

		2008	
Balance of Retained Earnings, December 31, 2007		$543m.	
Plus: Net Income for 2008		169m.	(= $589m. + $123m. - $543m.)
Less: Cash Dividends Paid			
Preferred Stock	$35m.		
Common Stock	88m.		
Total Cash Dividends Paid		123m.	
Balance of Retained Earnings, December 31, 2008		$589m.	

LG1 2-28 **Statement of Retained Earnings** Jamaica Tours, Inc. started the year with a balance of retained earnings of $1,047 million. The company reported net income for the year of $168 million, paid dividends of $10 million to the preferred stock holders and $35 million to common stock holders. Calculate Jamaica Tour's end of year balance in retained earnings.

Statement of Retained Earnings as of December 31, 2008
(in millions of dollars)

		2008
Balance of Retained Earnings, December 31, 2007		$1,047m.
Plus: Net Income for 2008		168m.
Less: Cash Dividends Paid		
Preferred Stock	$10m.	
Common Stock	35m.	
Total Cash Dividends Paid		45m.
Balance of Retained Earnings, December 31, 2008		$1,170m.

Advanced Problems LG1 2-29 **Income Statement** Listed below is the 2008 income statement for Tom and Sue Travels Inc.

Tom and Sue Travels, Inc.
Income Statement for Year Ending December 31, 2008
(in millions of dollars)

	2008
Net sales	$16.500
Less: Cost of goods sold	10.300
Gross profits	6.200
Less: Depreciation	2.900
Earnings before interest and taxes (EBIT)	3.300
Less: Interest	0.950
Earnings before taxes (EBT)	2.350
Less: Taxes	0.705
Net income	$ 1.645

The CEO of Tom and Sue's wants the company to earn a net income of $2.250 million in 2009. Cost of goods sold is expected to be 60 percent of net sales, depreciation expense is not expected to change, interest expense is expected to increase to $1.050 million, and the firm's tax rate will be 30 percent. Calculate the net sales needed to produce net income of $2.250 million.

Tom and Sue Travels, Inc.
Income Statement for Year Ending December 31, 2009
(in millions of dollars)

		2009
Net sales	Step 4.	$17.910
Less: Cost of goods sold	Step 5.	10.746
Gross profits	Step 3.	7.164
Less: Depreciation		2.900
Earnings before interest and taxes (EBIT)	Step 2.	4.264
Less: Interest		1.050
Earnings before taxes (EBT)	Step 1.	3.214
Less: Taxes		
Net income		$ 2.250

Step 1. EBT (1-t) = Net income = $2.250m = EBT (1-.3) => EBT = $2.250m./(1-.3) = $3.214m.
Step 2. EBIT = EBT + Interest = $3.214m. + $1.050m. = $4.264m.
Step 3. Gross profits = EBIT + Depreciation = $4.264m. + $2.900m. = $7.164m
Step 4. Net sales = Gross profits/(1-Cost of goods sold percent) = $7.164m./(1. - .6) = $17.910m.
Step 5. Cost of goods sold = Net sales – Gross profits = $17.910m. - $7.164 = $10.746m.

LG1 2-30 **Income Statement** You have been given the following information for KellyGirl's Athletic Wear Corp. for the year 2008:
net sales = $22,500,000;
cost of goods sold = $16,100,000;
addition to retained earnings = $1,150,000;
dividends paid to preferred and common stockholders = $1,125,000;

interest expense = $1,050,000.
The firm's tax rate is 30 percent.
In 2009, net sales are expected to increase by $2.5 million,
cost of goods sold is expected to be 70 percent of net sales,
expensed depreciation is expected to be the same as in 2008,
interest expense is expected to be $1,200,000,
the tax rate is expected to be 30 percent of EBT, and
dividends paid to preferred and common stockholders will not change.
Calculate the addition to retained earnings expected in 2009.

Income Statement for Year Ending December 31, 2008
(in millions of dollars)

		2008
Net sales (all credit)		$22,500,000
Less: Cost of goods sold		16,100,000
Gross profits		6,400,000
Less: Depreciation	$6,400,000 - $4,300,000	2,100,000
Earnings before interest and taxes (EBIT)	$3,250,000 + $1,050,000	4,300,000
Less: Interest		1,050,000
Earnings before taxes (EBT)	$2,275,000/(1-.3)	3,250,000
Less: Taxes		
Net income		$2,275,000
Less: Preferred and common stock dividends		$1,125,000
Addition to retained earnings		$1,150,000

Income Statement for Year Ending December 31, 2009
(in millions of dollars)

		2009
Net sales (all credit)	$22,500,000 + $2,500,000	$25,000,000
Less: Cost of goods sold	.7 x $25,000,000	17,500,000
Gross profits		7,500,000
Less: Depreciation		2,100,000
Earnings before interest and taxes (EBIT)		5,400,000
Less: Interest		1,200,000
Earnings before taxes (EBT)		4,200,000
Less: Taxes (30%)		1,260,000
Net income		$2,940,000
Less: Preferred and common stock dividends		$1,125,000
Addition to retained earnings		$1,815,000

LG5 2-31 **Free Cash Flow** Martha Sue's Flowers 4U, Inc. had free cash flow during 2008 of $43 million, EBIT of $110 million, tax expense of $25 million, and depreciation of $14 million. Using this information, fill in the blanks on Martha Sue's balance sheet below.

Martha Sue's operating cash flow for 2008 was:

OCF = EBIT – Taxes + Depreciation = ($110m. – $25m. + $14m.) = $99m.

Martha Sue's free cash flow was:

FCF = Operating cash flow – Investment in operating capital
$43m. = $99m. - Investment in operating capital

So, Investment in operating capital = $99m. - $43m. = $56m.

IOC = ΔGross fixed assets + ΔNet operating working capital
$56m. = ($333m. - $300m.) + ΔNet operating working capital
=> ΔNet operating working capital = $56m. - ($333m. - $300m.) = $23m.

ΔNet operating working capital = $23m. = ΔCurrent assets - ΔCurrent liabilities
$23m. = ($221m. - $190m.) - ΔCurrent liabilities
=> ΔCurrent liabilities = ($221m. - $190m.) - $23m. = $8m.
=> 2008 Current liabilities = $110m. + $8m. = $118m.
and 2008 Current liabilities = Accrued wages and taxes + Accounts payable + Notes payable

$118m. = $17m. + Accounts payable + $45m.

=> Accounts payable = $118m. - $17m. - $45m. = $56m.

Martha Sue's Flowers 4U, Inc.
Balance Sheet as of December 31, 2007 and 2008
(in millions of dollars)

	2007	2008		2007	2008
Assets			**Liabilities & Equity**		
Current assets:			Current liabilities:		
Cash and marketable securities	$ 25	$ 28	Accrued wages and taxes	$ 15	$ 17
Accounts receivable	65	75	Accounts payable	50	$56
Inventory	100	118	Notes payable	45	45
Total	$190	$221	Total	$110	$118
Fixed assets:			Long-term debt:	$190	$195
Gross plant and equipment	$300	$333	Stockholders' equity:		
Less: Depreciation	40	54	Preferred stock (5 million shares)	$ 5	$ 5
Net plant and equipment	$260	$279	Common stock and paid-in surplus (20 million shares)	40	40
Other long-term assets	50	50	Retained earnings	155	192
Total	$310	$329	Total	$200	$237
Total assets	$500	$550	Total liabilities and equity	$500	$550

LG5 2-32 **Free Cash Flow** Wondy's Overhead Construction had free cash flow during 2008 of $12 million. The change in gross fixed assets on Wondy's balance sheet during 2008 was $10 million and the change in net operating working capital was $14 million. Using this information, fill in the blanks on Wondy's income statement below.

IOC = ΔGross fixed assets + ΔNet operating working capital
=> IOC = $10m. + $14m. = $24m.

FCF = Operating cash flow – Investment in operating capital
=> $12m. = $24m. - Investment in operating capital
=> Investment in operating capital = $24m. - $12m. = $12m.

OCF = EBIT – Taxes + Depreciation
Using the numbers below: $24m. = $25.5m. – Taxes + $6.0
=> Taxes = $25.5m. + $6.0m. - $24m. = $7.5m.

Wondy's Overhead Construction, Corp.
Income Statement for Year Ending December 31, 2008
(in millions of dollars)

	2008	
Net sales	$ 107.1	Step 1. (= $31.5m. + $75.6m.)
Less: Cost of goods sold	75.6	
Gross profits	31.5	
Less: Depreciation	6.0	
Earnings before interest and taxes (EBIT)	25.5	Step 2. (= $31.5m. - $6.0m.)
Less: Interest	2.5	Step 5. (= $22.5m. - $20.0m.)
Earnings before taxes (EBT)	23.0	Step 4. (= $15.5m. + $7.5m.)
Less: Taxes (22.5%)	7.5	Step 3. (from above)
Net income	$15.5	

Research It!
Reviewing Financial Statements
Go the web site of Wal-Mart Stores, Inc. at **www.walmartstores.com** and get the latest financial statements from the annual report using the following steps.

Go to Wal-Mart Stores, Inc.'s Web site at **www.walmartstores.com.** Click on Investors, then select Financial Information; next choose Annual Reports; finally, click on the most recent date. This will bring the file onto your computer that contains the relevant data. Locate the total assets, total equity, net sales, net income, dividends paid, cash flows from operating activities, and cash flows from investing activities for the last two years. How have these items changed over the last two years?

SOLUTION: The solution will vary with the year annual report is accessed. However, the annual report for each year summarizes the financial information necessary to evaluate key information used by firm managers, who make financial decisions, and by investors, who decide whether or not to invest in the firm.

Integrated Mini Case: Working with Financial Statements

Listed below are partial financial statements for Garners' Platoon Mental Health Care, Inc. Fill in the blanks on the four financial statements.

Garners' Platoon Mental Health Care, Inc.
Balance Sheet as of December 31, 2007 and 2008
(in millions of dollars)

	2007	2008		2007	2008
Assets			**Liabilities & Equity**		
Current assets:			Current liabilities:		
Cash and marketable securities	$____	$ 421	Accrued wages and taxes	$ 242	$ 316
Accounts receivable	1,020	____	Accounts payable	791	867
Inventory	1,581	1,760	Notes payable	714	____
Total	$____	$3,290	Total	$ 1,747	$2,055
Fixed assets:			Long-term debt:	$____	$3,090
Gross plant and equipment	$4,743	$____	Stockholders' equity:		
Less: Depreciation	640	840	Preferred stock (25 million shares)	$ 60	$ 60
Net plant and equipment	$____	$4,972	Common stock and paid-in surplus (200 million shares)	___	637
Other long-term assets	790	____	Retained earnings	2,440	3,312
Total	$4,893	$5,864	Total	$3,137	$4,009
Total assets	$7,889	$____	Total liabilities and equity	$7,889	$9,154

Garners' Platoon Mental Health Care, Inc.
Income Statement for Years Ending December 31, 2007 and 2008
(in millions of dollars)

	2 007	2008
Net sales	$____	$4,980
Less: Cost of goods sold	2,135	____
Gross profits	2,213	2,609
Less: Depreciation	191	200
Earnings before interest and taxes (EBIT)	____	2,409
Less: Interest	285	____
Earnings before taxes (EBT)	1,737	2,094
Less: Taxes	____	____
Net income	$1,105	$1,327
Less: Preferred stock dividends	$____	$ 60
Net income available to common stockholders	$1,045	$1,267
Less: Common stock dividends	395	$ 395
Addition to retained earnings	$____	$ 872
Per (common) share data:		
Earnings per share (EPS)	$____	$____
Dividends per share (DPS)	$____	$____
Book value per share (BV)	$____	$____

Market value (price) per share (MV)	$22.500	$26.850

Garners' Platoon Mental Health Care, Inc.
Statement of Cash Flows for Year Ending December 31, 2008
(in millions of dollars)

	2008
A. Cash Flows from Operating Activities	
Net income	$___
Additions (sources of cash):	
Depreciation	___
Increase accrued wages and taxes	___
Increase in accounts payable	___
Subtractions (uses of cash):	
Increase in accounts receivable	___
Increase in inventory	___
Net cash flow from operating activities:	$___
B. Cash Flows from Investing Activities	
Subtractions:	
Increase fixed assets	___
Increase in other long-term assets	___
Net cash flow from investing activities:	$ ___
C. Cash Flows from Financing Activities	
Additions:	
Increase in notes payable	$___
Increase in long-term debt	___
Increase in common and preferred stock	___
Subtractions:	
Pay dividends	___
Net cash flow from financing activities:	$___
D. Net Change in Cash and Marketable Securities	**-$ 26**

Garners' Platoon Mental Health Care, Inc.
Statement of Retained Earnings as of December 31, 2008
(in millions of dollars)

		2008
Balance of Retained Earnings, December 31, 2007		$2,440
Plus: Net Income for 2008		_____
Less: Cash Dividends Paid		
Preferred Stock	$____	
Common Stock	_____	
Total Cash Dividends Paid		
Balance of Retained Earnings, December 31, 2008		$____

SOLUTION:

Garners' Platoon Mental Health Care, Inc.
Balance Sheet as of December 31, 2007 and 2008
(in millions of dollars)

	2007	2008		2007	2008
Assets			**Liabilities & Equity**		
Current assets:			Current liabilities:		
Cash and marketable securities	$ 395	$ 421	Accrued wages and taxes	$ 242	$ 316
Accounts receivable	1,020	1,109	Accounts payable	791	867
Inventory	1,581	1,760	Notes payable	714	872
Total	$2,996	$3,290	Total	$ 1,747	$2,055
Fixed assets:			Long-term debt:	$3,005	$3,090
Gross plant and equipment	$4,743	$5,812	Stockholders' equity:		
Less: Depreciation	640	840	Preferred stock (25 million shares)	$ 60	$ 60
Net plant and equipment	$4,103	$4,972	Common stock and paid-in surplus	637	637
Other long-term assets	790	892	(200 million shares)		
Total	$4,893	$5,864	Retained earnings	2,440	3,312
			Total	$3,137	$4,009
Total assets	$7,889	$9,154			
			Total liabilities and equity	$7,889	$9,154

Garners' Platoon Mental Health Care, Inc.
Income Statement for Years Ending December 31, 2007 and 2008
(in millions of dollars)

	2 007	**2008**
Net sales	$4,348	$4,980
Less: Cost of goods sold	2,135	2,371
Gross profits	2,213	2,609
Less: Depreciation	191	200
Earnings before interest and taxes (EBIT)	2,022	2,409
Less: Interest	285	315
Earnings before taxes (EBT)	1,737	2,094
Less: Taxes	632	767
Net income	$1,105	$1,327
Less: Preferred stock dividends	$ 60	$ 60
Net income available to common stockholders	$1,045	$1,267
Less: Common stock dividends	395	$ 395
Addition to retained earnings	$ 650	$ 872
Per (common) share data:		
Earnings per share (EPS)	$ 5.225	$ 6.335
Dividends per share (DPS)	$ 1.975	$ 1.975
Book value per share (BV)	$39.445	$45.770
Market value (price) per share (MV)	$22.500	$26.850

Garners' Platoon Mental Health Care, Inc.
Statement of Cash Flows for Year Ending December 31, 2008
(in millions of dollars)

A. Cash Flows from Operating Activities	
Net income	$1,327
Additions (sources of cash):	
Depreciation	200
Increase accrued wages and taxes	74
Increase in accounts payable	76
Subtractions (uses of cash):	
Increase in accounts receivable	-89
Increase in inventory	-179
Net cash flow from operating activities:	$1,409
B. Cash Flows from Investing Activities	
Subtractions:	
Increase net fixed assets	-1,069
Increase in other long-term assets	-102
Net cash flow from investing activities:	$-1,171
C. Cash Flows from Financing Activities	
Additions:	
Increase in notes payable	$ 158
Increase in long-term debt	85
Increase in common and preferred stock	0
Subtractions:	
Pay dividends	-(60+395)
Net cash flow from financing activities:	$ -212
D. Net Change in Cash and Marketable Securities	**-$ 26**

Garners' Platoon Mental Health Care, Inc.
Statement of Retained Earnings as of December 31, 2008
(in millions of dollars)

		2008
Balance of Retained Earnings, December 31, 2007		$2,440
Plus: Net Income for 2008		1,327
Less: Cash Dividends Paid		
Preferred Stock	$ 60	
Common Stock	395	
Total Cash Dividends Paid		$ 455
Balance of Retained Earnings, December 31, 2008		$3,312