**Case Solutions**

***Fundamentals of Corporate Finance***

**Ross, Westerfield, and Jordan**

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***CHAPTER 1***

**THE McGEE CAKE COMPANY**

**1.** The advantages to an LLC are: (*a*) Reduction of personal liability. A sole proprietor has unlimited liability, which can include the potential loss of all personal assets. (*b*) Taxes. Forming an LLC may mean that more expenses can be considered business expenses and be deducted from the company’s income. (*c*) Improved credibility. The business may have increased credibility in the business world compared to a sole proprietorship. (*d*) Ability to attract investment. Corporations, even LLCs, can raise capital through the sale of equity. (*e*) Continuous life. Sole proprietorships have a limited life, while corporations have a potentially perpetual life. (*f*) Transfer of ownership. It is easier to transfer ownership in a corporation through the sale of stock.

The biggest disadvantage is the potential cost, although the cost of forming an LLC can be relatively small. There are also other potential costs, including more expansive record-keeping.

**2.** Forming a corporation has the same advantages as forming an LLC, but the costs are likely to be higher.

**3.** As a small company, changing to a LLC is probably the most advantageous decision at the current time. If the company grows, and Doc and Lyn are willing to sell more equity ownership, the company can reorganize as a corporation at a later date. Additionally, forming an LLC is likely to be less expensive than forming a corporation.

***CHAPTER 2***

**CASH FLOWS AND FINANCIAL STATEMENTS AT SUNSET BOARDS**

Below are the financial statements that you are asked to prepare.

**1.** The income statement for each year will look like this:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | *Income Statement* | | | |
|  |  | *2020* |  | *2021* |
|  | Sales | $601,729 |  | $733,469 |
|  | Cost of goods sold | 306,726 |  | 387,290 |
|  | Selling and administrative | 60,322 |  | 78,732 |
|  | Depreciation | 86,590 |  | 97,871 |
|  | EBIT | $148,091 |  | $169,576 |
|  | Interest | 18,824 |  | 21,576 |
|  | EBT | $129,267 |  | $148,000 |
|  | Taxes | 27,146 |  | 31,080 |
|  | Net income | $102,121 |  | $116,920 |

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | Dividends | $40,848 |  | $46,768 |
|  | Addition to retained earnings | $61,273 |  | $70,152 |

**2.** The balance sheet for each year will be:

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | *Balance Sheet as of Dec. 31, 2020* | | | | | |
|  | Cash | $44,261 |  |  | Accounts payable | $31,423 |
|  | Accounts receivable | 31,363 |  |  | Notes payable | 35,654 |
|  | Inventory | 60,382 |  |  | Current liabilities | $67,077 |
|  | Current assets | $136,006 |  |  |  |  |
|  |  |  |  |  | Long-term debt | $192,827 |
|  | Net fixed assets | $382,014 |  |  | Owners' equity | $258,116 |
|  | Total assets | $518,020 |  |  | Total liab. and equity | $518,020 |

In the first year, equity is not given. Therefore, we must calculate equity as a plug variable. Since total liabilities and equity is equal to total assets, equity can be calculated as:

Equity = $518,020 – 67,077 – 192,827

Equity = $258,116

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | *Balance Sheet as of Dec. 31, 2021* | | | | | |
|  | Cash | $66,870 |  |  | Accounts payable | $53,181 |
|  | Accounts receivable | 40,681 |  |  | Notes payable | 38,929 |
|  | Inventory | 81,209 |  |  | Current liabilities | $92,110 |
|  | Current assets | $188,760 |  |  |  |  |
|  |  |  |  |  | Long-term debt | $210,408 |
|  | Net fixed assets | $465,426 |  |  | Owners' equity | $351,668 |
|  | Total assets | $654,186 |  |  | Total liab. and equity | $654,186 |

The owner’s equity for 2021 is the beginning of year owners’ equity, plus the addition to retained earnings, plus the new equity, so:

Equity = $258,116 + 70,152 + 23,400

Equity = $351,668

**3.** Using the OCF equation:

OCF = EBIT + Depreciation – Taxes

The OCF for each year is:

OCF2020 = $148,091 + 86,590 – 27,146

OCF2020 = $207,535

OCF2021 = $169,576 + 97,871 – 31,080

OCF2021 = $236,367

**4.** To calculate the cash flow from assets, we need to find the capital spending and change in net working capital. The capital spending for the year was:

|  |  |  |
| --- | --- | --- |
|  | *Capital spending* |  |
|  | Ending net fixed assets | $465,426 |
|  | – Beginning net fixed assets | 382,014 |
|  | + Depreciation | 97,871 |
|  | Net capital spending | $181,283 |

And the change in net working capital was:

|  |  |  |
| --- | --- | --- |
|  | *Change in net working capital* | |
|  | Ending NWC | $96,650 |
|  | – Beginning NWC | 68,929 |
|  | Change in NWC | $27,721 |

So, the cash flow from assets was:

|  |  |  |
| --- | --- | --- |
|  | *Cash flow from assets* |  |
|  | Operating cash flow | $236,367 |
|  | – Net capital spending | 181,283 |
|  | – Change in NWC | 27,721 |
|  | Cash flow from assets | $27,363 |

**5.** The cash flow to creditors was:

|  |  |  |
| --- | --- | --- |
|  | *Cash flow to creditors* |  |
|  | Interest paid | $21,576 |
|  | – Net new borrowing | 17,581 |
|  | Cash flow to creditors | $3,995 |

**6.** The cash flow to stockholders was:

|  |  |  |
| --- | --- | --- |
|  | *Cash flow to stockholders* |  |
|  | Dividends paid | $46,768 |
|  | – Net new equity raised | 23,400 |
|  | Cash flow to stockholders | $23,368 |

*Answers to questions*

**1.** The firm had positive earnings in an accounting sense (NI > 0) and had positive cash flow from operations. The firm invested $27,721 in new net working capital and $181,283 in new fixed assets. The firm gave $27,363 to its stakeholders. It paid $3,995 to bondholders and paid $23,368 to stockholders.

**2.** The expansion plans may be a little risky. The company does have a positive cash flow, but a large portion of the operating cash flow is already going to capital spending. The company has had to raise capital from creditors and stockholders for its current operations. So, the expansion plans may be too aggressive at this time. On the other hand, companies do need capital to grow. Before investing or loaning the company money, you would want to know where the current capital spending is going, and why the company is spending so much in this area already.