#### CASE

1

# Harrod’s Sporting Goods

Jim Harrod knew that service, above all, was important to his customers. Jim and Becky Harrod had opened their first store in Medicine Hat, Alberta eighteen years ago. Harrod’s carried a full line of sporting goods including everything from baseball bats and uniforms to fishing gear and hunting equipment. By the year 20XX, there were twelve Harrod stores producing $5 million in total sales and generating a profit of over $200,000 per year.

On the positive side, there was an increasing demand for sporting goods as leisure time activities continued to grow. Also, Western Canada, where all twelve stores were located, was experiencing moderate growth. Finally, there had been a sharp upturn in the last decade for women’s sporting goods equipment. This was particularly true of softball uniforms for high school, college, and city league women’s teams. Jim’s wife Becky was one of the top softball players in the city of Medicine Hat, and her extensive contacts throughout the province help to bring in new business. While Alberta is primarily known as a hockey province, Medicine Hat hosts a Western Canada baseball world series each year in June and this generates a lot of interest in baseball (and softball as well).

Jim, who had been an offensive tackle at the University of Alberta took great pride in his stores as well as his prior university affiliation. He and Becky (also a University of Alberta graduate) contributed $2,000 annually to the University of Alberta athletic program.

The growth in the stores was the good news for Jim and Becky. The less than good news was the intense competition that they faced. Not only were they forced to compete with nationally established sporting goods stores such as Sport Chek and National Sports, but Walmart also represented intense competition for the sporting goods dollar. The national stores were extremely competitive in terms of pricing. However, Jim, Becky and their employees offered great personal service, and they hoped this would allow them to continue with their specialty niche.

In January of 20XY, Becky, who served as the company’s chief financial officer, walked into Jim’s office and said, “I’ve had it with the National Bank here in Medicine Hat. It is willing to renew our loan and line of credit, but the bank wants to charge us 2½ percent 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 1 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.

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| Required | 1. Compute the profitability ratios (3‒1, 3‒2, 3‒3), including the a and b components (DuPont Methods) of the ratios as shown in the textbook. The profitability ratios should be shown for all three years. 2. Write a brief one-paragraph description of any trends that appear to have taken place over the three-year time period. 3. In examining the income statement in Figure 1, note that there was an extraordinary loss of $170,000 in 20XX. 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.[[1]](#footnote-1)\*  |  |  |  | | --- | --- | --- | | $170,000 |  | Extraordinary loss | | .65 |  | (1-tax rate) | | $110,500 |  | Aftertax addition to profits from eliminating the extraordinary loss from net income |   The more representative net income number for 20XX would now be:   |  |  | | --- | --- | | Initially reported (Figure 1) | $200,318 | | Adjustment for extraordinary loss being eliminated | +110,500 | | Adjusted net income | $310,818 | |
|  | Based on the adjusted net income figure ($310,818), recompute the profitability ratios for 20XX (include parts a and b for ratios 2 and 3). |
| Required | 1. Now with the adjusted net income numbers as part of the ratios for 20XX, write a brief one-paragraph description of trends that appear to have taken place over the three-year time period (refer back to the data in Question 1 for 20XV and 20XW). 2. Once again, using the revised profitability ratios for 20XX that you developed in Question 3, write a complete one paragraph analysis of the company’s profitability ratios compared to the industry ratios (figure 3). Make sure to include asset turnover and debt to total assets as supplemental material in your analysis. 3. Harrod’s has superior sales to total assets ratio compared to the industry. For 20XX, compute ratios 3‒4a, 3‒5a and 3‒7a as described in the text and compare them to industry data to see why this is so. Write a brief one-paragraph description of the results. Note: for ratio 4, only half the sales are on credit terms. 4. Conclusion: Based on your analysis in answering Questions 4 and 5, do you think that Becky Harrod has a legitimate complaint about being charged 2½ percent over prime instead of one percent over prime? There is no absolute right answer to this question, but use your best judgment. |

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| Figure 1 | |  | | | | | | | |
|  | | **Harrod’s Sporting Goods**  **Income Statement**  **(20XV-20XX)** | | | | | | | |
|  | |  | | **20XV** | | **20XW** | | **20XX** | |
|  | | 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**  **(20XV-20XX)** | | | | | | | |
|  | |  | | **20XV** | | **20XW** | | **20XX** | |
|  | | 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 Shareholders’ 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[[2]](#footnote-2) | | 837,200 | | 942,665 | | 965,800 | |
|  | | Total shareholders’ equity | | 1,204,600 | | 1,310,655 | | 1,333,800 | |
|  | | Total liabilities and shareholders’ equity | | $3,170,200 | | $3,360,650 | | $3,510,110 | |

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| **Figure 3** | | | | | | |
| **Harrod’s Sporting Goods** | | | | | |
| **Selected Industry Ratios for 20XX** | | | | | |
| 1. | | Net income/Sales | | 4.51% | |
| 2a. | | Net income/Total Assets | | 5.10% | |
| 2b. | | Sales/Total Assets | | 1.33 × | |
| 3a. | | Net income/Shareholder’s Equity | | 9.80% | |
| 3b. | | Debt/Total Assets | | 0.48 | |
| 4. | | Sales/Receivables | | 5.75 × | |
| 5. | | Sales/Inventory | | 3.01 × | |
| 6. | | Sales/Capital Assets | | 3.20 × | |
|  |  | |  | |  | | |

1. \* 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 aftertax benefit of the tax adjustment for the extraordinary loss is $110,500. [↑](#footnote-ref-1)
2. Withdrawal of funds in the form of dividends or other means makes the increase in retained earnings less than net income. [↑](#footnote-ref-2)