

CASE 2: MICROLINE CORPORATION

You work in the finance and investment department of Mega Industries, which recently purchased several small high-tech companies. An additional company, Microline Corporation, is presently under consideration. You have been asked to serve on a project team that is preparing a recommendation to the chief financial officer about whether Mega should attempt to acquire Microline. Your duty on this team is to review the company's financial statements and write a memo to the team leader, Sharon Sonneborn. The memo should analyze Microline's solvency position, earning power potential, and the extent to which the reported financial statements reflect the company's "true" financial position and performance. After a brief review of Microline, Sharon believes that you should also address in your report the following important questions:

1. Is there any evidence that management's bonus caused it to enter into any transactions, especially at year-end, that may not have been in the shareholders' interest?
 2. Has the debt covenant imposed any restrictions that may have influenced any of management's reporting choices?
 3. What was the acquisition price of Littleton when it was purchased by Microline?
 4. Is Microline's bad debt allowance sufficient?
 5. How much cash was received by Ellery Inc. during 2011, and what percentage of Ellery's total income was paid out in the form of dividends?
 6. How much cash was collected from customers during 2011?
- Microline's most recent financial statements are as follows (dollars in thousands).

Microline Corporation
Income Statements
for the Periods Ending December 31, 2011 and 2010

	2011	2010
Sales	\$60,000	\$52,500
Cost of goods sold	34,000	31,500
Gross profit	\$26,000	\$21,000
Selling and administrative expenses	(22,750)	(17,500)
Bad debt expense	(250)	(350)
Depreciation expense	(2,500)	(2,100)
Interest expense	(1,000)	(600)
Other gains (losses)	5,250	1,250
Net income before taxes	\$ 4,750	\$ 1,700
Income tax expense	1,500	800
Net income	\$ 3,250	\$ 900
Earnings per share	\$ 0.26	\$ 0.072

FOOTNOTES (DOLLARS IN THOUSANDS)**SHORT-TERM EQUITY INVESTMENTS.** Short-term equity investments consist of

trading securities and available-for-sale securities. The trading securities were valued