

Auditor's Report

Board of Directors and Stockholders

We have examined the consolidated balance sheets of **A B C** and subsidiaries as of December 31, 19X9 and 19X8, and the related consolidated statements of earnings, retained earnings, and cash flows for each of the 3 years in the period ended December 31, 19X9. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

~~In our opinion, the financial statements referred to above present fairly the consolidated financial position of **A B C** and subsidiaries at December 31, 19X9 and 19X8, and the consolidated results of their operations and cash flows for each of the 3 years in the period ended December 31, 19X9, in conformity with generally accepted accounting principles applied on a consistent basis.~~

J. J. Michaels and Company
Donelyn, Texas
January 27, 20X0

ABC
 Consolidated Balance Sheets at December 31, 19X9 and 19X8
 (In thousands)

| | 19X9 | 19X8 |
|--|-----------------|-----------------|
| Assets | | |
| Current Assets | | |
| Cash | \$ 4,061 | \$ 2,382 |
| Marketable securities (note A) | 5,272 | 8,004 |
| Accounts receivable, less allowance for doubtful accounts of \$448 in 19X9 and \$417 in 19X8 | 8,960 | 8,350 |
| Inventories (note A) | 47,041 | 36,769 |
| Prepaid expenses | 512 | 759 |
| Total current assets | <u>65,846</u> | <u>56,264</u> |
| Property, Plant, and Equipment (notes A, C, and E) | | |
| Land | 811 | 811 |
| Buildings and leasehold improvements | 18,273 | 11,928 |
| Equipment | <u>21,523</u> | <u>13,768</u> |
| | 40,607 | 26,507 |
| Less accumulated depreciation and amortization | <u>11,528</u> | <u>7,530</u> |
| Net property, plant, and equipment | 29,079 | 18,977 |
| Other Assets (note A) | 373 | 668 |
| Total Assets | <u>\$95,298</u> | <u>\$75,909</u> |
| Liabilities and Stockholders' Equity | | |
| Current Liabilities | | |
| Accounts payable | \$14,294 | \$ 7,591 |
| Notes payable—banks (note B) | 5,614 | 6,012 |
| Current maturities of long-term debt (note C) | 1,884 | 1,516 |
| Accrued liabilities | <u>5,669</u> | <u>5,313</u> |
| Total current liabilities | 27,461 | 20,432 |
| Deferred Federal Income Taxes (notes A and D) | 843 | 635 |
| Long-Term Debt (note C) | <u>21,059</u> | <u>16,975</u> |
| Total liabilities | 49,363 | 38,042 |
| Stockholders' Equity | | |
| Common stock, par value \$1, authorized, 10,000,000 shares; issued, 4,803,000 shares in 19X9 and 4,594,000 shares in 19X8 (note F) | 4,803 | 4,594 |
| Additional paid-in capital | 957 | 910 |
| Retained earnings | <u>40,175</u> | <u>32,363</u> |
| Total stockholders' equity | 45,935 | 37,867 |
| Total Liabilities and Stockholders' Equity | <u>\$95,298</u> | <u>\$75,909</u> |

The accompanying notes are an integral part of these statements.

ABC

Consolidated Statements of Earnings and Retained Earnings
For the Years ended December 31, 19X9, 19X8, and 19X7
(in thousands except per share amounts)

| | 19X9 | 19X8 | 19X7 |
|---|------------------|------------------|------------------|
| Statements of Consolidated Earnings | | | |
| Net Sales | \$215,600 | \$153,000 | \$140,700 |
| Cost of goods sold (note A) | <u>129,364</u> | <u>91,879</u> | <u>81,606</u> |
| Gross profit | 86,236 | 61,121 | 59,094 |
| Selling and administrative expenses (note A) | 32,664 | 26,382 | 25,498 |
| Advertising | 14,258 | 10,792 | 9,541 |
| Lease payments (note E) | 13,058 | 7,111 | 7,267 |
| Depreciation and amortization (note A) | 3,998 | 2,984 | 2,501 |
| Repairs and maintenance | <u>3,015</u> | <u>2,046</u> | <u>3,031</u> |
| Operating profit | 19,243 | 11,806 | 11,256 |
| Other income (expense) | | | |
| Interest income | 422 | 838 | 738 |
| Interest expense | <u>(2,585)</u> | <u>(2,277)</u> | <u>(1,274)</u> |
| Earnings before income taxes | 17,080 | 10,367 | 10,720 |
| Income taxes (notes A and D) | <u>7,686</u> | <u>4,457</u> | <u>4,824</u> |
| Net Earnings | <u>\$ 9,394</u> | <u>\$ 5,910</u> | <u>\$ 5,896</u> |
| Earnings per common share (note G) | <u>\$1.96</u> | <u>\$1.29</u> | <u>\$1.33</u> |
| Statements of Consolidated Retained Earnings | | | |
| Retained earnings at beginning of year | \$ 32,363 | \$ 28,315 | \$ 24,260 |
| Net earnings | 9,394 | 5,910 | 5,896 |
| Cash dividends (19X9—\$.33 per share; 19X8 and 19X7—\$.41 per share) | <u>(1,582)</u> | <u>(1,862)</u> | <u>(1,841)</u> |
| Retained earnings at end of year | <u>\$ 40,175</u> | <u>\$ 32,363</u> | <u>\$ 28,315</u> |

The accompanying notes are an integral part of these statements.

ABC
 Consolidated Statements of Cash Flows
 for the Years Ended December 31, 19X9, 19X8, and 19X7
 (In thousands)

| | 19X9 | 19X8 | 19X7 |
|---|-------------------|-------------------|------------------|
| Cash Flow from Operating Activities—Direct Method | | | |
| Cash received from customers | \$214,990 | \$149,661 | \$140,252 |
| Interest received | 422 | 838 | 738 |
| Cash paid to suppliers for inventory | (132,933) | (99,936) | (83,035) |
| Cash paid to employees (S & A expenses) | (32,664) | (26,382) | (25,498) |
| Cash paid for other operating expenses | (29,728) | (21,350) | (20,848) |
| Interest paid | (2,585) | (2,277) | (1,274) |
| Taxes paid | <u>(7,478)</u> | <u>(4,321)</u> | <u>(4,706)</u> |
| Net cash provided (used) by operating activities | \$ 10,024 | (\$ 3,767) | \$ 5,629 |
| Cash Flows from Investing Activities | | | |
| Additions to property, plant, and equipment | (14,100) | (4,773) | (3,982) |
| Other investing activities | <u>295</u> | <u>0</u> | <u>0</u> |
| Net cash provided (used) by investing activities | (\$13,805) | (\$4,773) | (\$3,982) |
| Cash flow from financing activities: | | | |
| Sales of common stock | 256 | 183 | 124 |
| Increase (decrease) in short-term borrowings (includes current maturities of long-term debt) | (30) | 1,854 | 1,326 |
| Additions to long-term borrowings | 5,600 | 7,882 | 629 |
| Reductions of long-term borrowings | (1,516) | (1,593) | (127) |
| Dividends paid | <u>(1,582)</u> | <u>(1,862)</u> | <u>(1,841)</u> |
| Net cash provided (used) by financing activities | \$ 2,728 | \$ 6,464 | \$ 111 |
| Increase (decrease) in cash and marketable securities | (\$ 1,053) | (\$ 2,076) | \$ 1,758 |
| Supplementary Schedule | | | |
| Cash Flow from Operating Activities—Indirect Method | | | |
| Net income | \$ 9,394 | \$ 5,910 | \$ 5,896 |
| Noncash revenue and expense included in net income: | | | |
| Depreciation and amortization | 3,998 | 2,984 | 2,501 |
| Deferred income taxes | 208 | 136 | 118 |
| Cash provided (used) by current assets and liabilities: | | | |
| Accounts receivable | (610) | (3,339) | (448) |
| Inventories | (10,272) | (7,006) | (2,331) |
| Prepaid expenses | 247 | 295 | (82) |
| Accounts payable | 6,703 | (1,051) | 902 |
| Accrued liabilities | <u>356</u> | <u>(1,696)</u> | <u>(927)</u> |
| Net cash provided (used) by operations | \$ 10,024 | (\$ 3,767) | \$ 5,629 |

ABC
Notes to Consolidated Financial Statements
December 31, 19X9, December 31, 19X8, and December 31, 19X7

Note A—Summary of Significant Accounting Policies

ABC is a retailer of recreational equipment and clothing.

Consolidation: The consolidated statements include the accounts and transactions of the company and its wholly-owned subsidiaries. The company accounts for its investment in its subsidiaries using the equity method of accounting. All significant intercompany transactions have been eliminated in consolidation.

Marketable securities: Marketable securities consist of short-term, interest-bearing securities stated at cost, which approximates market.

Inventories: Inventories are stated at the lower of cost (LIFO) or market. If the first-in, first-out (FIFO) method of inventory accounting had been used, inventories would have been approximately \$2,681,000 and \$2,096,000 higher than reported at December 31, 19X9 and 19X8.

Depreciation and Amortization: Property, plant, and equipment is stated at cost. Depreciation expense is calculated principally by the straight-line method based on estimated useful lives of 3 to 10 years for equipment, 3 to 30 years for leasehold improvements, and 40 years for buildings. Estimated useful lives of leasehold improvements represent the remaining term of the lease in effect at the time the improvements are made.

Income Taxes: Deferred income taxes are provided for timing differences between earnings for financial reporting and income tax purposes. The timing differences are principally related to accelerated tax depreciation and use of the installment method for tax purposes on contract and charge sales.

Expenses of New Stores: Expenses associated with the opening of new stores are charged to expense as incurred.

Other Assets: Other assets are investments in properties not used in business operations.

Note B—Short-Term Debt

The company has a \$10,000,000 bank line of credit. Interest is calculated at the prime rate plus 1% on any outstanding balance. Any balance on March 31, 20X1, converts to a term note payable in quarterly installments over 5 years.

Note C—Long-Term Debt

Long-term debt consists of the following at the end of each year:

| | 19X9 | 19X8 |
|---|-------------|-------------|
| Mortgage notes collateralized by land and buildings (approximate cost of \$7,854,000) payable in aggregate monthly installments of \$30,500 plus interest at 8¾–10½% maturing in fifteen to twenty-five years | \$3,808,000 | \$4,174,000 |
| Unsecured promissory note due December, 20X5, payable in quarterly installments of \$100,000 plus interest at 8½% | 4,800,000 | 5,200,000 |
| Promissory notes secured by equipment (approximate cost of \$9,453,000) payable in semiannual installments of \$375,000 plus interest at 13%, due in January, 20X7 | 6,000,000 | 6,750,000 |

| | | |
|---|---------------------|---------------------|
| Unsecured promissory note payable in three installments of \$789,000 in 20X1, 20X2, and 20X3, plus interest at 9¼% payable annually | 2,367,000 | 2,367,000 |
| Promissory notes secured by equipment (approximate cost of \$8,546,000) payable in annual installments of \$373,000 plus interest at 12½% due in June, 20X9 | 5,968,000 | — |
| | <u>22,943,000</u> | <u>18,491,000</u> |
| Less current maturities | 1,884,000 | 1,516,000 |
| | <u>\$21,059,000</u> | <u>\$16,975,000</u> |
| Current maturities for each of the following 5 years are: | | |
| | December 31, 20X0 | \$2,678,000 |
| | 20X1 | 2,678,000 |
| | 20X2 | 2,678,000 |
| | 20X3 | 1,884,000 |
| | 20X4 | 1,884,000 |

Note D—Income Taxes

A reconciliation of income tax expense computed by using the statutory Federal income tax rate and the amount of income tax expense reported in the consolidated statements of earnings is as follows:

| | 19X9 | 19X8 | 19X7 |
|--------------------------------------|--------------------|--------------------|--------------------|
| Federal income tax at statutory rate | \$7,859,000 | \$4,769,000 | \$4,931,000 |
| Increase (decreases) | | | |
| State income taxes | 489,000 | 381,000 | 344,000 |
| Tax credits | (465,000) | (429,000) | (228,000) |
| Other items, net | (197,000) | (264,000) | (223,000) |
| Income Tax expense reported | <u>\$7,686,000</u> | <u>\$4,457,000</u> | <u>\$4,824,000</u> |

Deferred tax expense applicable to major timing differences is as follows:

| | 19X9 | 19X8 | 19X7 |
|--|------------------|------------------|------------------|
| Excess of tax depreciation over book depreciation | \$146,000 | \$98,000 | \$84,000 |
| Timing differences applicable to installment sales | 62,000 | 38,000 | 34,000 |
| Total | <u>\$208,000</u> | <u>\$136,000</u> | <u>\$118,000</u> |

Note E—Operating Leases

The company conducts some of its operations in facilities leased under noncancellable operating leases. Certain agreements include options to purchase the property and certain agreements include renewal options with provisions for increased rental during the renewal term.

Minimum annual rental commitments as of December 31, 19X9, are as follows:

| | |
|------|--------------|
| 20X0 | \$14,561,000 |
| 20X1 | 14,082,000 |
| 20X2 | 13,673,000 |
| 20X3 | 13,450,000 |

| | |
|------------|----------------------|
| 20X4 | 13,003,000 |
| Thereafter | <u>107,250,000</u> |
| | <u>\$176,019,000</u> |

Note F—Common Stock

The company has a stock option plan providing that options may be granted to key employees at an option price of not less than 100% of the market value of the shares at the time the options are granted. As of December 31, 19X9, the company has under option 75,640 shares (19X8—96,450 shares). All options expire 5 years from date of grant.

Note G—Earnings Per Share

Earnings per common share are based on the weighted average number of common shares outstanding during each year. For 19X9, 19X8, and 19X7 the weighted average number of common shares outstanding was 4,792,857, 4,581,395, and 4,433,083, respectively. Outstanding options are included in periods where they have a dilutive effect. Earnings per share assuming full dilution are not significantly different (less than 3%) from earnings per common share.
