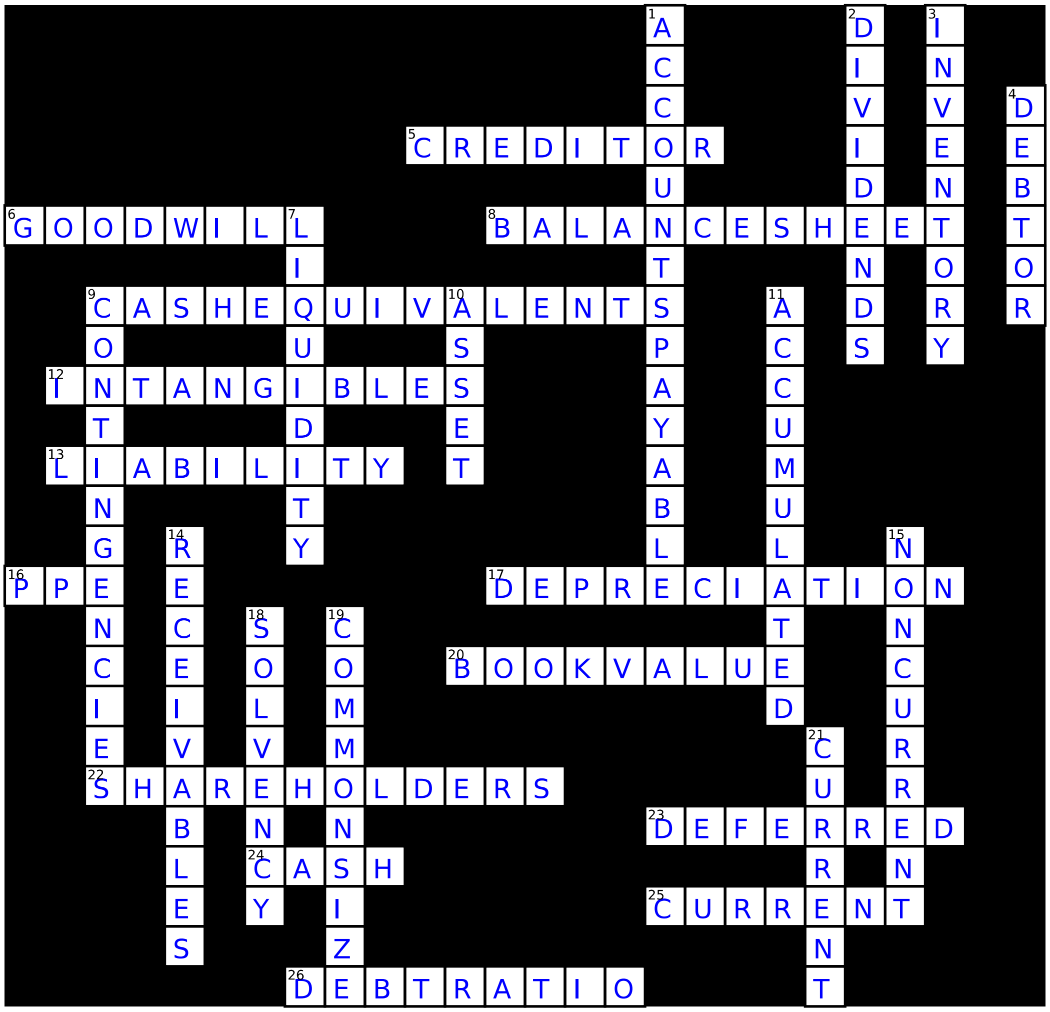
ACTIVITY 12 CROSSWORD PUZZLE FOR CHAPTER 2



Across

5. Lends money
6. Extra value recorded when buying another company
8. Reports assets, liabilities, and stockholders' equity (2 words)
9. Investments available for quick liquidation (2 words)
12. Patents, copyrights, and brand names
13. Accounts payable is a _____ account
16. Buildings, equipment, and land (abbreviation)
17. Cost allocation
20. Acquisition Cost less Accumulated Depreciation (2 words)
22. Owners of a corporation
23. Income tax amounts to be paid later
24. Money in the bank
25. Ratio that measures the ability to pay current liabilities with current assets
26. Total liabilities divided by total assets (2 words)

Down

1. Amounts owed to suppliers (2 words)
2. Distribution of earnings
3. Merchandise held for sale
4. Borrows money
7. Ratios that measure the ability to pay liabilities as they come due
9. Lawsuits and other events that could create new liabilities for the company
10. Inventory is an _____ account
11. Total amount of depreciation expensed since the assets' date of purchase
14. Monies to be received from customers
15. Equipment is a _____ asset account, which is used for more than one year
18. Ratios that measure the ability to pay liabilities for many years
19. Balance Sheet reporting all amounts as a percentage of total assets (2 words)
21. Liabilities due within 12 months

ACTIVITY 13 THE CLASSIFIED BALANCE SHEET

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

STARBUCKS (SBUX) 10/02/2011 BALANCE SHEET ($ in millions)			
ASSETS		**LIABILITIES**	
Cash and cash equivalents	$ 1,148.1	Accounts payable	$ 540.0
Short-term investments	902.6	Short-term debt	0.0
Accounts receivable	385.6	Other current liabilities	1,535.8
Inventories	965.8	Long-term debt	549.5
Other current assets	392.8	Other noncurrent liabilities	350.2
PPE, net	2,355.0	**STOCKHOLDERS' EQUITY**	
Goodwill and intangibles	433.5	Contributed capital	41.2
Long-term investments	479.3	Retained earnings	4,297.4
Other noncurrent assets	297.7	Other stockholders' equity	46.3
TOTAL ASSETS	**$7,360.4**	**TOTAL L & SE**	**$7,360.4**

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 an asset's long-term 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 of 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) are amounts paid-in (contributed) by stockholders to purchase common stock and preferred stock. Accounts include capital 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 / 2 / 5**)

Q2 What is the total amount reported for Current Liabilities? **$2,075.8** million

Noncurrent Liabilities? **$899.7** million Total Stockholders' Equity? **$4,384.9** million

ACTIVITY 14 UNDERSTANDING THE BALANCE SHEET

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

Use Starbucks' balance sheet dated 10/02/2011 (on the opposite page) to answer the following questions.

a. How much do customers owe this company? **$385.6** million

b. For *inventories*, $965.8 million is the (**acquisition cost / current market value / can't tell**).

c. For *property, plant, and equipment, net*, $2,355.0 million is the (**acquisition cost / current market value / book value / can't tell**).

d. What amount of investments does this company intend to hold for more than a year? **$479.3** million

e. (**PPE / Goodwill / Long-term investments**) is created when a company is acquired.

f. How much does this company owe to suppliers? **$540.0** million

g. Current assets total **$3,794.9** million and current liabilities total **$2,075.8** 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 **$3,565.5** million and noncurrent liabilities total **$899.7** million. Noncurrent liabilities are used to finance (**current / noncurrent**) assets.

i. Contributed capital represents (**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 / liquidity**), which means that (**PPE / cash**) will always be reported 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 15 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	**10/02/2011**	**10/03/2010**	**9/27/2009**	**9/28/2008**
Cash and cash equivalents	$ 1,148.1	$ 1,164.0	$ 599.8	$ 269.8
Short-term investments	902.6	285.7	66.3	52.5
Accounts receivable	385.6	302.7	271.0	329.5
Inventories	965.8	543.3	664.9	692.8
Other current assets	392.8	460.7	433.8	403.4
Property, plant, and equipment	6,163.1	5,888.7	5,700.9	5,717.3
Accumulated depreciation	(3,808.1)	(3,472.2)	(3,164.5)	(2,760.9)
PPE, net	2,355.0	2,416.5	2,536.4	2,956.4
Goodwill and other intangibles	433.5	333.2	327.3	333.1
Long-term investments	479.3	533.3	423.5	374.0
Other noncurrent assets	297.7	346.5	253.8	(L)
TOTAL ASSETS	**$ 7,360.4**	**$ 6,385.9**	**$ 5,576.8**	**$ 5,672.6**
LIABILITIES				
Accounts payable	$ 540.0	$ 282.6	$ 267.1	$ 324.9
Short-term debt	0.0	0.0	0.0	713.0
Other current liabilities	1,535.8	1,496.5	1,313.9	1,151.8
Long-term debt	549.5	549.4	549.3	549.6
Other noncurrent liabilities	350.2	382.7	400.8	442.4
STOCKHOLDERS' EQUITY				
Contributed capital	41.2	146.3	187.1	40.1
Retained earnings	4,297.4	3,471.2	2,793.2	2,402.4
Other stockholders' equity	46.3	57.2	65.4	48.4
TOTAL L & SE	**$ 7,360.4**	**$ 6,385.9**	**$ 5,576.8**	**$ (Z)**

Q1 Calculate the amounts that should be reported for (L) and (Z) on the 9/28/2008 balance sheet:
(L) = **$261.1** million (Z) = **$5,672.6** million

Q2 What was the beginning balance of the inventories account for the fiscal year ended on
10/02/2011? **$543.3** million 10/03/2010? **$664.9** million 9/27/2009? **$692.8** million

Q3 What amount of property, plant, and equipment was purchased (assuming no PPE was sold) during fiscal year ended 10/02/2011? **$274.4** million 10/03/2010? **$187.8** million

Q4 From 9/28/2008 to 10/02/2011 accounts payable (**increased** / **decreased**), indicating (**more** / **less**) financial risk. This company paid off accounts payable during fiscal years ended in (**2011 / 2010 / 2009**). As of 10/02/2011 this company owes **$540.0** million to its suppliers.

Q5 Total Assets are (**increasing** / **decreasing**), indicating that this company is (**expanding** / **shrinking**).

Q6 What are total liabilities for the fiscal year ended on:

10/02/2011? **$2,975.5** million 9/28/2008? **$3,181.70** million

What is the debt ratio for the fiscal year ended on:

10/02/2011? **40.4**% 9/28/2008? **56.1**%

Discuss the change in the company's use of debt over this 4-year period.

On 9/28/2008 this company is primarily financing assets with debt (56.1% debt ratio), and three years later the company has reduced its liabilities and is financing assets primarily with equity (40.4% debt ratio).

Q7 From 9/28/2008 to 9/27/2009, Contributed Capital (**increased** / **decreased**), indicating the company (**issued more stock** / **purchased more assets** / **reported net income**) during this accounting period.

Q8 Retained Earnings is (**increasing** / **decreasing**), indicating the company (**issued more stock** / **purchased more assets** / **reported net income**) during this accounting period. Assuming no dividends were issued, how much net income (loss) was reported for the fiscal year ended on:

10/02/2011? **$826.2** million 10/03/2010? **$678.0** million 9/27/2009? **$390.8** million

The most profitable year was fiscal year ended (**2011** / **2010** / **2009**).

Q9 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.

Q10 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 of the following:

- ***Total assets increased, indicating the company is expanding.***
- ***The gross amount of property, plant, and equipment increased, indicating the company is updating assets on a regular basis.***
- ***The debt ratio decreased from 56.1% down to 40.4%, indicating a decrease in financial risk. Decreasing financial risk in a volatile economy creates a stronger financial position.***
- ***Retained earnings increased, indicating the company remained profitable during challenging economic times.***

ACTIVITY 16 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,* while 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) 12/31/2011	General Mills (GIS) 5/29/2011
Assets	$ 72,574	**$18,675**
Liabilities	$ 14,429	$ 12,309
Stockholders' equity	**$ 58,145**	$ 6,366
Debt ratio	**19.88%**	**65.91%**

Q1 Compute the values for (B) and (Y) in the above chart. Compute the **Debt Ratio** and record in the above chart. (*Debt ratio = Liabilities / Assets)* This ratio quantifies the proportion of assets financed with debt. (**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 / <u>does not</u>**) dilute current shareholders' ownership, but issuing additional shares of common stock (**<u>does</u> / does not**) dilute current shareholders' ownership.

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

Either choice may be correct if supported with good reasons.

The issuance of <u>debt</u> maintains current shareholders' ownership interest:

- ***Debt does not increase the number of issued shares.***
- ***Interest expense on debt is tax deductible.***

The issuance of <u>equity</u> reduces financial risk:

- ***Amounts paid-in by shareholders for capital stock never have to be paid back.***
- ***Dividend payments are not required.***

ACTIVITY 17 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.

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

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.

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

For the year 2010	***Industry Average for Restaurants***	**DineEquity (DIN)**	**Darden Restaurants (DRI)**	**Nathan's Famous (NATH)**
Current Ratio	*1.1*	1.32	0.54	6.12
Debt Ratio	52%	97%	64%	17%
Debt-to-Equity Ratio*	*1.10*	33.17	1.77	0.20

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** / **NATH**)

All responses are correct.

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

Q2 (**DIN** / **DRI** / **NATH**) 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** / **NATH**). 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, and 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** / **NATH**) are relying more on debt to finance assets and have a debt ratio (**greater** / **less**) than 50%. Darden Restaurants is financing **64%** 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 principal 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 may 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 large investment in 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. To convert:*

Debt ratio = [Debt-to-equity ratio/ (1 + Debt-to-equity ratio)]

For DineEquity 0.97 = 33.17 / 34.17

ACTIVITY 18 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 (NC) liabilities, common stock, and retained earnings by dividing each amount by the amount for the base year. Record the resulting *trend index* in the shaded area. Use 9/28/2008 as the base year.

STARBUCKS	**10/02/2011**		**10/03/2010**		**9/27/2009**		**9/28/2008**	
($ in millions)	$	Trend	$	Trend	$	Trend	BASE YEAR	
Current assets	3,794.9	217	2,756.4	158	2,035.8	116	1,748.0	100
PPE, net	2,355.0	80	2,416.5	82	2,536.4	86	2,956.4	100
Goodwill + Intang.	433.5	130	333.2	100	327.3	98	333.1	100
Other assets	777.0	122	879.8	139	677.3	107	635.1	100
TOTAL ASSETS	**7,360.4**	**130**	**6,385.9**	**113**	**5,576.8**	**98**	**5,672.6**	**100**
Current liabilities	2,075.8	95	1,779.1	81	1,581.0	72	2,189.7	100
NC liabilities	899.7	**91**	932.1	**94**	950.1	**95**	992.0	**100**
Common stock	41.2	**103**	146.3	**365**	187.1	**467**	40.1	**100**
Retained earnings	4,297.4	**179**	3,471.2	**144**	2,793.2	**116**	2,402.4	**100**
Other SE	46.3	96	57.2	118	65.4	135	48.4	100
TOTAL L and SE	**7,360.4**	**130**	**6,385.9**	**113**	**5,576.8**	**98**	**5,672.6**	**100**

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

Q2 A trend index of 130 (total assets) indicates that the dollar amount is (**greater** / **less**) than the (**previous** / **base**) year, whereas a trend index of 80 (PPE, net) indicates the dollar amount is (**greater** / **less**) than the (**previous** / **base**) year. For *total assets*, the trend index of 130 is computed by dividing $7,360.4 (total assets on 10/02/2011) by **$5,672.6** million (total assets of the base year). A trend index of 130 indicates *total assets* (**increased** / **decreased**) by **30%** (from an index of 100 to 130) from 9/28/2008 to 10/02/2011.

Q3 From 9/28/2008 to 10/02/2011, which of the following accounts increased at a greater rate than total assets? (**Noncurrent liabilities** / **Common stock** / **Retained earnings**). The assets of this company are primarily financed with (**liabilities** / **contributed capital** / **retained earnings**). This is referred to as (**internal** / **external**) financing because these funds are generated by operations. Issuing stocks and bonds are forms of (**internal** / **external**) financing because these funds come from investors outside of the firm.

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

Assume less than 5% is low, 5 to 15% is moderate, and more than 15% is high.

The three-year average total asset growth rate of this company is considered (**low** / **moderate** / **high**). *(30% / 3 years = 10% < 15%, but > 5%)*

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 vary and may include two of the following…

- ***Assets increased 30% over the three-year period, indicating moderate growth. SBUX has been expanding by building domestic relationships (Green Mountain Coffee Roasters) and international joint-ventures within China and India.***
- ***The majority of asset growth was in current assets. SBUX has greatly increased its cash and equivalents over the past three years.***
- ***PP&E has been trending downwards, indicating the international joint-ventures must not include the ownership of additional PPE.***
- ***Goodwill and intangibles increased at a rate equal to that of total assets, indicating growth through the acquisition of other businesses. However, these amounts are only a small proportion of total assets.***
- ***Both current liabilities and noncurrent liabilities decreased, indicating lower financial risk.***
- ***Retained earnings increased, indicating the company remains profitable even during these uncertain economic times.***

ACTIVITY 19 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 Nathan's Famous 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 %.)

2010	DineEquity (DIN)		Darden Restaurants (DRI)		Nathan's Famous (NATH)	
($ in millions)	$	CS%	$	CS%	$	CS%
Current assets	351.0	**12.3%**	678.5	12.9%	43.82	**82.1%**
PPE, net	612.2	**21.4%**	3,403.7	64.9%	5.47	**10.2%**
Goodwill + intangibles	1,533.4	**53.7%**	994.9	19.0%	1.44	**2.7%**
Other assets	360.0	**12.6%**	170.3	3.2%	2.63	**4.9%**
TOTAL ASSETS	**2,856.6**	100.0%	**5,247.4**	**100.0%**	**53.37**	100.0%
Current liabilities	265.1	**9.3%**	1,254.6	23.9%	7.16	**13.4%**
Long-term debt	2,013.0	**70.5%**	1,466.3	27.9%	0.0	**0.0%**
Other NC liabilities	494.7	**17.3%**	632.5	12.1%	1.91	**3.6%**
Contributed capital	234.5	**8.2%**	2,297.9	43.8%	52.1	**97.6%**
Retained earnings	124.3	**4.3%**	2,621.9	50.0%	16.8	**31.5%**
Other SE	(275.0)	**(9.6)%**	(3,025.8)	(57.7)%	(24.6)	**(46.1)%**
TOTAL L and SE	**2,856.6**	100.0%*	**5,247.4**	**100.0%**	**53.37**	100.0%

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

Refer to the information above to answer the following questions.

Q2 The debt ratio (Total liabilities / Total assets) for Darden Restaurants is **63.90%** or **0.6390** (decimal form).

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

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

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

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:

- ***Current assets comprise the majority of assets for NATH, but DRI is mainly invested in PP&E. This indicates that NATH franchises most of its restaurants, whereas DRI owns the majority of their restaurants.***
- ***Goodwill and intangibles comprise 53.7% of DIN's assets, indicating that growth is through acquisition.***
- ***Each company relies on different forms of primary financing … DIN relies most heavily on LT debt, whereas NATH relies on contributed capital. In comparison, DRI is more evenly balanced among the financing options.***

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

Using a common-size statement allows easier comparison between companies of different size. 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 20 ANALYSIS OF YUM! BRANDS

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

YUM! BRANDS (YUM) BALANCE SHEET ($ in millions)				
ASSETS	**12/25/2010**	**12/26/2009**	**12/27/2008**	**12/29/2007**
Cash and cash equivalents	$ 1,426	$ 353	$ 216	$ 789
Accounts receivable	256	239	229	225
Inventories	189	122	143	128
Other current assets	442	494	363	339
Property, plant, and equipment	7,103	7,247	6,897	7,132
Accumulated depreciation	(3,273)	(3,348)	(3,187)	(3,283)
PPE, net	3,830	3,899	3,710	3,849
Goodwill and other intangibles	1,134	1,102	940	1,026
Long-term investments	154	144	65	153
Other noncurrent assets	885	795	861	679
TOTAL ASSETS	**$8,316**	**$7,148**	**$6,527**	**$7,188**
LIABILITIES				
Accounts payable	$ 540	$ 499	$ 508	$ 519
Short-term debt	673	59	25	288
Other current liabilities	1,235	1,095	1,189	1,255
Long-term debt	2,915	3,207	3,564	2,924
Other noncurrent liabilities	1,377	1,263	1,349	1,063
STOCKHOLDERS' EQUITY				
Contributed capital (CC)	86	253	7	0
Retained earnings (RE)	1,717	996	303	1,119
Other stockholders' equity (SE)	(227)	(224)	(418)	20
TOTAL L & SE	**$8,316**	**$7,148**	**$6,527**	**$7,188**

YUM! BRANDS (YUM) Classified Balance Sheet / Common-Size Statements ($ in millions)								
	12/25/2010		12/26/2009		12/27/2008		12/29/2007	
	$	CS%	$	CS%	$	CS%	$	CS%
Current assets	2,313	27.8%	1,208	16.9%	951	14.6%	1,481	20.6%
PPE, net	3,830	46.1%	3,899	54.6%	3,710	56.8%	3,849	53.5%
Goodwill +Intang.	1,134	13.6%	1,102	15.4%	940	14.4%	1,026	14.3%
Other assets	1,039	12.5%	939	13.1%	926	14.2%	832	11.6%
TOTAL ASSETS	8,316	100.0%	7,148	100.0%	**6,527**	**100.0%**	**7,188**	**100.0%**
C liabilities	2,448	29.4%	1,653	23.1%	1,722	26.4%	2,062	28.7%
NC liabilities	4,292	51.6%	4,470	62.6%	4,913	75.3%	3,987	55.5%
TOTAL LIAB	6,740	81.0%	6,123	85.7%	**6,635**	**101.7%**	**6,049**	**84.2%**
CCapital	86	1.0%	253	3.5%	7	0.0%	0	0.0%
REarnings	1,717	20.7%	996	13.9%	303	4.7%	1,119	15.5%
Other SE	(227)	(2.7)%	(224)	(3.1)%	(418)	(6.4)%	20	0.3%
TOTAL SE	1,576	19.0%	1,025	14.3%	**(108)**	**(1.7)%**	**1,139**	**15.8%**

YUM! BRANDS (YUM) RATIOS					
	Industry Norm	12/25/2010	12/26/2009	12/27/2008	12/29/2007
Current ratio	*1.10*	**0.95**	**0.73**	0.55	0.72
Debt ratio	*52%*	**81%**	**86%**	102%	84%

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 **$1,128** million since 12/29/2007, an increase of **16%**, which is the result of (**purchasing additional assets** / **issuing more common stock** / **increasing net income**). This company has a major investment in (**inventories** / **PPE** / **goodwill**), which (**is** / **is not**) expected.

Q3 On 12/29/2007, 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 $322 million in 2008, $362 million in 2009, and $412 million in 2010. Use this information to compute net income for:

2010 **$1,133** million; 2009 **$1,055** million; 2008 **$(494)** million

2008 (Beg RE $1,119 + NI – Div $322 = Ending RE $ 303)

2009 (Beg RE $ 303 + NI – Div $362 = Ending RE $ 996)

2010 (Beg RE $ 996 + NI – Div $412 = Ending RE $1,717)

Q5 For 12/26/2009 and 12/25/2010 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 12/29/2007 and 12/27/2008 have already been completed.

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

Q6 For 12/26/2009 and 12/25/2010 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 12/29/2007 and 12/27/2008 have already been completed. ***Comment*** on the trends in Total Liabilities and Total Stockholders' Equity and what this indicates.

Assets have increased moderately while liabilities have been holding steady, decreasing the debt ratio from 84% in 2007 down to 81% in 2010, reducing financial risk.

After the net loss in 2008, profitability has returned increasing retained earnings, and in turn, increasing total stockholders' equity. This is reflected in total stockholders' equity moving from 15.8% of assets in 2007 up to 19% of assets in 2010.

Q7 For 12/26/2009 and 12/25/2010 compute the current ratio and the debt ratio. Record your results in the area provided above. Ratios for 12/29/2007 and 12/27/2008 have already been computed. ***Comment*** on the results.

The current ratio increased dramatically from a low of 0.72 in 2007 to a high of 0.95 in 2010, heading towards the industry norm of 1.10, indicating increased liquidity.
The debt ratio increased from 84% on 12/29/2007 to 102% on 12/27/2008, revealing the company's increased reliance on debt financing, and therefore, increased financial risk. However, by 2010 year end, the debt ratio declined to 81%, still much higher than the industry norm, but down to a level of reasonable financial risk.

Q8 If you had $10,000, would you consider investing in this company? (**Yes / No**) *Why*?
Support your response with at least three good reasons.
Either choice may be correct if supported with good reasons.

Yes … the recovering economy has allowed this restaurant company to regain its footing after a few tough years, with profitability and financial risk returning back to 2007 levels. Evidence is reflected in the following:

- ***Total assets increased moderately during a poor economy.***
- ***After reporting a net loss in 2008, YUM has returned to profitability. Retained earnings has increased from 15.5% of assets in 2007 up to 20.7% of assets in 2010. Steady dividend payments continue.***
- ***The current ratio is climbing toward the industry norm, signaling increased liquidity.***
- ***Long-term debt is back down to the 2007 level, whereas noncurrent liabilities as a percentage of sales and the debt ratio are back down and even below 2007 levels, indicating a significant decrease in financial risk compared to the prior two years.***

No … the economy has a ways to go before getting back to a healthy normal, so I prefer not to invest. In addition, the current ratio and the debt ratio still indicate greater financial risk than industry norms.

ACTIVITY 21 ANALYSIS OF MCDONALD'S

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

McDONALD's (MCD) BALANCE SHEET ($ in millions)				
ASSETS	**12/31/2010**	**12/31/2009**	**12/31/2008**	**12/31/2007**
Cash and cash equivalents	$ 2,387.0	$ 1,796.0	$ 2,063.4	$ 1,981.3
Accounts receivable	1,179.1	1,060.4	931.2	1,053.8
Inventories	109.9	106.2	111.5	125.3
Other current assets	692.5	453.7	411.5	421.5
Property, plant, and equipmt	$34,482.4	$33,440.5	$31,152.4	$32,203.7
Accumulated depreciation	(12,421.8)	(11,909.0)	(10,897.9)	(11,219.0)
PPE, net	22,060.6	21,531.5	20,254.5	20,984.7
Goodwill	2,586.1	2,425.2	2,237.4	2,301.3
Long-term investments	1,335.3	1,212.7	1,222.3	1,156.4
Other noncurrent assets	1,624.7	1,639.2	1,229.7	1,367.4
TOTAL ASSETS	**$31,975.2**	**$30,224.9**	**$28,461.5**	**$29,391.7**
LIABILITIES				
Accounts payable	$ 943.9	$ 636.0	$ 620.4	$ 624.1
Short-term debt	0.0	0.0	0.0	1,126.6
Other current liabilities	1,980.8	2,352.7	1,917.5	2,747.8
Long-term debt	11,497.0	10,560.3	10,186.0	7,310.0
Other noncurrent liabilities	2,919.3	2,642.0	2,355.0	2,303.4
STOCKHOLDERS' EQUITY				
Common stock, par	16.6	16.6	16.6	16.6
Additional paid-in capital	5,196.4	4,853.9	4,600.2	4,226.7
Retained earnings	33,811.7	31,270.8	28,953.9	26,461.5
Treasury stock	(25,143.4)	(22,854.8)	(20,289.4)	(16,762.4)
Other stockholders' equity	752.9	747.4	101.3	1,337.4
TOTAL L & SE	**$31,975.2**	**$30,224.9**	**$28,461.5**	**$29,391.7**

McDONALD's Classified Balance Sheet / Trend Analysis ($ in millions)								
	12/31/2010		**12/31/2009**		**12/31/2008**		**12/31/2007**	
	$	Trend	$	Trend	$	Trend	**BASE YEAR**	
Current assets	4,368.5	122	3,416.3	95	3,517.6	98	3,581.9	100
PPE, net	22,060.6	105	21,531.5	103	20,254.5	97	20,984.7	100
Goodwill	2,586.1	112	2,425.2	105	2,237.4	97	2,301.3	100
Other assets	2,960.0	117	2,851.9	113	2,452.0	97	2,523.8	100
TOTAL Assets	31,975.2	109	30,224.9	103	**28,461.5**	**97**	**29,391.7**	**100**
Current liabilities	2,924.7	65	2,988.7	66	2,537.9	56	4,498.5	100
NC Liabilities	14,416.3	150	13,202.3	137	12,541.0	130	9,613.4	100
TOTAL Liab	17,341.0	123	16,191.0	115	**15,078.9**	**107**	**14,111.9**	**100**
Contributed capital	5,213.0	123	4,870.5	115	4,616.8	109	4,243.3	100
Retained earnings	33,811.7	128	31,270.8	118	28,953.9	109	26,461.5	100
Other SE	(24,390.5)	(158)	(22,107.4)	(143)	(20,188.1)	131	(15,425.0)	100
TOTAL SE	14,634.2	96	14,033.9	92	**13,382.6**	**88**	**15,279.8**	**100**

McDONALD's (MCD) RATIOS					
	Industry Norm	12/31/2010	12/31/2009	12/31/2008	12/31/2007
Current ratio	*1.10*	**1.49**	**1.14**	1.39	0.80
Debt ratio	*52%*	**54%**	**54%**	53%	48%

Refer to McDonald's balance sheets 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 more than 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 (**inventories** / **PPE** / **goodwill**). On average, the PPE has been used for (**more** / **less**) than half of its useful life.

Q3 *Long-term debt* was borrowed during (**2010** / **2009** / **2008**).

Q4 This company was able to attract new shareholders during (**2010** / **2009** / **2008**). As of 12/31/2010 shareholders have contributed a total of **$5,213.0** million to this corporation.

Q5 This company distributed dividends of $1,823.4 million in 2008, $2,235.5 million in 2009, and $2,408.1 million in 2010. Use this information to compute net income for:

2010 **$4,949.0** million; 2009 **$4,552.4** million; 2008 **$4,315.8** million

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

2009 (Beg RE $28,953.9 + NI – Div $2,235.5 = Ending RE $31,270.8)

2010 (Beg RE $31,270.8 + NI – Div $2,408.1 = Ending RE $33,811.7)

Q6 Treasury stock results from (**selling assets** / **refinancing debt** / **repurchasing common stock**). Additional *treasury stock* was acquired during (**2010** / **2009** / **2008**).

Q7 For 12/31/2009 and 12/31/2010 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 12/31/2007 and 12/31/2008 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**), which is (**internal** / **external**) financing.

Q9 For 12/31/2009 and 12/31/2010 complete the trend analysis by dividing each amount by the amount for the base year of 12/31/2007, and then multiply by 100. Record the resulting *trend index* in the area provided on the previous page. For 12/31/2007 and 12/31/2008 the trend indexes have already been computed.

Q10 *Refer to the trend index.* At the end of 2008, assets were (**above** / **below**) base year levels, an indication of a (**recovering** / **poor**) economy, while at the end of 2010 assets were (**above** / **below**) base year levels, an indication of a (**recovering** / **poor**) economy.
Since the base year, total assets (**increased** / **decreased**) by **9%**, total liabilities (**increased** / **decreased**) by **23%**, while total stockholders' equity (**increased** / **decreased**) by **4%**, indicating a greater reliance on (**debt** / **equity**) financing.
Current liabilities (**increased** / **decreased**) by **35%**, while noncurrent liabilities (**increased** / **decreased**) by **50%,** indicating (**greater** / **lesser**) reliance on long-term financing.
Retained earnings (**increased** / **decreased**) by **28%,** which is the result of (**purchasing additional assets** / **acquiring other companies** / **reporting net income**).

Q11 For 12/31/2009 and 12/31/2010 compute the current ratio and the debt ratio. Record your results in the area provided above. Ratios for 12/31/2007 and 12/31/2008 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 increased 22% while current liabilities decreased 35%, causing the current ratio to sky-rocket to 1.49, significantly above the industry norm, indicating strong liquidity.***
- ***Contributed capital increased by 23%, indicating the company is able to attract investors.***
- ***Retained earnings increased each year, indicating three years of profitability.***
- ***Treasury stock increased each year, indicating fewer common shares outstanding, resulting in a possible EPS increase.***

b. warning signs or signs of financial weakness.

Over this three year period…

- ***Current liabilities decreased by 35%, while noncurrent liabilities increased by 50%, indicating a shift toward long-term financing.***
- ***The debt ratio moved from 48% to 54%, a bit 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?

Either choice may be correct if supported with good reasons.

Yes …

- ***The company is financially stable and continues to produce steady profits.***
- ***Assets grew by 9% since the base year, indicating slow growth.***
- ***Contributed capital grew by 23% since the base year, indicating the continued ability to attract investors.***
- ***Retained earnings grew by 28% since the base year, indicating continued profitability and the ability to attract customers.***

No …

- ***Company growth appears rather sluggish.***
- ***There is a shift toward greater reliance on long-term debt.***

ACTIVITY 22 TEST YOUR UNDERSTANDING

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

BALANCE SHEETS ($ in millions)				
ASSETS	**CORP A 6/30/2010**	**CORP B 5/31/2010**	**CORP C 12/31/2010**	**CORP D 12/31/2010**
Cash and cash equivalents	$ 344.6	$ 3,079.1	$ 1,526.4	$ 27,972
Short-term investments	0.0	2,066.8	1,357.7	1,044,590
Accounts receivable	45.1	2,649.8	1,028.9	608,139
Inventories	26.7	2,040.8	0.0	0
Other current assets	84.6	1,122.7	432.6	0
Property, plant, and equipment	2,099.3	4,389.8	2,551.2	0.0
Accumulated depreciation	(970.3)	(2,457.9)	(897.8)	0.0
PPE, net	1,129.0	1,931.9	1,653.4	0
Goodwill + Intangibles	124.1	654.6	3,937.5	38,210
Long-term investments	0.0	0.0	4,803.0	0
Other noncurrent assets	98.0	873.6	188.6	194,991
TOTAL ASSETS	**$1,852.1**	**$14,419.3**	**$14,928.1**	**$1,913,902**
LIABILITIES				
Accounts payable	$ 112.8	$ 1,254.5	$ 162.4	$ 51,749
Short-term debt	0.0	138.6	0.0	258,348
Other current liabilities	337.1	1,971.1	1,463.5	873,168
Long-term debt	524.5	445.8	142.8	362,983
Other noncurrent liabilities	149.0	855.3	601.3	204,186
STOCKHOLDERS' EQUITY				
Contributed capital	483.4	3,443.4	10,111.2	101,628
Retained earnings	1,923.6	6,095.5	1,942.7	79,559
Other stockholders' equity	(1,678.3)	215.1	504.2	(17,719)
TOTAL L & SE	**$1,852.1**	**$14,419.3**	**$14,928.1**	**$1,913,902**

Classified Balance Sheets / Common-Size Statements ($ in millions)								
	A 6/30/2010		B 5/31/2010		C 12/31/2010		D 12/31/2010	
	$	CS%	$	CS%	$	CS%	$	CS%
Current assets	501.0	27.0	10,959.2	76.0	4,345.6	29.1	1,680,701	87.8
PPE, net	1,129.0	61.0	1,931.9	13.4	1,653.4	11.1	-0-	0.0
Goodwill+	124.1	6.7	654.6	4.5	3,937.5	26.4	38,210	2.0
Other assets	98.0	5.3	873.6	6.1	4,991.6	33.4	194,991	10.2
TTL Assets	**1,852.1**	**100.0**	**14,419.3**	**100.0**	**14,928.1**	**100.0**	**1,913,902**	**100.0**
C Liabilities	449.9	24.3	3,364.2	23.3	1,625.9	10.9	1,183,265	61.8
NC Liabilities	673.5	36.4	1,301.1	9.0	744.1	5.0	567,169	29.7
TTL Liab	**1,123.4**	**60.7**	**4,665.3**	**32.3**	**2,370.0**	**15.9**	**1,750,434**	**91.5**
Cont capital	483.4	26.1	3,443.4	23.9	10,111.2	67.7	101,628	5.3
R/Earnings	1,923.6	103.9	6,095.5	42.3	1,942.7	13.0	79,559	4.2
Other SE	(1,678.3)	(90.7)	215.1	1.5	504.2	3.4	(17,719)	(1.0)
TTL SE	**728.7**	**39.3**	**9,754.0**	**67.7**	**12,558.1**	**84.1**	**163,468**	**8.5**

	CORP A	CORP B	CORP C	CORP D
RATIOS	**6/25/2010**	**5/31/2010**	**12/31/2010**	**12/31/2010**
Current ratio	1.11	3.26	2.67	1.42
Debt ratio	61%	32%	16%	91%

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, ST or LT investments?		X	X	X
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			
Finances assets primarily with…				
liabilities?				X Liab
contributed capital?			X CC	
retained earnings?	X RE	X RE		
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 more than 180 countries around the world.

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

Nike sells athletic products, 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, 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.