



# Chapter 6

## Financial Statement Analysis

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## Learning Objectives

**After studying Chapter 6, you should be able to:**

- Understand the purpose of basic financial statements and their contents.
- Explain why financial statement analysis is important to the firm and to outside suppliers of capital.
- Define, calculate, and categorize (according to liquidity, financial leverage, coverage, activity, and profitability) the major financial ratios and understand what they can tell us about the firm.
- Define, calculate, and discuss a firm's operating cycle and cash cycle.
- Use ratios to analyze a firm's health and then recommend reasonable alternative courses of action to improve the health of the firm.
- Analyze a firm's return on investment (i.e., "earning power") and return on equity using a DuPont approach.
- Understand the limitations of financial ratio analysis.
- Use trend analysis, common-size analysis, and index analysis to gain additional insights into a firm's performance.

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## Topics

- Financial Statements
- A Possible Framework for Analysis
- Balance Sheet Ratios
- Income Statement and Income Statement/Balance Sheet Ratios
- Trend Analysis
- Common-Size and Index Analysis

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## Examples of External Uses of Statement Analysis

- Trade Creditors -- Focus on the liquidity of the firm.
- Bondholders -- Focus on the long-term cash flow of the firm.
- Shareholders -- Focus on the profitability and long-term health of the firm.

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## Examples of Internal Uses of Statement Analysis

- **Plan** -- Focus on assessing the current financial position and evaluating potential firm opportunities.
- **Control** -- Focus on return on investment for various assets and asset efficiency.
- **Understand** -- Focus on understanding how suppliers of funds analyze the firm.

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## Primary Types of Financial Statements

### Balance Sheet

- ◆ A summary of a firm's financial position on a given date that shows total assets = total liabilities + owners' equity.

### Income Statement

- A summary of a firm's revenues and expenses over a specified period, ending with net income or loss for the period.

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## Basket Wonders' Balance Sheet (Asset Side)

Basket Wonders Balance Sheet (thousands) Dec. 31, 2007<sup>a</sup>

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Cash and C.E.	\$ 90	a. How the firm stands on a specific date.
Acct. Rec. <sup>c</sup>	394	b. What BW owned.
Inventories	696	c. Amounts owed by customers.
Prepaid Exp <sup>d</sup>	5	d. Future expense items already paid.
Accum Tax Prepay	<u>10</u>	e. Cash/likely convertible to cash within 1 year.
Current Assets <sup>e</sup>	\$1,195	f. Original amount paid.
Fixed Assets (@Cost) <sup>f</sup>	1030	g. Acc. deductions for wear and tear.
Less: Acc. Depr. <sup>g</sup>	(329)	
Net Fix. Assets	\$ 701	
Investment, LT	50	
Other Assets, LT	<u>223</u>	
Total Assets <sup>b</sup>	<u>\$2,169</u>	

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## Basket Wonders' Balance Sheet (Liability Side)

Basket Wonders Balance Sheet (thousands) Dec. 31, 2007

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Notes Payable	\$ 290	a. Note, Assets = Liabilities + Equity.
Acct. Payable <sup>c</sup>	94	b. What BW owed and ownership position.
Accrued Taxes <sup>d</sup>	16	c. Owed to suppliers for goods and services.
Other Accrued Liab. <sup>d</sup>	<u>100</u>	d. Unpaid wages, salaries, etc.
Current Liab. <sup>e</sup>	\$ 500	e. Debts payable < 1 year.
Long-Term Debt <sup>f</sup>	530	f. Debts payable > 1 year.
Shareholders' Equity		g. Original investment.
Com. Stock (\$1 par) <sup>g</sup>	200	h. Earnings reinvested.
Add Pd in Capital <sup>g</sup>	729	
Retained Earnings <sup>h</sup>	<u>210</u>	
Total Equity	\$1,139	
Total Liab/Equity <sup>a,b</sup>	<u>\$2,169</u>	

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## Basket Wonders' Income Statement

Basket Wonders Statement of Earnings (in thousands) for Year Ending Dec. 31, 2007<sup>a</sup>

Net Sales	\$ 2,211	a. Measures profitability over a time period.
Cost of Goods Sold <sup>b</sup>	<u>1,599</u>	
Gross Profit	\$ 612	b. Received, or receivable, from customers.
SG&A Expenses <sup>c</sup>	<u>402</u>	c. Sales comm., adv., officers' salaries, etc.
EBIT <sup>d</sup>	\$ 210	d. Operating income.
Interest Expense <sup>e</sup>	<u>59</u>	e. Cost of borrowed funds.
EBT <sup>f</sup>	\$ 151	f. Taxable income.
Income Taxes	<u>60</u>	
EAT <sup>g</sup>	\$ 91	g. Amount earned for shareholders.
Cash Dividends	<u>38</u>	
Increase in RE	\$ <u>53</u>	

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## Framework for Financial Analysis

Trend / Seasonal Component

How much funding will be required in the future?  
Is there a seasonal component?

1. Analysis of the funds needs of the firm.

Analytical Tools Used

Sources and Uses Statement  
Statement of Cash Flows  
Cash Budgets

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# Framework for Financial Analysis

1. Analysis of the funds needs of the firm.
2. Analysis of the financial condition and profitability of the firm.

## Health of a Firm

### Financial Ratios

1. Individually
2. Over time
3. In combination
4. In comparison

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# Framework for Financial Analysis

1. Analysis of the funds needs of the firm.
2. Analysis of the financial condition and profitability of the firm.
3. Analysis of the business risk of the firm.

**Business risk** relates to the risk inherent in the operations of the firm.

### Examples:

Volatility in sales

Volatility in costs

Proximity to break-even point

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**Framework for Financial Analysis**

1. Analysis of the funds needs of the firm.
2. Analysis of the financial condition and profitability of the firm.
3. Analysis of the business risk of the firm.

Determining the financing needs of the firm.

A *Financial Manager* must consider all three jointly when determining the financing needs of the firm.

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**Framework for Financial Analysis**

1. Analysis of the funds needs of the firm.
2. Analysis of the financial condition and profitability of the firm.
3. Analysis of the business risk of the firm.

Determining the financing needs of the firm.

Negotiations with suppliers of capital.

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## Use of Financial Ratios

A *Financial Ratio* is an index that relates two accounting numbers and is obtained by dividing one number by the other.

### Types of Comparisons

Internal Comparisons

External Comparisons

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## External Comparisons and Sources of Industry Ratios

This involves comparing the ratios of one firm with those of *similar* firms or with industry averages.

*Similarity* is important as one should compare “apples to apples.”

### Examples:

Risk Management Association

Dun & Bradstreet

Almanac of Business and Industrial Financial Ratios

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## Liquidity Ratios

Balance Sheet Ratios

Liquidity Ratios

Current

Current Assets

Current Liabilities

Shows a firm's ability  
to cover its current  
liabilities with its  
current assets.

For *Basket Wonders*  
December 31, 2007

$$\frac{\$1,195}{\$500} = 2.39$$

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## Liquidity Ratio Comparisons

**Current Ratio**

<u>Year</u>	<u>BW</u>	<u>Industry</u>
-------------	-----------	-----------------

2007	2.39	2.15
------	------	------

2006	2.26	2.09
------	------	------

2005	1.91	2.01
------	------	------

Ratio is stronger than the industry average.

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## Liquidity Ratios

Balance Sheet Ratios

Liquidity Ratios

Shows a firm's ability  
to meet current  
liabilities with its most  
liquid assets.

Acid-Test (Quick)

Current Assets - Inv  
Current Liabilities

For *Basket Wonders*  
December 31, 2007

$$\frac{\$1,195 - \$696}{\$500} = 1.00$$

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## Liquidity Ratio Comparisons

Acid-Test Ratio

<u>Year</u>	<u>BW</u>	<u>Industry</u>
2007	1.00	1.25
2006	1.04	1.23
2005	1.11	1.25

Ratio is weaker than the industry average.

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## Summary of the Liquidity Ratio Comparisons

<u>Ratio</u>	<u>BW</u>	<u>Industry</u>
Current	2.39	2.15
Acid-Test	1.00	1.25

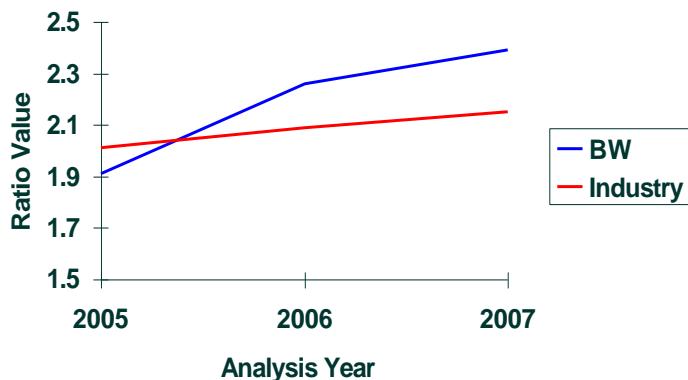
- Strong current ratio and weak acid-test ratio indicates a potential problem in the inventories account.
- Note that this industry has a relatively high level of inventories.

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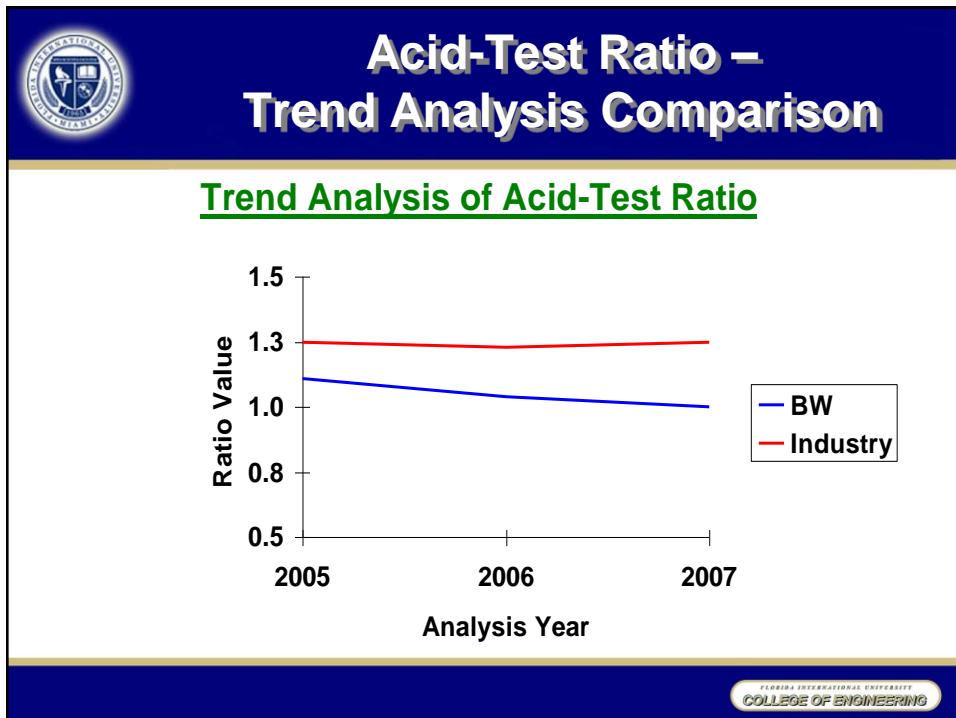


## Current Ratio – Trend Analysis Comparison

### Trend Analysis of Current Ratio



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## Summary of the Liquidity Trend Analyses

- The current ratio for *BW* has been rising at the same time the acid-test ratio has been declining.
- The current ratio for the *industry* has been rising slowly at the same time the acid-test ratio has been relatively stable.
- This indicates that inventories are a significant problem for *BW*.



## Financial Leverage Ratios

Balance Sheet Ratios

Financial Leverage  
Ratios

Shows the extent to  
which the firm is  
financed by debt.

Debt-to-Equity

Total Debt  
Shareholders' Equity

For *Basket Wonders*  
December 31, 2007

$$\frac{\$1,030}{\$1,139} = .90$$

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## Financial Leverage Ratio Comparisons

Debt-to-Equity Ratio

<u>Year</u>	<u>BW</u>	<u>Industry</u>
-------------	-----------	-----------------

2007	.90	.90
------	-----	-----

2006	.88	.90
------	-----	-----

2005	.81	.89
------	-----	-----

BW has average debt utilization  
relative to the industry average.

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## Financial Leverage Ratios

Balance Sheet Ratios

Financial Leverage  
Ratios

Shows the percentage  
of the firm's assets that  
are supported by debt  
financing.

Debt-to-Total-Assets

Total Debt  
Total Assets

For *Basket Wonders*  
December 31, 2007

$$\frac{\$1,030}{\$2,169} = .47$$

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## Financial Leverage Ratio Comparisons

Debt-to-Total-Asset Ratio

<u>Year</u>	<u>BW</u>	<u>Industry</u>
2007	.47	.47
2006	.47	.47
2005	.45	.47

BW has average debt utilization  
relative to the industry average.

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## Financial Leverage Ratios

Balance Sheet Ratios

Financial Leverage  
Ratios

Shows the relative  
importance of long-term  
debt to the long-term  
financing of the firm.

**Total Capitalization**  
(i.e., LT-Debt + Equity)

Long-term Debt  
Total Capitalization

For *Basket Wonders*  
December 31, 2007

$$\frac{\$530}{\$1,669} = .32$$

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## Financial Leverage Ratio Comparisons

**Total Capitalization Ratio**

<u>Year</u>	<u>BW</u>	<u>Industry</u>
-------------	-----------	-----------------

2007	.32	.30
------	-----	-----

2006	.32	.31
------	-----	-----

2005	.37	.32
------	-----	-----

BW has average long-term debt utilization  
relative to the industry average.

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## Coverage Ratios

Income Statement  
Ratios

Coverage Ratios

Indicates a firm's  
ability to cover interest  
charges.

### Interest Coverage

$$\frac{\text{EBIT}}{\text{Interest Charges}}$$

For *Basket Wonders*  
December 31, 2007

$$\frac{\$210}{\$59} = 3.56$$

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## Coverage Ratio Comparisons

### Interest Coverage Ratio

<u>Year</u>	<u>BW</u>	<u>Industry</u>
-------------	-----------	-----------------

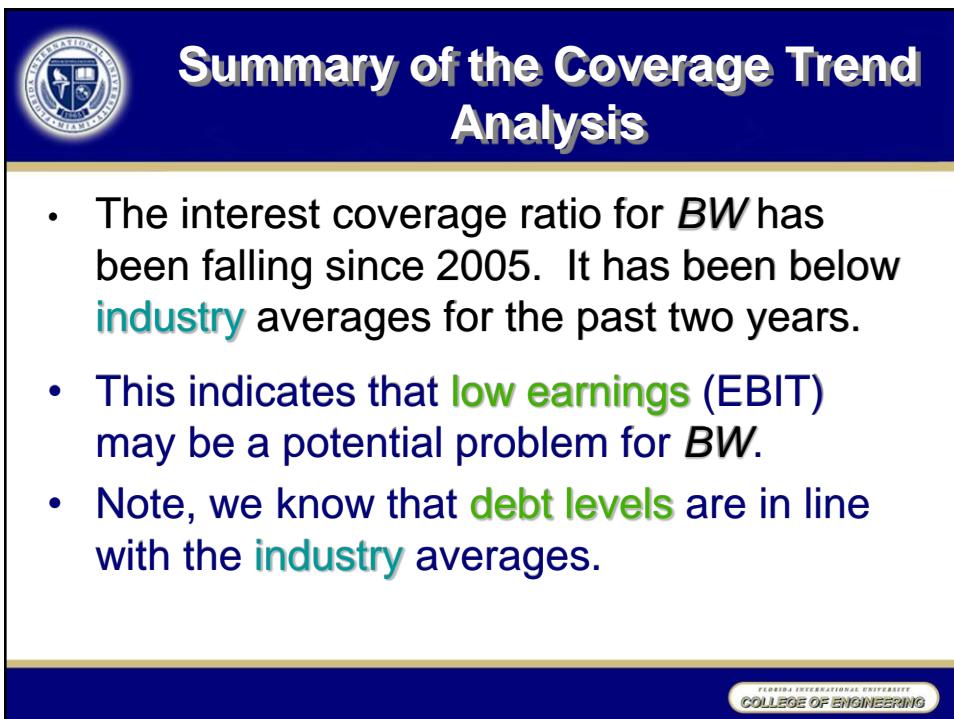
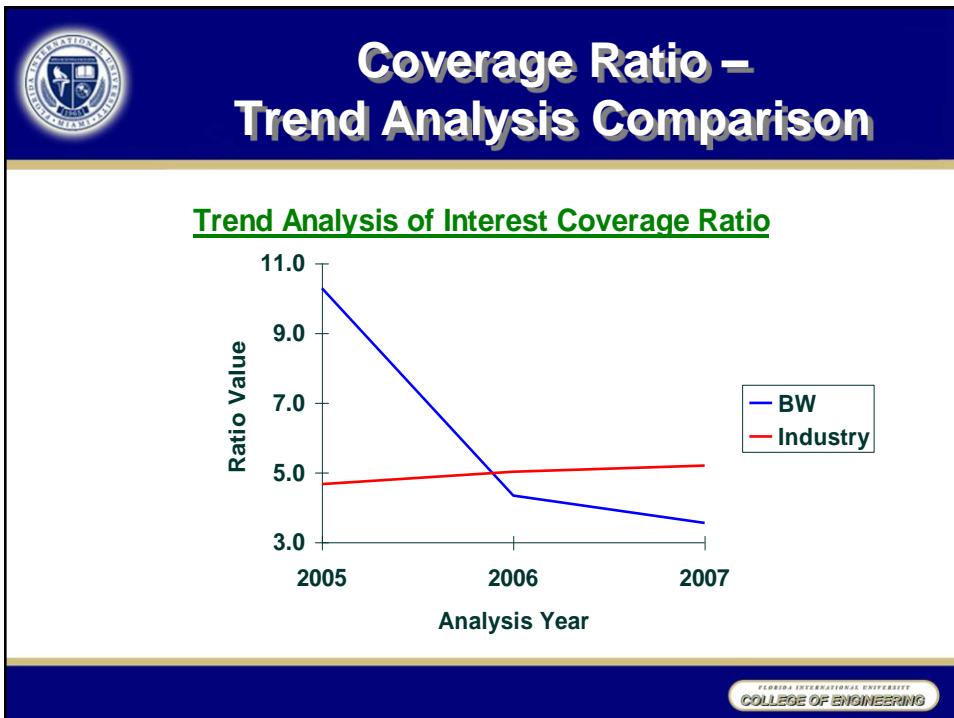
2007	3.56	5.19
------	------	------

2006	4.35	5.02
------	------	------

2005	10.30	4.66
------	-------	------

BW has below average interest coverage  
relative to the industry average.

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## Activity Ratios

Income Statement /  
Balance Sheet  
Ratios

### Activity Ratios

Indicates quality of receivables and how successful the firm is in its collections.

#### Receivable Turnover

(Assume all sales are credit sales.)

Annual Net Credit Sales

Receivables

For *Basket Wonders*  
December 31, 2007

$$\frac{\$2,211}{\$394} = 5.61$$

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## Activity Ratios

Income Statement /  
Balance Sheet  
Ratios

### Activity Ratios

Average number of days that receivables are outstanding.  
(or RT in days)

#### Avg Collection Period

Days in the Year  
Receivable Turnover

For *Basket Wonders*  
December 31, 2007

$$\frac{365}{5.61} = 65 \text{ days}$$

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## Activity Ratio Comparisons

### Average Collection Period

<u>Year</u>	<u>BW</u>	<u>Industry</u>
2007	65.0	65.7
2006	71.1	66.3
2005	83.6	69.2

BW has improved the average collection period to that of the industry average.

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## Activity Ratios

Income Statement /  
Balance Sheet  
Ratios

Activity Ratios

Indicates the promptness  
of payment to suppliers by  
the firm.

### Payable Turnover (PT)

(Assume annual credit  
purchases = \$1,551.)

Annual Credit Purchases  
Accounts Payable

For *Basket Wonders*  
December 31, 2007

$$\frac{\$1551}{\$94} = 16.5$$

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## Activity Ratios

**Income Statement / Balance Sheet Ratios**

Activity Ratios

Average number of days that payables are outstanding.

*PT in Days*

$\frac{\text{Days in the Year}}{\text{Payable Turnover}}$

For Basket Wonder  

$$\frac{365}{16.5} = 22.1 \text{ days}$$

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## Activity Ratio Comparisons

### Payable Turnover in Days

<u>Year</u>	<u>BW</u>	<u>Industry</u>
2007	22.1	46.7
2006	25.4	51.1
2005	43.5	48.5

BW has improved the PT in Days.  
**Is this good?**

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# Activity Ratios

Income Statement /  
Balance Sheet  
Ratios

Activity Ratios

Indicates the effectiveness of the inventory management practices of the firm.

Inventory Turnover

Cost of Goods Sold  
Inventory

For *Basket Wonders*  
December 31, 2007

$$\frac{\$1,599}{\$696} = 2.30$$

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# Activity Ratio Comparisons

Inventory Turnover Ratio

<u>Year</u>	<u>BW</u>	<u>Industry</u>
-------------	-----------	-----------------

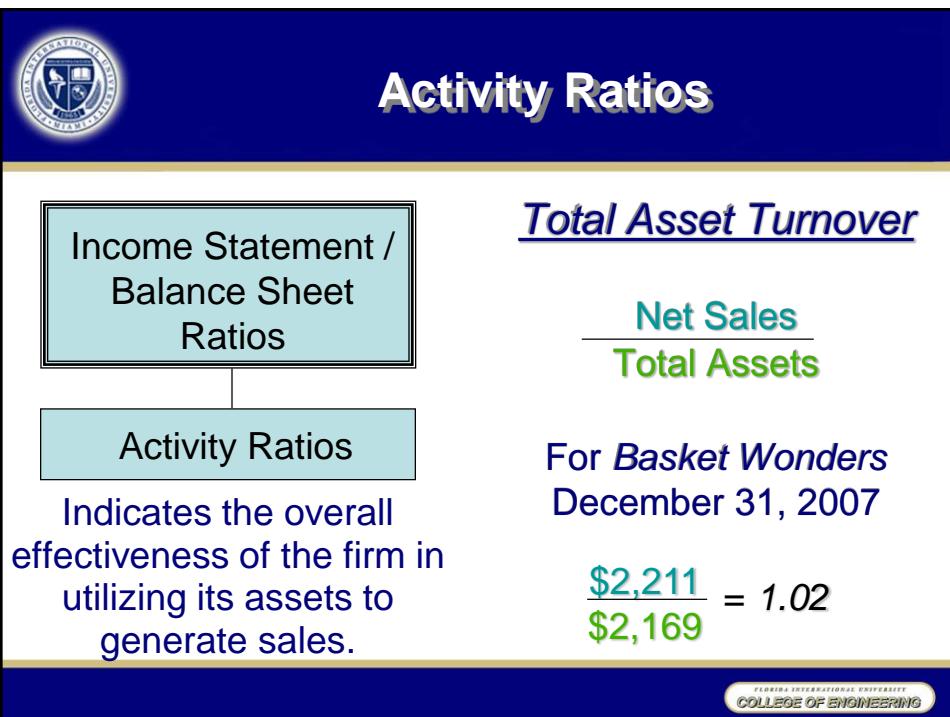
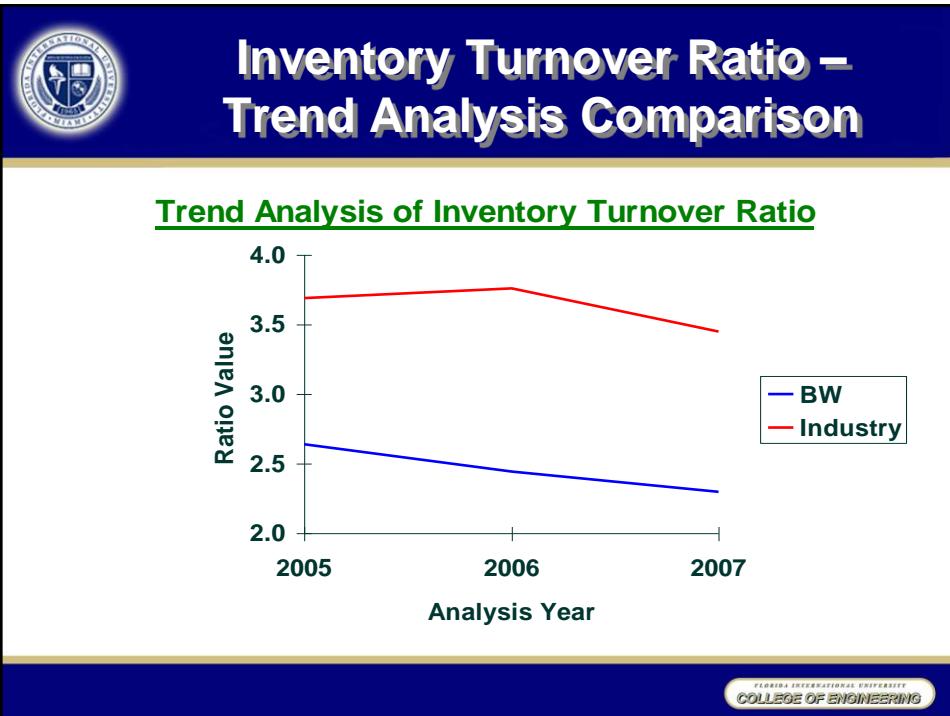
2007	2.30	3.45
------	------	------

2006	2.44	3.76
------	------	------

2005	2.64	3.69
------	------	------

BW has a very poor inventory turnover ratio.

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## Activity Ratio Comparisons

### Total Asset Turnover Ratio

<u>Year</u>	<u>BW</u>	<u>Industry</u>
2007	1.02	1.17
2006	1.03	1.14
2005	1.01	1.13

BW has a weak total asset turnover ratio.

**Why is this ratio considered weak?**

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## Profitability Ratios

Income Statement /  
Balance Sheet  
Ratios

Profitability Ratios

Indicates the efficiency of  
operations and firm  
pricing policies.

Gross Profit Margin

Gross Profit  
Net Sales

For *Basket Wonders*  
December 31, 2007

$$\frac{\$612}{\$2,211} = .277$$

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## Profitability Ratio Comparisons

### Gross Profit Margin

<u>Year</u>	<u>BW</u>	<u>Industry</u>
2007	27.7%	31.1%
2006	28.7	30.8
2005	31.3	27.6

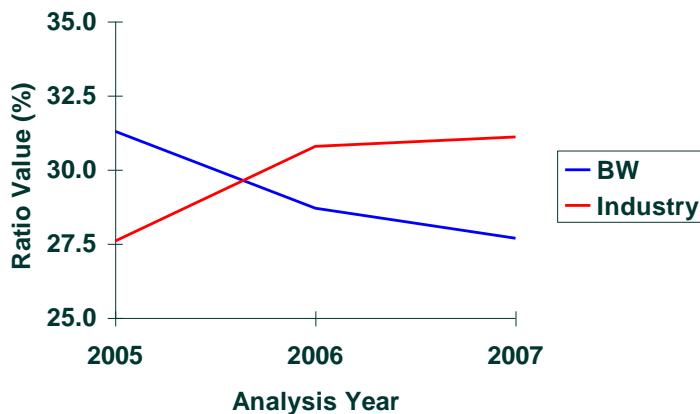
BW has a weak Gross Profit Margin.

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## Gross Profit Margin -- Trend Analysis Comparison

### Trend Analysis of Gross Profit Margin



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## Profitability Ratios

Income Statement /  
Balance Sheet  
Ratios

### Profitability Ratios

Indicates the firm's profitability after taking account of all expenses and income taxes.

Net Profit Margin

Net Profit after Taxes

Net Sales

For *Basket Wonders*  
December 31, 2007

$$\frac{\$91}{\$2,211} = .041$$

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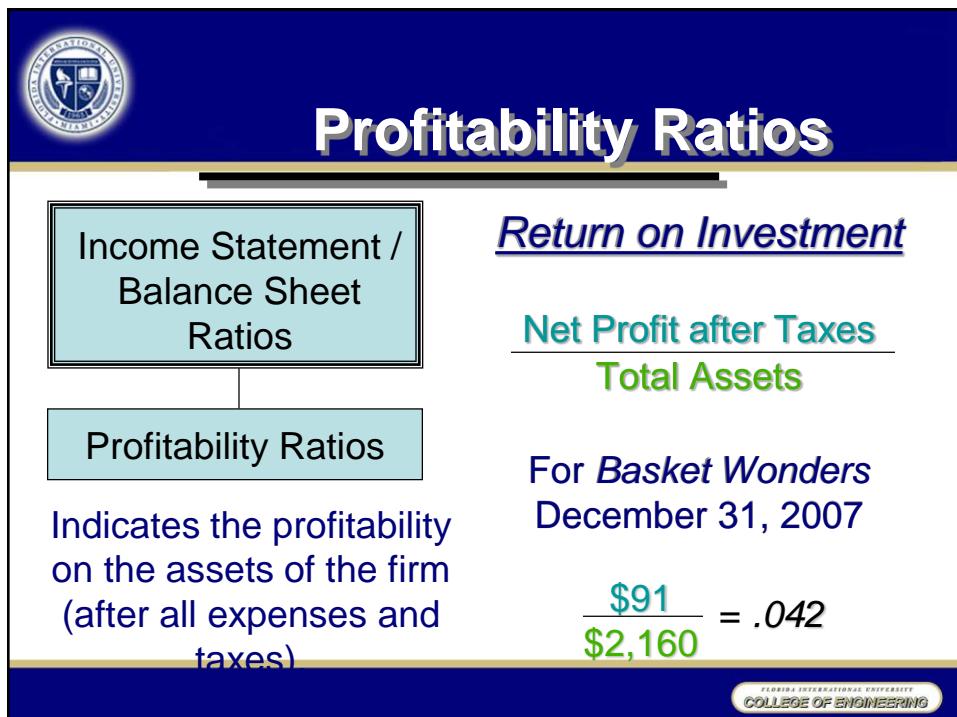
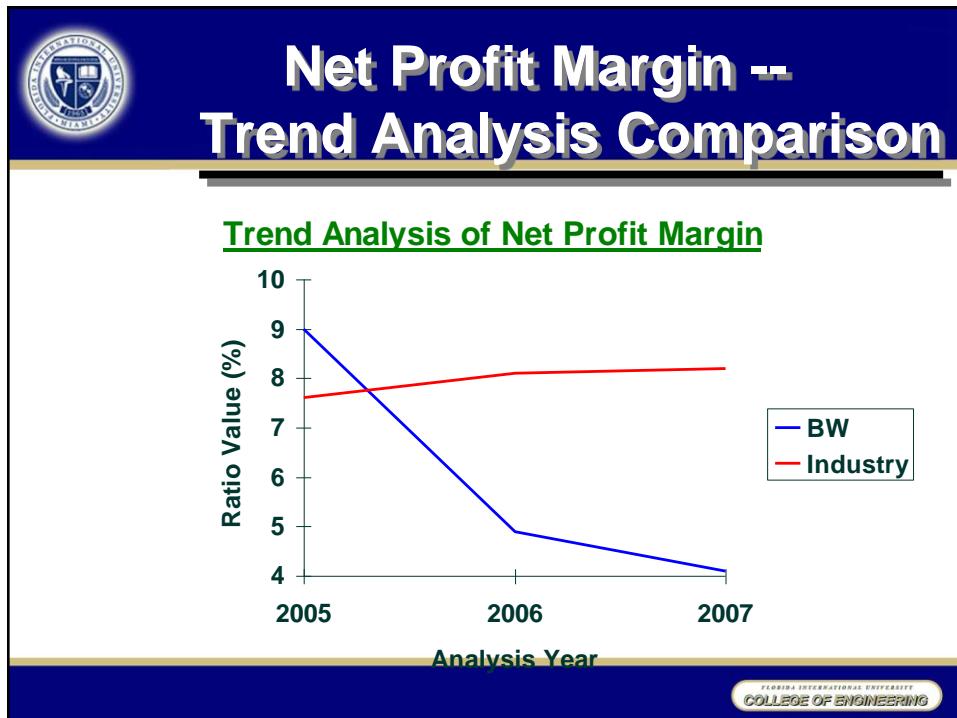
## Profitability Ratio Comparisons

### Net Profit Margin

<u>Year</u>	<u>BW</u>	<u>Industry</u>
2007	4.1%	8.2%
2006	4.9	8.1
2005	9.0	7.6

BW has a poor Net Profit Margin.

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# Profitability Ratio Comparisons

## Return on Investment

<u>Year</u>	<u>BW</u>	<u>Industry</u>
2007	4.2%	9.8%
2006	5.0	9.1
2005	9.1	10.8

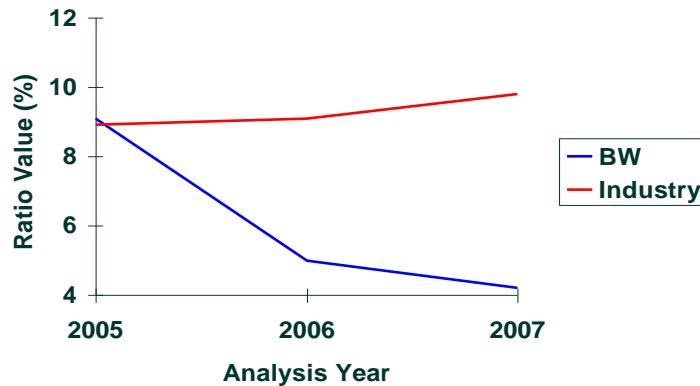
BW has a poor Return on Investment.

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# Return on Investment – Trend Analysis Comparison

## Trend Analysis of Return on Investment



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## Profitability Ratios

Income Statement /  
Balance Sheet  
Ratios

Profitability Ratios

Indicates the profitability to  
the shareholders of the firm  
(after all expenses & taxes).

Return on Equity

Net Profit after Taxes  
Shareholders' Equity

For *Basket Wonders*  
December 31, 2007

$$\frac{\$91}{\$1,139} = .08$$

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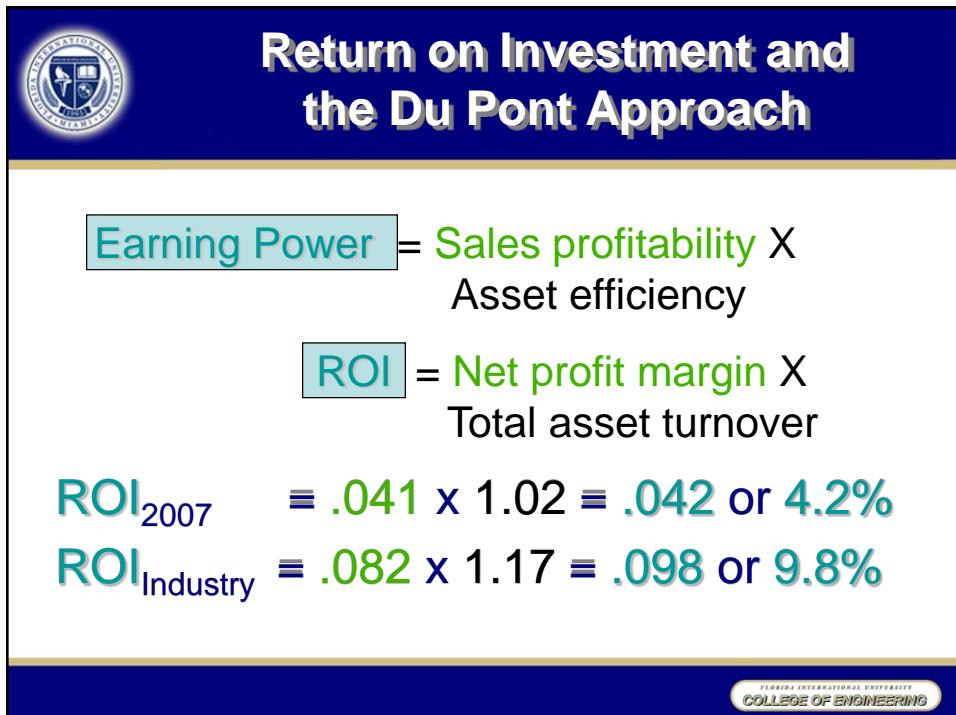
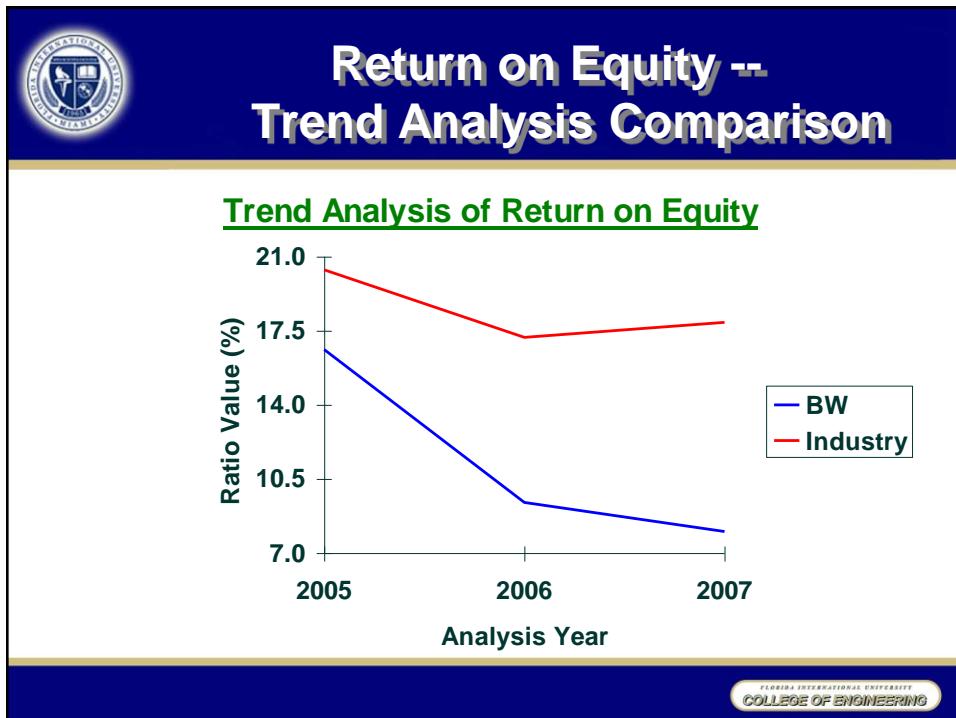
## Profitability Ratio Comparisons

Return on Equity

<u>Year</u>	<u>BW</u>	<u>Industry</u>
2007	8.0%	17.9%
2006	9.4	17.2
2005	16.6	20.4

BW has a poor Return on Equity.

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## Return on Equity and the Du Pont Approach

**Return On Equity** = Net profit margin X  
 Total asset turnover X  
 Equity Multiplier

$$\text{Equity Multiplier} = \frac{\text{Total Assets}}{\text{Shareholders' Equity}}$$

$$\text{ROE}_{2007} = .041 \times 1.02 \times 1.90 = .080$$

$$\text{ROE}_{\text{Industry}} = .082 \times 1.17 \times 1.88 = .179$$

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## Summary of the Profitability Trend Analyses

- The profitability ratios for *BW* have *ALL* been falling since 2005. Each has been below the *industry* averages for the past three years.
- This indicates that **COGS** and **administrative costs** may both be too high and a potential problem for *BW*.
- Note, this result is consistent with the low interest coverage ratio.

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## Summary of Ratio Analyses

- Inventories are too high.
- May be paying off creditors (accounts payable) too soon.
- COGS may be too high.
- Selling, general, and administrative costs may be too high.

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## Common-size Analysis

An analysis of *percentage* financial statements where all balance sheet items are divided by *total assets* and all income statement items are divided by *net sales* or *revenues*.

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## Basket Wonders' Common Size Balance Sheets

Assets	Regular (thousands of \$)			Common-Size (%)		
	2005	2006	2007	2005	2006	2007
Cash	148	100	90	12.10	4.89	4.15
AR	283	410	394	23.14	20.06	18.17
Inv	322	616	696	26.33	30.14	32.09
Other CA	10	14	15	0.82	0.68	0.69
Tot CA	763	1,140	1,195	62.39	55.77	55.09
Net FA	349	631	701	28.54	30.87	32.32
LT Inv	0	50	50	0.00	2.45	2.31
Other LT	111	223	223	9.08	10.91	10.28
Tot Assets	1,223	2,044	2,169	100.0	100.0	100.0

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## Basket Wonders' Common Size Balance Sheets

Liab+Equity	Regular (thousands of \$)			Common-Size (%)		
	2005	2006	2007	2005	2006	2007
Note Pay	290	295	290	23.71	14.43	13.37
Acct Pay	81	94	94	6.62	4.60	4.33
Accr Tax	13	16	16	1.06	0.78	0.74
Other Accr	15	100	100	1.23	4.89	4.61
Tot CL	399	505	500	32.62	24.71	23.05
LT Debt	150	453	530	12.26	22.16	24.44
Equity	674	1,086	1,139	55.11	53.13	52.51
Tot L+E	1,223	2,044	2,169	100.0	100.0	100.0

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## Basket Wonders' Common Size Income Statements

	Regular (thousands of \$)			Common-Size (%)		
	2005	2006	2007	2005	2006	2007
Net Sales	1,235	2,106	2,211	100.0	100.0	100.0
COGS	849	1,501	1,599	68.7	71.3	72.3
Gross Profit	386	605	612	31.3	28.7	27.7
Adm.	180	383	402	14.6	18.2	18.2
EBIT	206	222	210	16.7	10.5	9.5
Int Exp	20	51	59	1.6	2.4	2.7
EBT	186	171	151	15.1	8.1	6.8
EAT	112	103	91	9.1	4.9	4.1
Cash Div	50	50	50	4.0	2.4	2.3

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## Index Analyses

An analysis of *percentage* financial statements where all balance sheet or income statement figures for a base year equal 100.0 (percent) and subsequent financial statement items are expressed as percentages of their values in the base year.

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 Basket Wonders' Indexed Balance Sheets						
	Regular (thousands of \$)			Indexed (%)		
Assets	2005	2006	2007	2005	2006	2007
Cash	148	100	90	100.0	67.6	60.8
AR	283	410	394	100.0	144.9	139.2
Inv	322	616	696	100.0	191.3	216.1
Other CA	10	14	15	100.0	140.0	150.0
Tot CA	763	1,140	1,195	100.0	149.4	156.6
Net FA	349	631	701	100.0	180.8	200.9
LT Inv	0	50	50	100.0	inf.	inf.
Other LT	111	223	223	100.0	200.9	200.9
Tot Assets	1,223	2,044	2,169	100.0	167.1	177.4

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	Regular (thousands of \$)			Indexed (%)		
Liab+Equity	2005	2006	2007	2005	2006	2007
Note Pay	290	295	290	100.0	101.7	100.0
Acct Pay	81	94	94	100.0	116.0	116.0
Accr Tax	13	16	16	100.0	123.1	123.1
Other Accr	15	100	100	100.0	666.7	666.7
Tot CL	399	505	500	100.0	126.6	125.3
LT Debt	150	453	530	100.0	302.0	353.3
Equity	674	1,086	1,139	100.0	161.1	169.0
Tot L+E	1,223	2,044	2,169	100.0	167.1	177.4

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## Basket Wonders' Indexed Income Statements

	Regular (thousands of \$)			Indexed (%)		
	2005	2006	2007	2005	2006	2007
Net Sales	1,235	2,106	2,211	100.0	170.5	179.0
COGS	849	1,501	1,599	100.0	176.8	188.3
Gross Profit	386	605	612	100.0	156.7	158.5
Adm.	180	383	402	100.0	212.8	223.3
EBIT	206	222	210	100.0	107.8	101.9
Int Exp	20	51	59	100.0	255.0	295.0
EBT	186	171	151	100.0	91.9	81.2
EAT	112	103	91	100.0	92.0	81.3
Cash Div	50	50	50	100.0	100.0	100.0

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