Stirling home corporation

ASSIGN BUSTER

CASE NO. 1: STIRLING HOMEX CORPORATION POINT OF VIEW: The Chief Financial Officer (CFO) of Stirling Homex Corporation (SHC) as he/she will be the one to be of best knowledge to analyze the financial statements of SHC. He/she will also have the authority to make decisions/recommendations and influence the CEO in making management decisions. CASE CONTEXT: In the late 1960's the US Department of Housing and Urban Development (HUD) launched the Operation Breakthrough, a project that aimed to " revolutionize" the housing industry, which attracted various housing companies to seek for means to construction technology.

One of which is the Stirling Homex Corporation (SHC), founded in 1967 which pioneered the concept of modular housing, making possible the construction of large number of houses at a fraction of a time for an average of $16, 000 to $25, 000 per house. From what started as a small Suburban Rochester project with housing 275 units in 1967, the company was able to expand through the development of system of jacks that gave way for SHC to supply a 2000-ft long train of modules to Mississippi. In 1971, the Company went public and sold Rochester housing (1/2 of which are bought by Homer investors) earning $1M sales of $10M for 1969.

Stocks more than tripled for the February to March 1970 period ($16. 50 to $51. 75 a share). At the same year SHC also won a HUD contract for construction of 13-storey apartment in Memphis, had a tentative understanding with Mississipi Greater Gulf Coast Housing Development Corporation (MGGCHDC) to build a $100 M worth of modular housing, and also planned to diversify by leasing a 350 sq ft. plant in Gulf Port to be financed by industrial revenue funds to be approved by local voters. In 1971

SHC also revealed its plan to widen its target market by catering not only to public housing projects.

It doubled its manufacturing facilities and created US Shelter Corporation, a subsidiary for construction and financing of its customers. As noted in the case, SHC recognizes sales when units are manufactured and assigned to specific contracts. Upon receipt of the proposals, the Local Housing Authority (LHA) assigns a letter of designation and countersigned by the HUD. Until the contract of sale is countersigned by the HUD, no legally binding commitment of federal funds is guaranteed by the HUD. Moreover, according to sources, a profit margin of SHC majorly comes from production of modular units; others were allocated on a break-even basis.

PROBLEM DEFINITION: Considering that the SHC is a new company and is diversifying in a very speedy manner, what safeguards must the company adapt in order to minimize losses and avoid sudden collapse? FRAMEWORK FOR ANALYSIS: The group analyzed the attached exhibit in the given case showing the financial statements and attached notes pertaining to the SHC, looking into the quality of earnings of the company (recurring vs non-recurring expenses and gains, analysis of operating cash flow, and the stability of its earnings).

ANALYSIS Looking into the SHC financial statements, we see derive the following analysis: Recurring vs. Non-recurring gains and expenses: Recurring Non-Recurring manufacturing Unbilled Accounts Receivable (as it is a 1971: Cost of expanding company policy, the company declares facilities in Avon, NY premature sales despite the fact that it will only receive cash

inflow upon completion of construction, unless revoked) Long term receivables Operating Cash Flows: Despite the fact that SHC acquired a 60% gain in net income ($2. 04M to $3. 25M) and 172% increase in working capital provided by operations ($2. 7M to $5. 59M), the bulk of the increase of the company's assets are due to accounts and preferred stock proceeds receivables, which are to be collected when the construction of a unit of housing is completed. Hence, cash inflow of the company is meager as compared to the outflow of cash, a bulk which goes to notes payable to banks (a huge $46. 20M in 1971 versus $16. 13M in 1970), which when referred to the notes of the statements are current liabilities (90 day unsecured notes to eleven banks at 1% to 2% interest rate). Earnings: Ballooning Accounts Receivable ?

In the balance sheet, increased to more than double ($15. 49M in 1970 to $37. 85M in 1971) and preferred stock proceeds receivable from none in 1970 to $19M in 1970; ? In the statement of cash flows, increased to 81. 98% from $12. 29M in 1970 to $22. 36m in 1971 The previous observations are based on the fact that the SHC recognizes sales when units are manufactured and assigned to specific contracts. Even before a sale is done, under this policy, SHC is recording a sale prematurely as no payment is to be made and transfer of responsibility to seller until construction of the house is finished.

A huge portion of the accounts receivable are unbilled receivables which are recorded sales on contracts in process for which the billing will be rendered in the near future, which is not in accordance to IAS 18 as it violates item number two of the criteria of recognizing sale of goods, to wit: Recognition of

Revenue: Recognition, as defined in the IASB Framework, means incorporating an item that meets the definition of revenue (above) in the income statement when it meets the following criteria: ? it is probable that any future economic benefit associated with the item of revenue will flow to the entity, and the amount of revenue can be measured with reliability IAS 18 provides guidance for recognising the following specific categories of revenue: Sale of Goods: Revenue arising from the sale of goods should be recognised when all of the following criteria have been satisfied: [IAS 18. 14] ? the seller has transferred to the buyer the significant risks and rewards of ownership ? the seller retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold ? the amount of revenue can be measured reliably ? t is probable that the economic benefits associated with the transaction will flow to the seller, and ? the costs incurred or to be incurred in respect of the transaction can be measured reliably DECISION: Upon analyzing the financial statements of SHC, the group recommends that the SHC revise its policy in revenue recognition and adhere to IAS 18 guidelines in recognizing revenue, that is not merely recording sales based on when the modules are manufacture and contracted but when the house, building or related structure is transferred to the owner to avoid overstating gains.

SHC must also revise its strategy and only produce a number of houses or facilities based on the actual demand and not merely based on contracts issued by the HUC. SHC must also declare actual losses and not lump it in accounts receivable if there are no buyers within a timeframe set by the company. JUSTIFICATION: Not revising the existing strategy and guidelines

would eventually lump all the accounts receivable that would result to deficit of cash inflow for SHC to fund its operational activities.

OPERATIONALIZATION: ? Conduct of meeting with HUC to form consensus and agreement on the revision of existing policy in the housing program project, negotiate for a possible counterpart of funds (ex. 50-50) on the government’s behalf; ? Conduct inventory of constructed housings and intensify marketing initiatives in order to acquire buyers of the constructed housing; ? Provide flexible schemes of payment for to entice buyers.