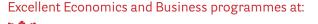
Problem 7

McEnroe Corporation and Edberg Corporation each sell tennis equipment. McEnroe Corporation's strategy is to focus on selling quality units at the best possible prices, while attempting to minimize selling, general, and administrative expenses (SG&A). Edberg Corporation has concluded that many customers will differentiate more on brand than quality, and is promoting its inferior goods with a significant marketing campaign.

Study each company's income statement below, and calculate the respective proportion of sales returns, the gross profit margin, and the net profit on sales. Both companies are subject to a 30% tax rate. Assuming no change in SG&A, which company would experience the biggest increase in profit from a 10% increase in net sales? Which company would experience the biggest decline in profit from a 10% decrease in net sales?





"The perfect start of a successful, international career."

CLICK HERE

to discover why both socially and academically the University of Groningen is one of the best places for a student to be

Download free eBooks at bookboon.com

www.rug.nl/feb/education



| MCENROE CORPORATION | | | |
|---------------------------------------|--------------|--------------|--|
| For the Year Ending December 31, 20X6 | | | |
| Net sales | | | |
| Gross sales | \$ 2,837,628 | | |
| Less: Sales return | 56,754 | \$ 2,780,874 | |
| Cost of goods sold | | 2,128,221 | |
| Gross profit | | \$ 652,653 | |
| Selling expenses | \$ 135,000 | | |
| General & administrative expenses | 360,000 | 495,000 | |
| Income before taxes | | \$ 157,653 | |
| Income tax expense (30%) | | 47,296 | |
| Net income | | \$ 110,357 | |

| BORG CORPORATION | | | | |
|---------------------------------------|--------------|--------------|--|--|
| Income Statement | | | | |
| For the Year Ending December 31, 20X6 | | | | |
| Net sales | | | | |
| Gross sales | \$ 2,957,628 | | | |
| Less: Sales return | 176,754 | \$ 2,780,874 | | |
| Cost of goods sold | | 1,251,393 | | |
| Gross profit | | \$ 1.529,393 | | |
| Selling expenses | \$ 1,011,828 | | | |
| General & administrative expenses | 360,000 | 1,371,828 | | |
| Income before taxes | | \$ 157,653 | | |
| Income tax expense (30%) | | 47,296 | | |
| Net income | | \$ 110,357 | | |
| | | | | |

Download free eBooks at bookboon.com

Worksheet 7

McEnroe Corporation

Sales returns rate

Gross profit margin

Net profit margin

Borg Corporation

Sales returns rate

Gross profit margin

Net profit margin

| | McEnroe | Borg |
|---|---------|------|
| 10% increase in net sales | | |
| Net sales (\$2,780,874 × 110%) | \$ | \$ |
| Cost of goods sold | | |
| Gross profit (net sales $	imes$ gross profit margin) | \$ | \$ |
| SG&A | | |
| Income before taxes | \$ | \$ |
| Income tax expense (30%) | | |
| Net income | \$ | \$ |
| | | |
| 10% decrease in net sales | | |
| Net sales (\$2,780,874 $	imes$ 90%) | \$ | \$ |
| Cost of goods sold | | |
| Gross profit (net sales \times gross profit margin) | \$ | \$ |
| SG&A | | |
| Income before taxes | \$ | \$ |
| Income tax expense (30%) | | |
| Net income | \$ | \$ |

Download free eBooks at bookboon.com

Solution 7

McEnroe Corporation

| Sales returns rate | (\$56,754 ÷ \$2,837,628) | 2,00% |
|---------------------|---------------------------|--------|
| Gross profit margin | (\$652,653 ÷ \$2,780,874) | 23,47% |
| Net profit margin | (\$110,357 ÷ \$2,780,874) | 3,97% |

Borg Corporation

| Sales returns rate | (\$176,754 ÷ \$2,957,628) | 5,98% |
|---------------------|-----------------------------|--------|
| Gross profit margin | (\$1,529,481 ÷ \$2,780,874) | 55,00% |
| Net profit margin | (\$110,357 ÷ \$2,780,874) | 3,97% |

Intuitively, the company with the highest gross profit rate (Borg) would benefit more from an increase in sales (assuming SG&A is not changing). Conversely, Borg will suffer more from a decline in sales. Below is a comparison of effects:

| | McEnroe | | Borg | |
|--|---------|-----------|------|-----------|
| 10% increase in net sales | | | | |
| Net sales (\$2,780,874 × 110%) | \$ | 3,058,961 | \$ | 3,058,961 |
| Cost of goods sold | | 2,341,043 | | 1,376,532 |
| Gross profit (net sales $	imes$ gross profit margin) | \$ | 717,918 | \$ | 1,682,429 |
| SG&A | | 495,000 | | 1,371,828 |
| Income before taxes | \$ | 222,918 | \$ | 310,601 |
| Income tax expense (30%) | | 66,875 | | 93,180 |
| Net income | \$ | 156,043 | \$ | 217,421 |

| 10% decrease in net sales | | |
|--|-----------------|-----------------|
| Net sales (\$2,780,874 × 90%) | \$ 2,502,787 | \$ 2,502,787 |
| Cost of goods sold | 1,915,399 | 1,126,254 |
| Gross profit (net sales $	imes$ gross profit margin) | \$ 587,388 | \$ 1,376,533 |
| SG&A | 495,000 | 1,371,828 |
| Income before taxes | \$ 92,388 | \$ 4,705 |
| Income tax expense (30%) | 27,716 | 1,411 |
| Net income | \$ 64,671 | \$ 3,293 |

Download free eBooks at bookboon.com