

## **James Jewelers**

### **Case Abstract**

James Jewelers is a critical decision case involving Bob and Bonnie James owners of James Jewelers in Spartanburg, South Carolina. This case accurately reflects dilemmas frequently faced by entrepreneurs in the highly competitive retail markets.

The very survival of James Jewelers and the financial stability of Bob and Bonnie is dependent on a correct decision regarding the future of James Jewelers. Bob and Bonnie have been working in the jewelry business for 20 years and are in the midst of experiencing their second failure. With debt concerns, shrinking inventory and a lost lease, Bob has to decide whether to throw in the towel and look for other forms of employment, or try to start over.

Bob's values and beliefs enter into the decision as he feels a strong obligation to repay his debt and continue to provide a quality product and service to devoted customers. Some suppliers and many customers have stuck with James Jewelers for a number of years and Bob feels that quitting would be a disservice to those who had faith in him. However, the financial condition of his operation continues to deteriorate. Sometimes staying in business could change a condition from bad to worse and even more people could be negatively impacted by an unsuccessful operation. Then again, if he can turn the business around, there is a greater probability that Bob can make good on his obligations.

Bob and Bonnie need to decide quickly if they want to try to save or discontinue the operation of James Jewelry.

### **Key Words**

Entrepreneurship

Small Business

Cash Flow

Financial Statement Analysis

Decision Analysis

Common Sized Financial Statement Analysis

## **James Jewelers**

### **Introduction**

Bob James of James Jewelers returned to his store in the spring of 2003 angry and depressed. “We just lost our lease; I don’t see how we can make it now.” It had been seven years since Bob and his wife, Bonnie, moved their business to Spartanburg, South Carolina. They had struggled, and sometimes excelled. But primarily, through sheer determination, they just survived in the jewelry business to this point. The loss of their lease and prime location could be the final blow that would destroy their business. Bob needed to decide, and quickly, either to fold the tent or give it one more shot.

### **York Operations**

James Jewelers originally started in 1972 as Able Jewelry and Music—a pawnshop in York, South Carolina, purchased by Bob’s parents from other family members. Bob helped his mom in the business after his graduation from the University of South Carolina with a major in business in 1983. Wanting to gain more business experience, Bob earned his MBA from Regent University in 1987 and, with Bonnie, assumed ownership of the store on July 1, 1987.

Bob and Bonnie met at the University of South Carolina. She graduated in three years with a major in foreign politics and a minor in Spanish. After college she was also able to get a Para-legal degree in business and real estate law and bankruptcy. Her legal training made it easy for her to find work with a law firm while Bob completed his MBA.

Even though the store was a well-recognized landmark in York, it initially had trouble earning a reasonable profit. After about three years, Bob saw the 80-20 rule in action. The pawnshop generated 80% of the headaches and 20% of the revenue. Bob wanted the store to be more upscale; he eliminated the electronics and musical equipment inventory associated with the pawnshop and changed the name of the store to James Jewelers. Over the next four years, sales and profits grew.

Bob and Bonnie lived in Spartanburg where Bonnie grew up, about 30 miles west of York on I-85. Through their associations and church activities, they established a loyal clientele in their hometown who would travel to York to shop at James Jewelers. Many of these customers often encouraged Bob and Bonnie to open a store in Spartanburg.

In York, however, Bob had the only jewelry store that catered to a middle-class market. Unlike in Spartanburg, where there were several similar jewelry stores already established, he did not have to worry about competition. The store’s roots were in York with a long history and a devoted following. Even though the drive to work sometimes seemed long, the York site was doing well.

This situation changed in the mid-1990s. Video poker was the new craze, and numerous people in the York seemed addicted to it. While illegal in South Carolina, it was legal in

North Carolina. Many York citizens frequently drove north a mere 10 miles to the next state to spend their discretionary income on these games. Bob saw a change in his customer spending habits as they bought less jewelry, and some even said they or their spouse used the money instead to gamble and “hit it big”.

At the same time, York’s Main Street was going the way of many small towns without a strong economic base. Downtown businesses were shutting their doors as shoppers drove to new malls or superstores like Wal-Mart. The only stores that seemed to be opening on Main Street were loan companies, which offered high interest rate loans to consumers and businesses. Within two years, this combination of events took Bob’s operation from being profitable to barely surviving.

### **Relocating to Spartanburg**

Bob and Bonnie had to decide if it was worthwhile to continue their jewelry business. They had two young children, five and nine, and roots in Spartanburg. With Bob’s MBA and business experience, the possibility of a job at a company in Spartanburg was attractive. Bonnie could stay home and raise the kids, and they would be free of the pressure of ownership and the worry over cash flow.

It was evident that James Jewelry in York would not survive. Persuaded by friends and motivated by his entrepreneurial spirit, Bob developed a business plan and sought financial assistance to move his operation to Spartanburg. To his surprise, local banks were not as supportive as Bob thought they would be. James Jewelers’ current financial condition did not help to qualify for a loan; it seemed too risky. The financial institutions denied funding.

Bob liked the idea of being his own boss, enjoyed the jewelry business, and felt he had some expertise in the area. So he kept looking for financial assistance. Eventually, he returned to his old bank in York. Even though he was leaving town, based on the relationship he had established with the bank and with their assistance, he qualified for a Small Business Administration loan of \$60,000. Bob and Bonnie sold their house in Spartanburg and used the equity to add another \$20,000 to start over in Spartanburg. Upon the sale of their house in Spartanburg, Bob and Bonnie and their two children, Hannah and Jonathan, moved from a 3,200-square-foot home into a 1,200-square-foot apartment.

### **Spartanburg Operations**

Bob secured a lease for almost 3,000 square feet in a prime location in west Spartanburg on a busy main street across from a large shopping center. This section of Spartanburg was experiencing sustained consumer consumption since it had easy access to I-85, and new upper-income home developments were opening on a regular basis. The rent for the store was \$3,000 per month. The strip shopping center included some other fine stores, including an upscale women’s fashion store and a quality shoe store.

Unexpectedly, Bob learned that the landlord charged him an additional \$40,000 to “up fit” the store before the first sale was even made. In some of the other lease contracts they considered, “up fitting” was already provided, and he wrongly assumed those lease stipulations were included in this current lease. Bob learned the importance of “buyer beware.” He regretted not getting professional guidance before signing the lease, but he was trying to save money and time. On top of that, Bob later learned that his share of the property tax for the facility was also charged to him at the end of the year as an additional expense versus being part of the monthly rent. Already cash poor, Bob used his remaining \$40,000 in funds to acquire inventory.

With limited working capital, a discretionary income type product with low turnover, and a seasonal business, Bob continually had cash flow problems. Jewelry was expensive, and the store needed significant inventory to display in showcases in order to attract customers. He bought lots of silver, which was relatively inexpensive, to supplement gold and diamonds.

Bob maintained a credit purchasing relationship with many of his suppliers, but when sales did not achieve anticipated levels, Bob quickly found himself past due on many accounts. It was not long before some of these suppliers wanted cash up front for purchases. Conditions seemed to go from bad to worse as debt mounted. In 1996, the business lost over \$108,000.

Bonnie and Bob both needed to work in the store because at least two people had to be around to prevent theft. With their responsibilities as parents, family activities, commitments at church, working six days a week at the store was demanding and there was little down time. They even had to give up attending or watching the games of their beloved University of South Carolina football team—an activity that in the past often gave them much-needed relaxation from the stress of running your own business.

Fortunately, the clientele from Spartanburg remained loyal and frequented the store even more now that the business was more conveniently located in Spartanburg. Store hours were 10:00 a.m. to 5:30 p.m., Monday through Saturday. Bob believed that the customers he was trying to reach, primarily non-working women who enjoyed shopping and socializing would shop during the day. These women generally entertained, wanted quality family time, and had other obligations in the evening. Also, this was more of a destination location as opposed to a mall location where there would be more walk by traffic in the evening.

Bob and Bonnie practiced a high moral and ethical standard and understood the importance of trust and honesty. They were fair in valuing stones for both buying and selling purposes, which was often a concern by less knowledgeable customers. They were also friendly and got to know their customers on a first-name basis. Customer service was highly regarded in all of their business dealings. As it turned out, many customers bought jewelry exclusively from James Jewelers. With over 10 years of experience, plus his educational training, Bob felt he knew the jewelry business and how to make it successful.

Additionally, Bonnie, who was completely self taught in the jewelry business, had a knack for picking the right products. She had always had an interest in colors and texture and was good at determining what looked good on fashion conscious women. As a teenager, Bonnie was paid commercial art work for the Governor of New Jersey. Since their market was primarily women in a middle- to upper-middle income bracket, it was important for Bonnie to recognize trends and styles when purchasing inventory. She believed in her products and her enthusiasm translated into sales to satisfied customers. Bonnie also learned to make jewelry. She bought older jewelry from estate sales and other secondary sources at a discounted price and used the materials to make new and more appealing jewelry items. Customers adored these unique items.

Even though competition from other jewelry stores in the immediate vicinity was fierce, James Jewelers effectively used good marketing strategy with ads in popular publications, radio, store specials, and especially word of mouth primarily catered to middle-income earners. They became active in the community and supported charitable events, which helped to give the business credibility. Also their products were more fashion forward and seemed to have a unique appeal to their customers. Their target customers were women who looked for something better than a run-of-the-mill Kmart or Wal-Mart type of product, but not the exorbitantly priced products found at the really upscale jewelry stores. Of course, many of the other individually-owned stores were trying to capture the same market.

As with many owner-run businesses, Bob and Bonnie focused on little, but significant, services. They did engraving, cleaning, and elaborate gift-wrapping at no extra charge. Their best promotion was word of mouth and personal friendly service.

Still with all the positive factors that Bob and Bonnie had going for them, maintaining the financial viability of the business was still a struggle in a very competitive market. There were any number of factors that seemed to impact their potential for success including the seasonal nature of sales, high carrying cost of inventory, high overhead costs, low sales volume, and even sometimes surprisingly low margins on items sold.

At times Bob had trouble making the monthly lease payment on the store. This last year he was four months behind. Like many businesses, the jewelry business was seasonal. The majority of sales were made during the Christmas season with other peaks in February, May, and June. Months like July and August were extremely slow. In the past, Bob caught up on the rent payments in December when he had a better cash flow.

Over the years, Bob and Bonnie had no choice but to rely on credit card debt, which had amounted to over \$50,000. Once they were unable to make even the minimum payment, their credit scores tumbled—and they no longer qualified for any personal loans or other credit cards. Nevertheless, they worked hard to repay suppliers and establish a better relationship with those companies to hopefully get more favorable terms for future purchases.

Even with their best efforts, the Spartanburg store did not live up to their expectations. It had been seven years. What did Bob and Bonnie have to show for their effort? They had already worked nine years in York with limited success and now another seven years in Spartanburg. There were good days, but then there were also days when Bob wished just to sell a watch battery. With a \$3,000-plus monthly rent, it was easy for Bob to determine that he needed over \$200 in sales (assuming a 100% markup) every day just to pay the rent. Sometimes Bob felt he was working for his landlord.

However, Bob and Bonnie both gained much joy selling a quality product, like an engagement ring to a satisfied customer, knowing they played a role in a special event. Bob and Bonnie enjoyed working the store together and had complementary skills and a strong marriage even though they were together almost 24-7.

Bob surveyed what he had. His \$100,000 of inventory could neatly fit into a couple of shoeboxes! There was the large safe, showcases, fixtures and some office furniture. Of course, there also was the \$250,000 debt. He felt fortunate that some of the debt was still interest-free and that his average cost of debt was around 11%. He had worked very hard to reduce the level of debt over the past few years. While the total company debt had decreased, his interest expenses increased as his credit rating went down and his perceived riskiness by creditors went up.

If he left the store he asked himself: how was he going to make good on this debt? Because of their high ethical values and integrity, Bob and Bonnie felt badly that they had created such a bad debt situation, and they felt morally obligated to make good on all of the outstanding debt. Suppliers and others had placed faith in them and given the store favorable credit terms and assumed they would fulfill these obligations.

### **Future Operations**

If Bob wanted to begin again, could he, especially now that his lease was terminated by his landlord? Seven years ago, he had a house with some equity that he sold to raise capital for the business. Now, he did not even have that. It was doubtful that he could arrange for debt financing, given his history. If he brought in a partner, that partner would probably want 51% ownership or more of the business, and he would lose control. Furthermore, could he even find a suitable location for his store close to where he had become established?

He was aware of another location that had recently become available. It was just three blocks away, but it was only 1,250 square feet, 40% of the size of his current store. Bob surmised that the monthly lease rate would be about half of his current rate. What kind of other lease terms would he face with a new landlord? Bob did not want to be surprised again with hidden charges in another lease agreement. Also, could he afford the cost of a move, especially transporting the large and very heavy safe?

There was also the issue of employees. Because of the need to always have at least two employees on site, Bob had often hired extra help at various times during the year.

Currently, two additional employees had come to depend on Bob and the job for their source of income. They too, would have to seek other employment. And there were his loyal customers. Many had stuck with him since his early days back in York. He had spent years developing this relationship and market. Did he want to give up this valuable but intangible resource?

If he folded the business, what would he do? For 20 years he had been in the jewelry business. Working for another company in jewelry, like a competitor, seemed like such a step down. He wanted to stay in Spartanburg, and he had plenty of connections. But after being an entrepreneur, could he work for someone else? What would Bonnie do? Their children were now 12 and 16. How would they react to this situation? They had already been through a lot.

Bob pulled out his last three years of financial data to try to determine if they even had resources or the financial viability available to make the store viable at a new location. From Bob's understanding of the jewelry business, successful operations have a gross margin of around 50 percent and a profit margin of at least five to ten percent.

Maybe it was time to consider another direction. He had an MBA and years of retail experience, surely he could find a job in the Spartanburg area in the \$50,000 to \$60,000 range. Plus Bonnie, with her talents and skills in the jewelry business, could easily find a part-time or maybe full time job and earn up to \$30,000. Also, with some catching up on the latest laws in the legal field, she could probably get a much higher paying job as a Para-legal with a law firm in the area. The thought of using her legal bankruptcy training on their own store was not amusing. But was it or should it be just about the money? They really enjoyed the jewelry business and the relationships established with their clientele. Their faith had remained strong, but this was going to be a test, or was it an opportunity?

James Jewelers  
Income Statement  
For the Years Ending June 30, 2000, 2001 and 2002

|                                  | <b>2000</b>            | <b>2001</b>             | <b>2002</b>            |
|----------------------------------|------------------------|-------------------------|------------------------|
| Sales                            | \$419,779              | \$419,667               | \$432,206              |
| Cost of Goods Sold               | <u>232,869</u>         | <u>297,161</u>          | <u>228,743</u>         |
| Gross Margin                     | 186,910                | 122,506                 | 203,463                |
| Operating Expenses               |                        |                         |                        |
| Salaries and Wages               | 50,374                 | 31,909                  | 44,891                 |
| Rent                             | 36,284                 | 38,639                  | 40,523                 |
| Taxes and Licenses               | 19,772                 | 18,804                  | 26,391                 |
| Advertising                      | 13,895                 | 15,515                  | 11,599                 |
| Insurance                        | 7,829                  | 7,683                   | 7,658                  |
| Utilities                        | 6,506                  | 7,412                   | 6,504                  |
| Depreciation                     | 19,047                 | 16,672                  | 16,738                 |
| Other General and Administration | <u>3,087</u>           | <u>11,767</u>           | <u>19,762</u>          |
| Total Operating Expenses         | 156,794                | 148,401                 | 174,066                |
| Interest Expense                 | <u>7,670</u>           | <u>3,812</u>            | <u>11,696</u>          |
| Total Expenses                   | <u>164,464</u>         | <u>152,213</u>          | <u>185,762</u>         |
| Net Income Before Tax*           | <b><u>\$22,446</u></b> | <b><u>\$-29,707</u></b> | <b><u>\$17,701</u></b> |

\*Due to significant losses from prior years, no taxes have been paid over the three years because of net operating loss carryforwards. The marginal federal plus state tax rate, if taxes had been paid, would be 15%.

James Jewelers  
Balance Sheet  
For the Years Ending June 30, 1999, 2000, 2001 and 2002

|                                                                   | 1999            | 2000           | 2001            | 2002            |
|-------------------------------------------------------------------|-----------------|----------------|-----------------|-----------------|
| <b>Current Assets</b>                                             |                 |                |                 |                 |
| Cash                                                              | \$-4,824        | \$413          | \$-4,150        | \$7,637         |
| Accounts Receivable                                               | 7,886           | 6,100          | 5,000           | 4,368           |
| Inventory                                                         | <u>186,450</u>  | <u>188,237</u> | <u>111,455</u>  | <u>99,351</u>   |
| Total Current Assets                                              | 189,512         | 194,750        | 112,305         | 111,356         |
| <b>Long-Term Assets</b>                                           |                 |                |                 |                 |
| Equipment                                                         | 139,497         | 150,790        | 149,332         | 152,942         |
| Less Accumulated Depreciation                                     | <u>-63,592</u>  | <u>-82,639</u> | <u>-99,311</u>  | <u>-116,049</u> |
| Equipment (net)                                                   | 75,905          | 68,151         | 50,021          | 36,893          |
| Other Assets                                                      |                 |                | <u>1,458</u>    | <u>1,458</u>    |
| Total Long-Term Assets                                            | 75,905          | 68,151         | 51,479          | 38,351          |
| <b>Total Assets</b>                                               | \$265,417       | \$262,901      | \$163,784       | \$149,707       |
| <b>Current Liabilities</b>                                        |                 |                |                 |                 |
| Accounts Payable                                                  | \$151,743       | \$140,000      | \$140,000       | \$141,328       |
| <b>Long-Term Liabilities</b>                                      |                 |                |                 |                 |
| Loans from Shareholders                                           | 19,471          | 17,200         | 16,200          | 44,177          |
| Notes Payable                                                     | <u>206,377</u>  | <u>201,846</u> | <u>133,436</u>  | <u>70,684</u>   |
| Total Long-Term Liabilities                                       | 225,848         | 219,046        | 149,636         | 114,861         |
| Total Liabilities                                                 | 377,591         | 359,046        | 289,636         | 256,189         |
| <b>Common Equity</b>                                              |                 |                |                 |                 |
| Common Stock                                                      | 1,000           | 1,000          | 1,000           | 1,000           |
| Retained Earnings*                                                | <u>-113,174</u> | <u>-97,145</u> | <u>-126,852</u> | <u>-107,482</u> |
| Total Equity                                                      | -112,174        | -96,145        | -125,852        | -106,482        |
| <b>Total Liabilities and Equity</b>                               | \$265,417       | \$262,901      | \$163,784       | \$149,707       |
| *Prior period adjustments made<br>to balance in retained earnings |                 | -6,417         |                 | 1,669           |

## **James Jewelers Instructor Manual**

### **Case Synopsis**

James Jewelers is a critical decision case involving Bob and Bonnie James, owners of James Jewelers in Spartanburg, South Carolina. This case accurately reflects dilemmas frequently faced by entrepreneurs in highly competitive retail markets.

The survival of James Jewelers and the financial stability of Bob and Bonnie is dependent on a correct decision regarding the future of James Jewelers. Bob and Bonnie have been working in the jewelry business for almost 20 years and are in the midst of experiencing their second failure. With substantial debt, shrinking inventory, and a lost lease, Bob has to decide whether to throw in the towel or start over.

Bob's values and beliefs enter into the decision as he feels a strong obligation to repay his debt and continue to provide a quality product and service to devoted customers. Some suppliers and many customers have stuck with James Jewelers for a number of years, and Bob feels that quitting would be a disservice to those who had faith in him. However, the financial condition of his operation continues to deteriorate. Sometimes staying in business could go from bad to worse and even more people could be negatively impacted by an unsuccessful operation. Then again, if he can turn the business around, there is a greater probability that Bob can make good on his obligations.

Bob and Bonnie need to decide quickly if they want to begin again for a third time or discontinue the operation of James Jewelers.

### **Learning Objectives**

This case can be either open-ended or directed through the suggested questions. The students should be able to do the following:

- Complete an analysis of a decision situation (Question 1) (Bloom's Taxonomy learning outcome level 4)
- Recall a knowledge of specific non-financial and non-quantitative facts that could be critical in a decision situation (Questions 2, 3 and 4) (Bloom's Taxonomy learning outcome level 1)
- Demonstrate a comprehension of specific financial and non-financial facts that could be critical in a decision situation (Questions 1, 2, 3 and 4) (Bloom's Taxonomy learning outcome level 2)
- Synthesize and apply knowledge and skills to recommend a course of action for the decision situation. (Question 5) (Bloom's Taxonomy learning outcome levels 3 and 5)

### **Intended Courses and Levels**

The James Jewelers case can be used in a small business, finance, or managerial accounting class at the undergraduate or graduate level that covers the topic of alternative choice decision making and financial statement analysis. The information presented is relatively straightforward, and there is a clear decision point. There are sufficient extenuating circumstances to make for a good discussion of critical factors in this type of decision analysis.

### **Teaching Plans/Approaches**

This case can be presented open-ended without any specific questions or directed with several recommended questions focusing on both quantitative and non-quantitative issues. Classroom formats can be instructor-led or student-led discussions of the critical issues and decision in the case. The case may also serve as an exam case if the instructor is using a text with cases and wants to offer a case in a slightly different format and not readily available to students.

This case has been classroom-tested in a financial and managerial accounting class of 40 students at the graduate level. It served as a final exam focusing on cash flow statements and financial analysis. The computational aspects proved sufficiently challenging and the discussion questions proved to be thorough and comprehensive. The decision dilemma was especially appealing as students were about equally divided between closing the store (60%) and continuing (40%). Additionally, there were a variety of creative suggestions for Bob to proceed, especially if he remained in the business.

### **Research Method**

This case was a field-researched case with three visits to James Jewelers and interviews with Bob and Bonnie. Follow-up communication via telephone and e-mail supported various drafts of the case study and accumulation of critical relevant financial and non-financial data.

### **Relevant Theory and Literature**

James Jewelers is a direct application of financial statement analysis and the alternative choice decision theory and processes. There are a large number of popular accounting and finance textbooks that have many references to decision making using both financial and non-financial data. Some texts include cases and some do not. Using supplemental cases, like James Jewelers, with a required text can offer a different perspective on teaching and applying various financial and accounting concepts to real-world situations. A partial list of texts, which includes alternative choice decision-making chapters, follows:

1. *Accounting for Decision Making and Control*, 4<sup>th</sup> edition, by Jerold L. Zimmerman, 1999. New York: McGraw-Hill Irwin. Chapters 2 & 3.

2. *Accounting: Text and Cases*, 10<sup>th</sup> edition, by Robert N. Anthony, Jack F. Hawkins, and Kenneth A. Merchant, 1999. New York: McGraw-Hill Irwin. Chapters 24 & 26.
3. *Case Problems in Finance*, 12<sup>th</sup> edition, by W. Carl Kester, Richard S. Ruback, and Peter Tufano, 2005. New York: McGraw-Hill Irwin. Parts 1 & 3.
4. *Corporate Finance*, 6<sup>th</sup> edition, by Stephen A. Ross, Randolph W. Westerfield, and Jeffrey Jaffe, 2002. New York: McGraw-Hill Irwin. Chapters 7 & 26.
5. *Corporate Finance*, by Scott B. Smart, William L. Megginson and Lawrence J. Gitman, 2004. Mason, OH: Thompson Southwestern. Chapters 7-9.
6. *Intermediate Financial Management*, 8<sup>th</sup> edition, by Eugene F. Brigham and Phillip R. Daves, 2004. Mason, OH: Thompson Southwestern. Chapters 11 & 12.
7. *Management Accounting*, 3<sup>rd</sup> edition, by Anthony A. Atkinson, Rajiv D. Banker, Robert S. Kaplan, and S. Mark Young, 2001. Upper Saddle River, NJ: Prentice Hall. Chapters 6 & 7.
8. *Management Accounting*, 6<sup>th</sup> edition, by Don R. Hanson and Maryanne M. Mowen, , 2003. Mason, OH: Thompson Southwestern. Chapters 17 & 18.
9. *Management Accounting – A Strategic Approach*, 3<sup>rd</sup> edition, by Wayne J. Morse, James R. Davis, and Al L. Hartgraves, 2003. Mason, OH: Thompson Southwestern. Chapters 3, 4, 9, & 10.
10. *Managerial Accounting – An Introduction to Concepts, Methods, and Uses*, 8<sup>th</sup> edition, by Michael W. Maher, Clyde P. Stickney, and Roman L. Weil, 2004. Mason, OH: Thompson Southwestern. Chapters 6-9.

### **Discussion Questions**

If the case is presented in a more directed format, the following questions may help to formulate the discussion.

1. Complete a financial analysis of James Jewelers and discuss your findings.
2. Identify critical non-quantitative issues that should be considered in the decision process.
3. What risk factors should Bob be most concerned about regarding his decision?
4. Identify possible ethical or at least values-based issues that could impact any decision.
5. What should Bob and Bonnie do?

## Answers to Discussion Questions

1. Complete a financial analysis of James Jewelers and discuss your findings.

**Author Note:** There are several widely accepted financial methods which can be used to aid in a financial analysis of James Jewelers. Included in this answer are: cash flow analysis, financial statement (ratio) analysis, growth rate analysis, common-sized financial statement analysis, and a decomposition of the return on equity (DuPont identity). The instructor could specifically direct the student to complete particular financial methods, including some, none or all of the ones in this answer key or leave the question more open-ended as done in the solution and allow the student to determine which financial methods are most appropriate.

### Cash Flow Analysis

Given three years of income statement data, along with four years of balance sheet data, it is possible to develop three years of cash flow statements. Given the critical nature of cash flow for James Jewelers, it is very important to understand how the business is operating from a cash flow perspective. Exhibit IM 1 illustrates the cash flow for James Jewelers for the years ending June 30, 2000, 2001, and 2002.

#### Exhibit IM 1

James Jewelers  
Cash Flow Statement  
For the Years Ending June 30, 2000, 2001, and 2002

|                                            | 2000           | 2001          | 2002          |
|--------------------------------------------|----------------|---------------|---------------|
| <b>Cash Flow from Operating Activities</b> |                |               |               |
| Net Income Before Tax                      | 22,446         | -29,707       | 17,701        |
| Depreciation                               | 19,047         | 16,672        | 16,738        |
| Interest Expense*                          | <u>7,670</u>   | <u>3,812</u>  | <u>11,696</u> |
| Cash Flow from Income Statement Acct       | 49,163         | -9,223        | 46,135        |
| Change in Current Accounts                 |                |               |               |
| Accounts Receivable                        | 1,786          | 1,100         | 632           |
| Inventory                                  | -1,787         | 76,782        | 12,104        |
| Accounts Payable                           | <u>-11,743</u> | <u>0</u>      | <u>1,328</u>  |
| Cash Flow form Changes in Current Acct     | <u>-11,744</u> | <u>77,882</u> | <u>14,064</u> |
| Cash Flow from Operating Activities        | 37,419         | 68,659        | 60,199        |
| <b>Cash Flow from Investing Activities</b> |                |               |               |
| Change in Equipment                        | -11,293        | 1,458         | -3,610        |

|                                     |          |               |          |
|-------------------------------------|----------|---------------|----------|
| Change in Other Assets              | <u>0</u> | <u>-1,458</u> | <u>0</u> |
| Cash Flow from Investing Activities | -11,293  | 0             | -3,610   |

### **Cash Flow from Financing Activities**

|                                     |               |               |               |
|-------------------------------------|---------------|---------------|---------------|
| Interest Expense*                   | -7,670        | -3,812        | -11,696       |
| Change in Loans from Shareholders   | -2,271        | -1,000        | 27,977        |
| Change in Notes Payable             | -4,531        | -68,410       | -62,752       |
| Change in Common Stock              | 0             | 0             | 0             |
| Dividends                           | 0             | 0             | 0             |
| Prior Period Adjustments            | <u>-6,417</u> | <u>0</u>      | <u>1,669</u>  |
| Cash Flow from Financing Activities | -20,889       | -73,222       | -44,802       |
| <br>                                |               |               |               |
| Net Cash Flow                       | <b>5,237</b>  | <b>-4,563</b> | <b>11,787</b> |
| Beginning Cash Balance              | <u>-4,824</u> | <u>413</u>    | <u>-4,150</u> |
| Ending Cash Balance                 | 413           | -4,150        | 7,637         |

\*Interest Expense is more appropriately classified as a finance activity versus an operation activity, so the amount of annual interest was transferred from the operation section to the finance section of the cash flow statement.

### **Analysis of Exhibit IM 1**

Cash flow is a very important aspect of a small business. A critical analysis and understanding on the impact of cash for James Jewelers is important.

The statement of cash flows shows a positive increase in cash flow coming from operating activities. Specifically in 2000 and 2002, this cash flow came mostly from income statement activities. While net income was not particularly high, the add-back of noncash depreciation helped in the cash flow. Also, interest expense activities were moved to the finance section for evaluation.

In 2001, a large reduction in inventory helped to offset a negative cash flow from income statement activities. James Jewelers may be taking a more aggressive working capital strategy by reducing levels of inventory while trying to maintain or grow sales. This may be a risky strategy, as the store needs to maintain a certain critical mass of inventory to appeal to the typical walk-in customer who wants to view a variety of product.

The cash flow from investing activities was relatively insignificant, especially over the last two years. James Jewelers is at least not making significant investments in fixed assets and has relatively few fixed assets, which is good given its critical cash flow position.

The cash flow from financing activities has shown a significant outflow over the past three years, especially in the last two years. In addition to paying interest, Bob has been

striving to reduce debt. Some of the debt in 2002 was also transferred from third parties to the shareholders as Bob probably used personal loans to pay off creditors.

Even though a fair amount of debt is being paid off in 2001 and 2002 there was a substantial increase in interest expense in 2002. It is possible that creditors were demanding higher rates of interest on the outstanding debt because the company was being perceived as a greater credit risk, making it even harder to improve the cash flow position.

There is no evidence of any payment of dividends to the shareholders (Bob and Bonnie) and the salary expense from the income statement was for other employees. One might question how Bob and Bonnie are surviving financially and providing for basic family needs during this period. More than likely they are accumulating large amounts of consumer debt.

Overall, the cash flow position is very precarious. Bob seems to be doing his best to efficiently manage cash flow, reduce debt, and maintain a minimum level of inventory, but he has little margin for error.

### **Financial Statement (Ratio) Analysis**

Financial statement analysis (ratios) will also provide valuable information regarding the current financial condition of James Jewelers. Exhibit IM 2 summarizes several critical financial ratios for the company.

#### **Exhibit IM 2**

James Jewelers  
Financial Statement Analysis  
For the Years Ending June 30, 1999, 2000, 2001, and 2002

|                              | <b>1999</b> | <b>2000</b> | <b>2001</b> | <b>2002</b> |
|------------------------------|-------------|-------------|-------------|-------------|
| <b>Liquidity Ratios</b>      |             |             |             |             |
| Current Ratio                | 1.249       | 1.391       | 0.802       | 0.788       |
| Quick Ratio                  | 0.020       | 0.047       | 0.006       | 0.085       |
| <b>Activity Ratios</b>       |             |             |             |             |
| Inventory Turnover           |             | 1.243       | 1.983       | 2.170       |
| Days in Inventory            |             | 293.6       | 184.1       | 168.2       |
| Accounts Receivable Turnover |             | 60.03       | 75.62       | 92.27       |
| Days in Receivables          |             | 6.08        | 4.83        | 3.96        |

|                           |       |       |       |
|---------------------------|-------|-------|-------|
| Accounts Payable Turnover | 1.596 | 2.123 | 1.626 |
| Days in Payables          | 228.6 | 172.0 | 224.5 |
| Fixed Asset Turnover      | 5.83  | 7.02  | 9.62  |
| Total Asset Turnover      | 1.59  | 1.97  | 2.76  |

### **Debt Ratios**

|                       |       |       |       |       |
|-----------------------|-------|-------|-------|-------|
| Debt to Asset Ratio   | 1.423 | 1.366 | 1.768 | 1.711 |
| Debt to Equity Ratio  | NMF   | NMF   | NMF   | NMF   |
| Times Interest Earned | 3.93  | -6.79 | 2.51  |       |

### **Profitability Ratios**

|                     |        |         |        |
|---------------------|--------|---------|--------|
| Gross Margin        | 0.445  | 0.292   | 0.471  |
| Profit Margin       | 0.053  | -0.071  | 0.041  |
| Basic Earning Power | 0.114  | -0.121  | 0.188  |
| Return on Assets    | 0.0850 | -0.1392 | 0.1129 |
| Return on Equity    | -0.215 | 0.268   | -0.152 |

## **Analysis of Exhibit IM 2**

To aid the discussion, ratios are divided into four categories: liquidity, activity, debt and profitability.

**Liquidity Ratios** – James Jewelers is clearly in a dangerous situation regarding liquidity. Both the current and quick ratios are extremely low, and the trend is in the wrong direction. Even a slight downturn in sales or other critical operating activities could create an irrevocable situation leading to termination of James Jewelers.

**Activity Ratios** – Turnover measures of inventory and accounts payable are poor, while fixed asset and total asset turnover are very good. If one only looked at the total asset turnover, one would not get a correct evaluation of James Jewelers because of the low amounts of long-term assets. The more correct measure of activity is reflected in the inventory and accounts payable turnover. Jewelry, by its nature, is a low-turnover and relatively high-margin product. The inventory turnover ratio for James Jeweler certainly reflects the low turnover. Hopefully, this is being offset by high margins. At least the inventory turnover is improving. This improvement is probably the result of a scale-back in the level of inventory. It would be even better if sales levels are also increasing to improve the inventory turnover.

The accounts payable turnover indicates a serious problem in credit relationships with suppliers. It is easy to see where suppliers will not want to do business with James

Jewelers for fear of not receiving payment for product for more than 200 days. If terms are net 30 or even 60 days, there is a critical problem with accounts payable.

The accounts receivable turnover is not a factor in this analysis, as James Jewelers apparently does not carry accounts receivable balances with its customers. One can probably assume that customers are either paying in cash or most likely with a commercial credit card. James Jewelers is fortunate that payment for retail sales is in this format, as any additional delays in the receipt of cash for sales would further jeopardize an already unhealthy cash flow situation.

**Debt Ratios** – James Jewelers is literally off the chart regarding its debt ratios as the level of debt far exceeds the level of assets. Additionally, the trend is getting worse as total debt is almost twice the level of total assets. Fortunately, much of this debt must be at low or no interest as the interest expense is relatively low for the amount of debt and risk of the company as reflected in a positive times interest earned ratio for 2000 and 2002. The debt to equity ratio gives results that are not meaningful figures (NMF) due to the negative equity amounts.

**Profitability Ratios** – Gross margins have been under 50% and even under 30% for 2001. This ratio is below the industry average of around 50% for a successful jewelry business. Given a high-margin item like jewelry, this appears to be a low margin, which when accompanied by low turnover will result in low profitability. James Jewelers could be under pricing their merchandise to try to generate sales or it is being forced by competition to reduce prices. The inability to make satisfactory margins could easily result in unsuccessful operations. The profit margin and basic earning power may be typical numbers for 2000 and 2002, but both were negative in 2001. Again, even when the profit margin was positive, it was at the low end, around 5 percent, of an industry norm of 5 to 10 percent for a successful operation. With all the other difficulties of the company, James Jewelers needs to have higher margins to begin to turn things around.

### **Summary Comments on Financial Statement Analysis**

There is not much positive to say about James Jewelers. Liquidity is in real danger, turnover of critical inventory is low, and payment policies with suppliers are extended well beyond normal credit terms. The debt situation makes conventional measures of performance almost irrelevant. Profitability beginning with gross margin is too low and leading to marginal levels of performance. About the only positive results is that there is a relatively low amount of capital tied up in fixed assets and interest levels on debt appear to be fairly reasonable given the risk of the operation.

### **Growth Analysis**

Another measure of financial performance could be related to growth. Exhibit IM 3 looks at the growth of some critical areas of James Jewelers.

### **Exhibit IM 3**

James Jewelers  
Growth Analysis  
For the Years Ending June 30, 2000, 2001, and 2002

|                                 | <b>2000</b> | <b>2001</b> | <b>2002</b> |
|---------------------------------|-------------|-------------|-------------|
| Growth in Sales                 |             | 0.000       | 0.030       |
| Growth in Gross Margin          |             | -0.345      | 0.661       |
| Growth in Net Income Before Tax |             | -2.323      | NMF         |
| Growth in Total Assets          | -0.009      | -0.377      | -0.086      |
| Growth in Total Liabilities     | -0.030      | -0.317      | -0.232      |

**Analysis of Exhibit IM 3**

There has been no growth in sales over the three-year period from 2000 through 2002. In spite of discussions regarding customer loyalty and various marketing techniques, the efforts have not translated into increased sales.

Because of the poor performance of 2001 with a negative net income before tax, the growth percentages in 2001 and 2002 for gross margin and profitability do not represent meaningful figures.

James Jewelers has shown reductions in the growth of its total assets with a rather significant reduction in size in 2001. There has also been a corresponding decrease in the growth rate for total liabilities. One might conclude that the company was too large in the beginning and is trying to become more efficient, and/or they are being forced to downsize because of unprofitable operations.

**Common Sized Income Statement Analysis**

A common sized income statement analysis can help to determine which expense categories consume the greatest proportion of revenue for James Jewelers and any trends over the three year period. Exhibit IM 4 highlights the revenue, expense and income categories in the common sized analysis.

**Exhibit IM 4**

James Jewelers  
Common Sized Income Statement Analysis  
For the Years Ending June 30, 2000, 2001, and 2002

|                          | <b>2000</b>    | <b>%</b> | <b>2001</b>    | <b>%</b> | <b>2002</b>    | <b>%</b> |
|--------------------------|----------------|----------|----------------|----------|----------------|----------|
| Sales                    | 419,779        | 1.00     | 419,667        | 1.00     | 432,206        | 1.00     |
| Cost of Goods Sold       | <u>232,869</u> | 0.55     | <u>297,161</u> | 0.71     | <u>228,743</u> | 0.53     |
| Gross Margin             | 186,910        | 0.45     | 122,506        | 0.29     | 203,463        | 0.47     |
| Operating Expenses       |                |          |                |          |                |          |
| Salaries and Wages       | 50,374         | 0.12     | 31,909         | 0.08     | 44,891         | 0.10     |
| Rent                     | 36,284         | 0.09     | 38,639         | 0.09     | 40,523         | 0.09     |
| Taxes and Licenses       | 19,772         | 0.05     | 18,804         | 0.04     | 26,391         | 0.06     |
| Advertising              | 13,895         | 0.03     | 15,515         | 0.04     | 11,599         | 0.03     |
| Insurance                | 7,829          | 0.02     | 7,683          | 0.02     | 7,658          | 0.02     |
| Utilities                | 6,506          | 0.02     | 7,412          | 0.02     | 6,504          | 0.02     |
| Depreciation             | 19,047         | 0.05     | 16,672         | 0.04     | 16,738         | 0.04     |
| General & Administration | <u>3,087</u>   | 0.01     | <u>11,767</u>  | 0.03     | <u>19,762</u>  | 0.05     |
| Total Operating Expenses | 156,794        | 0.37     | 148,401        | 0.35     | 174,066        | 0.40     |
| Interest Expense         | <u>7,670</u>   | 0.02     | <u>3,812</u>   | 0.01     | <u>11,696</u>  | 0.03     |
| Total Expenses           | 164,464        | 0.39     | 152,213        | 0.36     | 185,762        | 0.43     |
| Net Income Before Tax    | 22,446         | 0.05     | -29,707        | -0.07    | 17,701         | 0.04     |

#### **Analysis of Exhibit IM 4**

Cost of goods sold as a percentage of revenue was much higher in 2001 at 71% than the 55% in 2000 and 53% in 2002. That resulted in a lower gross margin rate of 29% and probably led to the negative net income before tax.

The total operating expense as a percent of sales remained relatively consistent between 35 and 40 percent over the three year time period and the individual operating expenses also remained relatively constant during this time period. This consistency should give credibility to expected levels of expenses in these areas in future years.

Interest expense as a percent of revenue remained at a very insignificant 1 to 3 percent over the three years. Given the concern over debt load, Bob should be thankful that these expenses were not a lot higher.

Overall, if James Jewelers can work toward a gross margin of around 50 percent and maintain a relatively consistent level of other operating expenses, they have a chance to earn a positive net income before taxes of between 5 and 10 percent which will be at the low end of the industry standard for their jewelry business.

#### **Common Sized Balance Sheet Analysis**

A common sized balance sheet analysis can help to determine the size of various asset, liability and equity accounts in relation to total assets for James Jewelers and any trends over the four year period. Exhibit IM 5 highlights the balance sheet in the common sized analysis.

#### **Exhibit IM 5**

James Jewelers  
Common Sized Balance Sheet Analysis  
For the Years Ending June 30, 1999, 2000, 2001, and 2002

|                                  | 1999            | %            | 2000           | %            | 2001            | %            | 2002            | %            |
|----------------------------------|-----------------|--------------|----------------|--------------|-----------------|--------------|-----------------|--------------|
| <b>Current Assets</b>            |                 |              |                |              |                 |              |                 |              |
| Cash                             | -4,824          | -0.02        | 413            | 0.00         | -4,150          | -0.03        | 7,637           | 0.05         |
| Accounts Receivable              | 7,886           | 0.03         | 6,100          | 0.02         | 5,000           | 0.03         | 4,368           | 0.03         |
| Inventory                        | <u>186,450</u>  | <u>0.70</u>  | <u>188,237</u> | <u>0.72</u>  | <u>111,455</u>  | <u>0.68</u>  | <u>99,351</u>   | <u>0.66</u>  |
| Total Current Assets             | 189,512         | 0.71         | 194,750        | 0.74         | 112,305         | 0.69         | 111,356         | 0.74         |
| <b>Long-Term Assets</b>          |                 |              |                |              |                 |              |                 |              |
| Equipment                        | 139,497         | 0.53         | 150,790        | 0.57         | 149,332         | 0.91         | 152,942         | 1.02         |
| Less Accumulated<br>Depreciation | <u>-63,592</u>  | <u>-0.24</u> | <u>-82,639</u> | <u>-0.31</u> | <u>-99,311</u>  | <u>-0.61</u> | <u>-116,049</u> | <u>-0.78</u> |
| Equipment (net)                  | 75,905          | 0.29         | 68,151         | 0.26         | 50,021          | 0.31         | 36,893          | 0.25         |
| Other Assets                     |                 |              |                |              | 1,458           | 0.01         | 1,458           | 0.01         |
| Long-Term Assets                 | 75,905          | 0.29         | 68,151         | 0.26         | 51,479          | 0.31         | 38,351          | 0.26         |
| <b>Total Assets</b>              | 265,417         | 1.00         | 262,901        | 1.00         | 163,784         | 1.00         | 149,707         | 1.00         |
| <b>Current Liabilities</b>       |                 |              |                |              |                 |              |                 |              |
| Accounts Payable                 | 151,743         | 0.57         | 140,000        | 0.53         | 140,000         | 0.85         | 141,328         | 0.94         |
| <b>Long-Term<br/>Liabilities</b> |                 |              |                |              |                 |              |                 |              |
| Loans Shareholders               | 19,471          | 0.07         | 17,200         | 0.07         | 16,200          | 0.10         | 44,177          | 0.30         |
| Notes Payable                    | <u>206,377</u>  | <u>0.78</u>  | <u>201,846</u> | <u>0.77</u>  | <u>133,436</u>  | <u>0.81</u>  | <u>70,684</u>   | <u>0.47</u>  |
| Total Long-Term<br>Liabilities   | 225,848         | 0.85         | 219,046        | 0.83         | 149,636         | 0.91         | 114,861         | 0.77         |
| Total Liabilities                | 377,591         | 1.42         | 359,046        | 1.37         | 289,636         | 1.77         | 256,189         | 1.71         |
| <b>Common Equity</b>             |                 |              |                |              |                 |              |                 |              |
| Common Stock                     | 1,000           | 0.00         | 1,000          | 0.00         | 1,000           | 0.01         | 1,000           | 0.01         |
| Retained Earnings                | <u>-113,174</u> | <u>-0.43</u> | <u>-97,145</u> | <u>-0.37</u> | <u>-126,852</u> | <u>-0.77</u> | <u>-107,482</u> | <u>-0.72</u> |
| Total Equity                     | -112,174        | -0.42        | -96,145        | -0.37        | -125,852        | -0.77        | -106,482        | -0.71        |
| <b>Liabilities &amp; Equity</b>  | 265,417         | 1.00         | 262,901        | 1.00         | 163,784         | 1.00         | 149,707         | 1.00         |

### Analysis of Exhibit IM 5

When looking at the various asset categories, it is evident that inventory is the key asset for James Jewelers which should not be surprising. Inventory represents about 70% of the total assets. However, there is a slight downward trend to the most recent inventory level of 66%. This trend may be an indication that Bob is doing a better job of efficiently managing inventory.

Accounts receivable is a relatively insignificant amount as retail customers generally either pay with a check or cash or most likely use a credit card. Bob at least does not seem to have any problem with the collection of accounts receivable or the accumulation of bad debts. There is some concern regarding cash which is sometimes even a negative balance, and never at a very high percentage of total assets. While Bob does not need to have a large amount of available cash, he has obviously been experiencing some cash flow difficulties and this low percentage leaves him with little margin for error.

Net equipment is around 25% of total assets and that proportion will probably continue to decline as the assets are depreciated. The case indicated that the fixed assets include showcases and fixtures along with some office furniture and a large safe. Assuming the safe has a long useful life and showcases, fixtures and office furnishings can be maintained reasonable inexpensively there should not be a need for any significant increase in fixed assets in the near future.

The liability and equity common sized analysis is a little unusual because of the increasing negative equity position. Total liabilities for the last two years have been at 177 and 171 percent of total assets up from around 140 percent in 1999 and 2000. However, long-term liabilities have been reduced by about half from 1999 to 2002 and the other major category, accounts payable in absolute dollar terms has remained relatively constant. Also, the negative equity position has been relatively constant in absolute dollar terms. The change in proportions has come about primarily from the reduction in the total asset of approximately \$100,000 in three years which roughly coincides with the reduction in long-term liabilities of just over \$100,000 in the same three year period. Bob appears to be improving his asset efficiencies along with making a concerted effort to reduce debt.

### **Return on Equity (DuPont) Analysis**

Additional information regarding financial performance can sometime be gained through a decomposition of the return on equity into several related ratios. In this analysis the return on equity (ROE) is divided into five specific ratios.

- Return on Equity = Tax Burden x Interest Burden x Operating Profit Margin x Total Asset Turnover x Leverage Ratio
- Net Income/Average Total Equity = Net Income/Earnings Before Tax x Earnings Before Tax/Earnings Before Interest and Tax x Earnings Before Interest and Tax/Sales x Sales/Average Total Assets x Average Total Assets/Average Total Equity

$$\frac{\text{NI}}{\text{Avg Equity}} = \frac{\text{NI}}{\text{EBT}} \times \frac{\text{EBT}}{\text{EBIT}} \times \frac{\text{EBIT}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Avg Assets}} \times \frac{\text{Avg Assets}}{\text{Avg Equity}}$$

Specific information regarding each ratio can help to analyze the overall performance of James Jewelers. Exhibit IM 6 highlights results for each of the five ratios over the 2000

to 2002 time period. When the five ratios are multiplied together they equal the return on equity.

### **Exhibit IM 6**

James Jewelers  
Decomposition of Return on Equity Analysis  
For the Years Ending June 30, 2000, 2001, and 2002

|                         | 2000   | 2001  | 2002   |
|-------------------------|--------|-------|--------|
| Return on Equity        | -0.215 | 0.268 | -0.152 |
| Tax Burden              | 1.00   | 1.00  | 1.00   |
| Interest Burden         | 0.75   | 1.15  | 0.60   |
| Operating Profit Margin | 0.07   | -0.06 | 0.07   |
| Total Asset Turnover    | 1.59   | 1.97  | 2.76   |
| Leverage Ratio          | -2.54  | -1.92 | -1.35  |

#### **Analysis of Exhibit IM 6**

##### Tax Burden Ratio

- Equals  $1 - \text{Tax Rate}$  or  $\text{NI}/\text{EBT}$
- EBT is greater than or equal to NI
- Reported as a percentage figure less than or equal to 100%.
- Zero taxes would give a burden ratio of 100%.
- The higher the tax rate, the lower the tax burden ratio.
- The lower the tax burden ratio, the lower the ROE.
- If the tax burden ratio is 100% there are no taxes and  $\text{NI} = \text{EBT}$  and taxes have no effect on ROE.
- A very high tax rate has the greatest reduction impact on ROE.

Since James Jewelers has not had to pay taxes for the last several years because of prior operating and current operating losses, the tax burden ratio, which is 100%, has had no impact on the overall return on equity.

##### Interest Burden Ratio

- Equals  $(\text{EBIT} - \text{Interest Expense})/\text{EBIT} = \text{EBT}/\text{EBIT}$
- EBIT is greater than or equal to EBT
- Reported as a percentage figure less than or equal to 100%.

- Zero interest would give a burden ratio of 100%.
- The higher the interest, the lower the interest burden ratio.
- The lower the interest burden ratio, the lower the ROE.
- If the interest burden ratio is 100% there is no interest expense and  $EBT = EBIT$  and there is no effect on ROE.
- A very high interest expense has the greatest reduction impact on ROE

The interest burden for 2001 is not a meaningful figure since both the earnings before tax and the earnings before interest and taxes are negative. In 2000 and 2002 this ratio is 75% and 60% respectively. The greatest impact on reducing ROE occurs in 2002 with the lower interest burden ratio. Also, the trend is in the less favorable direction; which could be an indication that the amount of debt is starting to have a greater detrimental impact on the return on equity for James Jewelers.

#### Operating Profit Margin Ratio

- Equals  $EBIT/Sales$ .
- EBIT could also be classified as Operating Income
- Differs from the typical profit margin ratio of  $NI/Sales$  to account for the tax burden and interest burden.
- $Profit\ Margin\ Ratio = Tax\ Burden \times Interest\ Burden \times Operating\ Profit\ Margin$
- Reported as a percentage figure less than 100%.
- Generally a low percentage amount as EBIT is a relatively small component of sales.
- The higher the operating expenses relative to sales, the lower the EBIT and the lower the operating profit margin ratio.
- The lower the operating profit margin ratio, the greater the reduction to ROE

The first question should be is 2001 with a negative operating profit margin of around -6.0% the norm or are the years 2000 and 2002 with a positive operating profit margin of around 7.0 percent more the norm. In either situation the ratio is low and is probably leading to lower levels of return on equity. If 2001 is more the norm, than the financial situation is much more serious.

#### Total Asset Turnover Ratio

- Equals  $Sales/Average\ Total\ Assets$
- Better to use average total assets versus ending assets since balance sheet numbers (assets) are being compared to an income statement number (sales)
- Reported as a times figure from 0 to any positive number
- Generally the ratio has a value of 1 to 2 times
- The higher the ratio value, the more efficient the utilization of assets in generating sales.

- The higher the average total assets relative to sales, the lower the turnover ratio and the greater the reduction in ROE

The total asset turnover ratios are quite high as James Jewelers are efficiently using their assets. The company requires a relatively low amount of long-term assets, and there is essentially no accounts receivable or cash balances. In recent years, inventory levels, the most significant asset category, have been decreased by almost 50 percent. Since sales levels have remained relatively constant, the improvement in the asset turnover ratio has been due to maintaining a consistent sales volume with fewer resources. The issue of concern could be the reduction in inventory. If inventory levels continue to drop, customers may see empty shelves with less quantity and quality and sales levels could drop. There is probably a critical mass of inventory that needs to be maintained to positively impact the customer perception of the jewelry store operations. While the high asset turnover numbers indicate a large positive impact on the return on equity, in reality, there could be a more long-term negative result.

### Leverage Ratio

- Average Total Assets/Average Total Equity
- Equals  $(\text{Average Total Equity} + \text{Average Total Debt})/\text{Average Total Equity}$
- $= 1 + \text{Debt/Equity Ratio}$
- Better to use average assets and average equity to be consistent with the other ratios and because some of the ratios in the ROE decomposition involve income statement numbers
- Reported as a times figure from 1.0 and higher
- If a company has zero debt than average total assets equal average total equity, the leverage ratio equals 1.0 and there is no leverage impact on ROE.
- The higher the leverage ratio value, the greater the use of financial leverage in increasing ROE
- Increased financial leverage also brings about increased risk of debt funding
- Higher levels of financial leverage will also bring about higher levels of interest burden which will somewhat offset the overall impact on ROE

The leverage ratio is negative due to the negative equity position for James Jewelers over the three year time period. Since the ratio is negative the figures are not especially meaningful, other than the fact that the relative debt levels were much higher in 2002 when the ratio was -2.54 than in 2001 when the ratio was just -1.35. The very fact that the ratio is negative means that there is more debt in the company than assets. Lenders, suppliers and various creditors have evidently been willing to support the operation even beyond its financially reported value. With this favorable financial leverage, Bob has the potential to gain a significant multiplicative impact on return on equity if the company can become profitable.

Overall Conclusions. The return on equity figure for 2001 is not meaningful since both the net income and total equity numbers are negative. The 2000 and 2002 return on equity figures are also not very useful because the amounts are negative. The

decomposition of ROE into the five ratios does not clarify the situation much better other than recognizing the precarious debt and asset situation, but the potential for great improvement if Bob can start earning a profit on a consistent basis.

2. Identify critical non-quantitative issues that should be considered in the decision process.

There are many non-quantitative (non-financial) issues that need to be considered in the decision-making process. Some of these issues support starting over for a third time, and some argue for discontinuing the operation.

Non-quantitative issues that support continuing the operation include the following:

- Almost 20 years in the business including 16 years as owner
- Strong values, integrity, and trust, which are important in a business line such as jewelry
- Past history of periods of good growth
- Total family commitment to the business
- Entrepreneurial mindset
- Extremely loyal customers
- Strong customer service
- Bonnie's knack for buying the right products
- Bonnie's talent designing and marketing jewelry
- There does not appear to be an alternative plan

Non-quantitative issues that support discontinuing the operation include the following:

- Will have to move from their current location
- Sales often dependent on discretionary income
- Strong competition
- No financial reserves to absorb downturns in sales
- Sales have been stagnate over the last three years
- Running your own business is stressful
- Poor credit rating
- Seems to be working for his landlord
- Will have to renegotiate new lease terms from a position of weakness
- Does not appear to have other skill sets
- There does not appear to be an alternative plan

3. What risk factors should Bob be most concerned about regarding his decision?

Entrepreneurs constantly deal with risk. Part of their make-up is having a higher than normal tolerance for risk. Entrepreneurs are often willing to trade the risk and potential of bankruptcy for the reward of being your own boss and the possibility of significantly above normal returns.

There are several significant risks that Bob is dealing with in his decision regarding continuing to operate James Jewelers.

- People often make jewelry purchases with discretionary income; this soft money is the first to go in times of need or economic downturn.
  - The community's culture can pose a risk. If you are not from an area, and there is history and a sense of family first, an "outsider" or someone new may be perceived as a threat to established operations.
  - The entrepreneurial mindset that believes one can make every situation into a success despite the odds and evidence.
  - Escalation of commitment
  - A "David versus Goliath" setting with the small retail "mom and pop" type of operation going up against a superstore like Wal-Mart.
  - Location, location, location.
  - The need to raise funds primarily through debt.
4. Identify possible ethical or at least values-based issues that could impact any decision.

Bob and Bonnie maintain a strong sense of values and have moral beliefs that influence their decision-making. Some of their concerns include the following:

- Making good on their debt obligations
- Sticking with suppliers who have stuck with them through difficult times
- Providing support and service to loyal customers
- Providing employment for their employees
- Exhibiting trust and integrity in dealings with the public
- They are a source of expertise in the jewelry business
- As parents they want to be a good example for their children and other family members

5. What should Bob and Bonnie do?

Financial evidence certainly points to discontinuing operations. Even if Bob and Bonnie wanted to start over a third time, they may not get the financial backing and support they need to cover necessary start-up costs.

The problem with closing the business is there appears to be no alternative strategy. Bob and Bonnie's expertise is all associated with running a retail jewelry operation. If they are serious about turning around their financial situation, continuing the business may be the only viable option. Either they could become extremely successful or collapse.

Given the education, skills, and talents both Bob and Bonnie possess, there may be more attractive options than they are aware of. They both have become known in their community and recognized for their honesty and integrity. If either is willing to work for

someone else, they could easily begin again in either the retail industry or for a more financially secure company with the possibility for promotion. The stress of running a store would be eliminated; that peace of mind alone might be worth making a change.

Regarding their obligation to other employees, customers, and suppliers, most would probably be understanding and work with them through a transition. The biggest obligation would be the debt repayment. Apparently many suppliers have already been willing to develop repayment programs. These plans could be maintained and/or modified as long as Bob continued to make the effort to repay his debt.

Sometimes it is just as important to know when to fold as it is to continue to bet more chips on a losing hand. The weakness of the financials strongly indicates that it would be best to terminate operations. There does not appear to be enough arguments in terms of favorable non-quantitative information to change that decision.

## **Epilogue**

Bob and Bonnie decided to begin again at a new location. They were able to secure leased space just three blocks from their existing location. While the new facilities were only 1,250 square feet, less than half the size of their current location, that turned out to be a blessing as overhead was cut significantly. They sold enough of their inventory to pay for a move and get reestablished. They moved during July and August, traditionally the slowest time of the year for sales, so they probably did not lose much business in the transition.

The goodwill and customer service that was built up during the seven years of operation in Spartanburg paid off. Customers remained loyal and supported the new operation to an even greater extent.

Without sufficient cash, Bob and Bonnie could not restock their inventory and had to rely on pictures in catalogues. But customers worked with them, and they made sales without buying excessive inventory. Bob and Bonnie found less expensive silver items and other materials to fill showcases and create an attractive appearance and some ambiance at the store. Gradually, improving cash flow and having a few devoted suppliers who stuck with them through the trial enabled James Jewelers to turn the corner and actually gain profitability within two years.

Through a combination of reducing overhead, strong customer loyalty, sticking by their principles and values, suppliers who gave them one more chance, better management of their cash flow, and their faith, Bob and Bonnie made James Jewelers a successful operation that is turning a profit and providing a positive cash flow. They recently bought a home, and the family is prospering.

**Instructor Note:** Due to the sensitive nature of this decision and the general unfavorable financial condition of the company, the instructor recommended to the owners of the company that their names, the company name, and company location be disguised.

Numerical data, which is critical for an accurate analysis of the decision, has not been modified. However, the owners were still willing to release the case undisguised.

Date: October 6, 2007

Subject: Submission of Case Manuscript

In submitting this case, James Jewelers, to the *Case Research Journal* for widespread distribution in print and electronic media, I certify that it is original work, based on real events in a real organization. It has not been published and is not under review elsewhere. Copyright holders have given written permission for the use of any material not permitted by the "Fair Use Doctrine." The host organization has assigned a release authorizing the publication of all information gathered with understandings of confidentiality.