Manufactured homes case essay sample

Finance

Question 1: Describe the key aspects of Manufactured Homes’ business. Does the company have a viable business?

•Manufactured Homes sells affordable fully furnished and carpeted mobile homes in the southeast of the United States of America. These Potential customers for Manufactured Homes include individuals seeking a single-family primary residence but lacking the ability to purchase conventional housing, retirees, and those wanting a second home for vacation purposes. The company targets individuals in the low-income category, which is a segment of the manufactured homes market in the company’s seven state area. The company’s customers are typically between the ages of 18 and 40, blue-collar workers in manufacturing, service and agricultural industries, and earned approximately $20, 000 per year. The company believes that its focus on the lower end of the market has two advantages. First, since its customers are seeking to fulfil an essential housing need, sales are less affected by changes in general economic conditions. Second, the company’s repossession rates are significantly lower than those of the industry since its customers are likely to work very hard to keep their primary residences even when times are bad.

•Most of Manufactured Homes’ sales are credit sales where the customer pays a down payment and enters into an installment sales contract with the company to pay the remaining amount over periods ranging from 84 to 180 months. Manufactured Homes sells the majority of this contracts to financial institutions. •The manufactured homes industry is fragmented. There are approximately 10, 000 manufactured home retailers throughout the nation, most of which fall into the category of ‘’mom and pop’’ operations. The

industry is undergoing a period of transition and consolidation. More and more of the smaller firms, lacking volume buying power and adequate capitalization, are disappearing of becoming a part of a larger company.

The industry has always been competitive bus has become more so in recent years. The continuing increases in the average price of conventional housing have forced low-income families to seek other alternatives. And more and more are turning to manufactured homes. •I believe that the company has a viable business for several reasons. First, because the company focuses on the lower end of the market, and as stated above, this segment is seeking alternatives for conventional housing. Second, because larger companies like Manufactured homes have the financial advantages of volume buying, and that is why independent dealers are actively seeking a working relationship with Manufactured Homes. Third, because Manufactured Homes' revenues increases rapidly in recent years, from $11 million in 1983 to $120 million in 1986.

Question 2: Describe and show the journal entries illustrating how the company accounts for its home sales. Is this accounting treatment reasonable? What are the key assumptions made under this approach? Do you agree with these assumptions?

•Most of Manufactured Homes' sales are credit sales where the customer pays a down payment (of 5 to 10 percent of the sales price) and enters into an installment sales contract with the company to pay the remaining amount over periods ranging from 84 to 180 months. •The journal entries are:

Dr. Accounts receivable

Dr. Cash

Cr. Net sales

Dr. Cost of sales

Cr. Inventories

•A sale is recognized when payment is received or, in the case of credit sales, when a down payment (generally 10% of the sales price) is received and the company and the customer enter into an installment contract. Installment contracts are normally payable over periods ranging from 120 to 180 months. •I believe this is aggressive type of revenue recognition, because all revenue from the sales is recognized when a customer enters into an installment contract with the company. Therefore I don't believe this accounting treatment is reasonable. In this case the collection of receivables involves a high level or risk and therefore I believe that the company must defer the recognition of revenue.

Question 3: Describe and show the journal entries illustrating how the company accounts for the transfer of its accounts receivable to financial institutions. Is this accounting treatment reasonable? What are the key assumptions made under this approach? Do you agree with these assumptions?

•The company sells the majority of its retail intstallment contracts to unrelated financial institutions on a recourse basis at an agreed upon interest rate which is below the contractual interest rate of the installment contract. Under this agreement, Manufactured Homes is responsible for

payment to the financial institution if the customer fails to make the payments specified in the installment contract. •At the time of the sale, the company receives immediate payment for the stated principal amount of the installment contract and a portion of the finance participation resulting from the interest rate differential. The remainder of the interest rate differential is retained by the financial institution as a security against credit losses and is paid to the company in proportion to customer payments received by the financial institution. •The journal entries are:

Dr. Cash

Cr. Accounts receivable

Dr. Cash

Dr. Finance participation receivable

Cr. Finance participation income

•The company accounts for these transactions as sales in accordance with Statement of Financial Accounting Standards No. 77, ‘’Reporting by Transferors for Transfers of Receivables with Recourse’’. Therefore I believe that this accounting treatment is reasonable. Transfers of receivables that are subject to recourse must be reported as sales if the following three conditions are satisfied: (1) The seller unequivocally surrenders the receivable to the buyer. (2) The seller’s remaining obligations to the buyer under the recourse provision must be subject to reasonable estimation on the date of the transfer of the receivable. For this purpose, the seller should be able to estimate: (a) the amount of bad debts and related costs of collection and repossession, and (b) the amount of prepayments. If the seller cannot make these estimates reasonably well, a transfer of the receivable

cannot be reported as a sale. And (3) the seller cannot be required to purchase the receivable from the buyer except in accordance with the recourse provision. If any of the above conditions is not satisfied, the seller of the receivable must report the proceeds from the transfer as a loan against the receivable. •The company recognizes finance participation income equal to the difference between the contractual interest rates of the installment contracts and the agreed upon rates to the financial institutions; the portion retained by the financial institutions is discounted for estimated time of collection and carried at its present value.

Question 4: The company's income statement shows that it has two sources of profits: home sales and finance participation income. What is the gross margin (gross profit ratio) in each of these two areas assuming that the costs relating to finance participation income are not material? What do these ratios tell you about the importance of each to the company's reported profits?

•Gross profit is defined as the difference between Sales and Cost of Sales. The gross margin (or gross profit ratio) expresses the gross profit as a proportion of net sales. The gross profit margin ratio measures how efficiently a company uses its resources, materials, and labour in the production process by showing the percentage of net sales remaining after subtracting the cost of making and selling a product or service. It indicates the profitability of a business before overhead costs. The higher the percentage, the more the business retains of each dollar of sales. So: the higher the gross profit margin ratio, the better.

•The reason for the high gross profit ratio for the finance participation income is that there are little to no costs relating to this income. The amount of gross profit for the home sales is higher than the gross profit for the finance participation income. These ratios tell you, that the interest rate ‘‘ spread’’ is more profitable than the sale of homes. Therefore, the income from the finance participation is very important for the company.

Question 5: Manufactured Homes significantly increased its provision for losses on credit sales. (See Note 7, on page 209 of the case) What economic factors underlie this increase? Do you think the company has been able to estimate the losses on credit sales on a timely basis?

•During the first three quarters of 1986, the provision for credit losses was approximately 1% of net sales. Due to recent fourth quarter charges, management increased the provision for losses for 1987 to 1½% of net sales as a precautionary measure against future repossession and early pay-off.
•There are several economic factors that underlie the recent fourth quarter charges. First, the industry of manufactured housing has been significantly impacted by the slow economic growth of the economy coupled with an extended period of low interest rates. These factors are reflected by a year-to-year decrease in 1986 of 15% in manufactured homes sold throughout the company’s market area.

Also, in late 1986, the prepayments of home mortgages became a recognized concern. Prepayment mortgages caused management to reevaluate certain assumptions resulting in a significant increase in the reserve for credit losses. And finally, during the fourth quarter of 1986,

approximately $2, 000, 000 of repossession expense and interest chargebacks were experienced and charged off. One of the causes of the $2, 000, 000 charge was the refusal of some unrelated financial institutions to refinance the repossession that occurred in their portfolio, and a second cause was that the company had to finance them through MANH Financial Services thereby having an immediate charge in finance participation on the pay-off and not recognizing the finance participation income of the resale. Therefore, a charge to earnings for both prepayments and repossessions was made and the reserve for credit losses was increased to $3, 000, 000 at December 31, 1986. •I think that the company has been able to estimate the losses on credit sales on a timely basis, because the estimated losses are based on historical loss experience and current economic conditions.

Question 6: What is the total amount of receivables ‘’sold’’ by Manufactured Homes for which the company has a contingent liability in case of default? If the cash from the sale of these receivables was recorded as debt (rather than as a reduction of receivables), what would be the company’s debt to equity ratio? How does it compare with the debt to equity ratio calculated from the company’s reported numbers? Which ratio better reflects the company’s financial risk?

Contract proceeds receivable from financial institutions$11, 496, 078 Net finance participation receivable – current portion1, 889, 986 Net finance participation receivable – noncurrent portion12, 205, 621 Total amount of receivables ‘‘ sold’’25, 591, 685

If the cash from the sale of these receivables was recorded as debt, the debt to equity ratio is:

Total liabilities$78, 706, 762

[$67, 210, 684 + $11, 496, 078]

Total shareholders' equity 14, 167, 119

Debt to equity ratio5. 56

Debt to equity ratio calculated from the company's reported numbers:

1986

Total liabilities$67, 210, 684

Total shareholders' equity14, 167, 119

Debt to equity ratio4. 74

[$67, 210, 684 ÷ $14, 167, 119]

•When the cash from the sale of the receivables is recorded as debt (rather than as a reduction of receivables), the company's debt to equity ratio is higher compared to the debt to equity ratio calculated from the company's reported numbers. The first ratio reflects the company's financial risk better, because the company also bears risk for these ' sold' receivables.