Harrod's Sporting Goods

In January of 2016, Becky, who served as the company's chief financial officer, walked into Jim's office and said, "I've had it with the First National Bank of Omaha. It is willing to renew our loan and line of credit, but the bank wants to charge us 2½ percentage points over prime." The prime rate is the rate at which banks make loans to their most creditworthy customers. It was 4.75 percent at the time Becky had visited the bank, so that the total rate on the loan would be 7.25 percent. It was not so much the total rate that Becky objected to, as the fact that Harrod's was being asked to pay 2½ percent over prime. She felt that Harrod's was a strong enough company that one percent over prime should be all that the bank required. Her banker told her he would review the firm's financial statements with her next week and reconsider the premium Harrod's was being asked to pay over prime.

While Becky knew the bank "crunched all the numbers," she decided to do some additional financial analysis on her own. She had a bachelor's degree in finance with a 3.3 GPA. She began by examining Figures 1, 2, and 3 below.

Figure 1

Harrod's Sporting Goods

Income Statement

(2013-2015)

	2013	**2014**	**2015**
Sales	$4,269,871	$4,483,360	$5,021,643
Cost of goods sold	2,991,821	2,981,434	3,242,120
Gross Profit	$1,278,050	$1,501,926	$1,779,523
Selling and administrative expense	865,450	1,004,846	1,175,100
Operating profit	$412,600	$497,080	$604,423

Interest expense	115,300	122,680	126,241
Extraordinary loss	__	__	170,000
Net income before taxes	297,300	374,400	308,182
Taxes	104,100	131,300	107,864
Net income	$ 193,200	$ 243,100	$ 200,318

Figure 2

Harrod's Sporting Goods

Balance Sheet

(2013-2015)

	2013	**2014**	**2015**
Cash	$ 121,328	$ 125,789	$ 99,670
Marketable securities	56,142	66,231	144,090
Accounts receivable	341,525	216,240	398,200
Inventory	972,456	1,250,110	1,057,008
Total current assets	$1,491,451	$1,658,370	$1,698,968

Net plant and equipment	1,678,749	1,702,280	1,811,142
Total assets	$3,170,200	$3,360,650	$3,510,110
Liabilities and Stockholders' Equity			
Accounts payable	$ 539,788	$ 576,910	$ 601,000
Notes payable	160,540	180,090	203,070
Total current liabilities	$700,328	$757,000	$804,070
Long-term liabilities	1,265,272	1,292,995	1,372,240
Total liabilities	$1,965,600	$2,049,995	$2,176,310
Common stock	367,400	368,000	368,000
Retained earnings[1]	837,200	942,665	965,800
Total Stockholders' equity	1,204,600	1,310,655	1,333,800
Total liabilities and stockholders' equity	$3,170,200	$3,360,650	$3,510,110

[1] Withdrawal of funds in the form of dividends or other means makes the increase in retained earnings less than net income.

Figure 3

Harrod's Sporting Goods
Selected Industry Ratios for 2015

1.	Net income/Sales	4.51%
2a.	Net income/Total Assets	5.10%
2b.	Sales/Total Assets	1.33 x
3a.	Net income/Stockholder's Equity	9.80%
3b.	Debt/Total Assets	0.48
4.	Sales/Receivables	5.75 x
5.	Sales/Inventory	3.01 x
6.	Sales/Fixed Assets	3.20 x

+

Required Activities:

1. **Calculate** the profitability ratios for all three years using the formulas provided in section "A. Profitability Ratios" within Chapter 3:
    1. Profit margin
    2. Return on assets (a and b)
    3. Return on equity (a and b)

2. **Write** a one-paragraph description of any trends that appear to have taken place over the three-year time period.

3. **Examine** the income statement in Figure 1 above. *Note* that there was an extraordinary loss of $170,000 in 2015. This might have represented uninsured losses from a fire, a lawsuit settlement, etc. It probably does not represent a recurring event or affect the earnings capability of the firm. For that reason, the astute financial analyst might add back in the extraordinary loss to gauge the true operating earnings of the firm. Since it was a tax-deductible item, we must first multiply by (1-tax rate) before adding it back in.* The tax rate was 35 percent for the year.

$170,000	Extraordinary loss
.65	(1-tax rate)
$110,500	After-tax addition to profits from eliminating the extraordinary loss from net income

The more representative net income number for 2015 would now be:

Initially reported (Figure 1 above)	$200,318
Adjustment for extraordinary loss being eliminated	+110,500
Adjusted net income	$310,818

Note: This adjustment was made because the $170,000 deduction saved 35 percent of this amount in taxes. If we eliminate the $170,000, the tax benefit would also be eliminated. Thus, the firm would only benefit by 65 percent of $170,000, based on a 35 percent tax rate. The after-tax benefit of the tax adjustment for the extraordinary loss is $110,500.

A. **Recompute** the same ratios for 2015 using the adjusted net income figure of $310,818.

4. **Write** a one-paragraph description of trends that appear to have taken place over the three-year time period (Refer to question 1 above for 2013 and 2014 data and question 3 above for the adjusted net income numbers for 2015).

5. **Write** a one-paragraph analysis of the company's profitability ratios compared to the industry ratios (Figure 3 above) using the revised ratios for 2015 from question 3 above. Include asset turnover and debt to total assets as supplemental material in your analysis.

6. **Calculate** the Asset Utilization ratios for 2015 using the formulas provided in section "B. Asset Utilization Ratios" within Chapter 3:

1. Receivable turnover (*Note:* For the Receivables turnover ratio, only half the sales are on credit terms.)
2. Inventory turnover
3. Fixed Asset turnover

7. **Write** a brief one-paragraph description of any trends that appear to have taken place. Compare Harrod's sales to total assets ratio to the industry in your description.

8. **Write** a one-paragraph conclusion that provides analysis of your answers to questions 4 and 5 above.
    a. Include your opinion on whether or not Becky Harrod has a legitimate complaint about being charged 2½ percent, instead of 1 percent over prime.