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	65,846	56,264
Property, Plant, and Equipment (notes A, C, and E)		
Land	811	811
Buildings and leasehold improvements	18,273	11,928
Equipment	21,523	13,768
	40,607	26,507
Less accumulated depreciation and amortization	11,528	7,530
Net property, plant, and equipment	29,079	18,977
Other Assets (note A)	373	668
Total Assets	$95,298	$75,909
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	5,669	5,313
Total current liabilities	27,461	20,432
Deferred Federal Income Taxes (notes A and D)	843	635
Long-Term Debt (note C)	21,059	16,975
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	40,175	32,363
Total stockholders' equity	45,935	37,867
Total Liabilities and Stockholders' Equity	$95,298	$75,909

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)	129,364	91,879	81,606
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	3,015	2,046	3,031
Operating profit	19,243	11,806	11,256
Other income (expense)			
Interest income	422	838	738
Interest expense	(2,585)	(2,277)	(1,274)
Earnings before income taxes	17,080	10,367	10,720
Income taxes (notes A and D)	7,686	4,457	4,824
Net Earnings	$ 9,394	$ 5,910	$ 5,896
Earnings per common share (note G)	$1.96	$1.29	$1.33
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)	(1,582)	(1,862)	(1,841)
Retained earnings at end of year	$ 40,175	$ 32,363	$ 28,315

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	(7,478)	(4,321)	(4,706)
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	295	0	0
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	(1,582)	(1,862)	(1,841)
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	356	(1,696)	(927)
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	—
	22,943,000	18,491,000
Less current maturities	1,884,000	1,516,000
	$21,059,000	$16,975,000

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	$7,686,000	$4,457,000	$4,824,000

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	$208,000	$136,000	$118,000

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	107,250,000
	$176,019,000

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.