

### **ZZZZ BEST Co., Inc.**

ZZZZ BEST Co., Inc. ("The Company") was organized on December 6, 1985 as a non-operating parent company of a sole proprietorship which had operated since 1981. The Company provided professional residential and commercial carpet, upholstery and drapery cleaning services from its eleven locations throughout California. Customers included homeowners, owners and operators of commercial establishments, such as hotels, restaurants, apartment complexes and office buildings, and two firms of adjusters representing various insurance companies. The insurance-related work typically involved the restoration or replacement of carpets and other furnishings which had been damaged or destroyed as a result of extensive water or fire casualties.

On November 3, 1986, the Company filed a Form S-1 (Registration Statement) with the Securities and Exchange Commission. The purpose of the registration statement was to raise approximately \$9 million in capital. The above description of the business of the Company and the following facts have been excerpted from that registration statement.

Beginning in about April 1985, the insurance restoration work supposedly became an increasingly important part of the Company's business. In certain cases, to obtain necessary financing, the Company claimed it undertook restoration contracts through joint ventures with unaffiliated parties. During the year ended April 30, 1986 and the three months ended July 31, 1986, approximately 55% and 14%, respectively, of the Company's revenue was generated from residential and commercial customers, and 45% and 86%, respectively, reputedly came from its insurance restoration business (not including revenue from restoration work performed by the Company through joint ventures).

Between August 1 and September 10, 1986, revenue from the Company's reported insurance restoration projects supposedly aggregated \$4,957,920, including \$1,940,213 through joint ventures. As of September 30, 1986, the Company allegedly was working on 13 contracts aggregating \$24,362,000 of which seven, aggregating \$15,068,000, were through joint ventures. The restoration work was accounted for under the percentage of completion method of accounting.

Typically the Company's joint venture partners arranged for the financing necessary to undertake the restoration projects (such as short-term bank loans). This financing supposedly covered the costs of materials and supplies, employee transportation and lodging costs, payroll and other expenses estimated to be incurred before the first progress payment was received from the insurance adjuster (generally, after approximately 25% of the work had supposedly been performed). The Company was primarily liable for the debt and the joint venturer was secondarily liable.

The profitability of a restoration contract depended on the Company's ability to control its expenses, the principal one of which was the cost of replacing the flooring materials. The Company claimed it had available a pool of approximately 200 experienced people capable of performing the restoration work, 90 of whom were Company employees and 110 of whom were independent contractors. Most of these persons were supposedly located in Southern California and were deployed, as needed, to the various project sites.

Using the facts above and the financial information on pages 4 and 5 answer the following questions:

1. Prepare a vertical analysis for each of the three periods, 1985, 1986, and the three months in fiscal year 1987.
2. Prepare two horizontal analyses, one for the changes between 1985 and 1986 and the other for the changes for the fifteen (15) month period, 1985 through the first three months of fiscal year 1987.
3. Prepare a summary of the Balance Sheet and Operations Ratios which pertain to the operations of this company.

4. Based on your answers to questions 1, 2, and 3 above, what relationships indicate that further investigation might be prudent? Prepare a graph of these items which you consider worthy of further investigation.
5. What does "Unbilled Charges on Restorations" represent?
6. For the three months ended July 31, 1986, there was a zero balance in Unbilled Charges on Restoration, yet there was a balance of \$107,301 in Overbilled Charges on Restoration. Is there any significance to this difference?
7. What do you think "Advances on Materials" represents?
8. What do you think "Advances - Joint Ventures" represents?
9. Can you identify the scheme(s) involved? If so, what might they have been? (Hint: explore the relationships detailed below.)
  - a. Increases in Accounts Receivable and increases in Advances on Materials?
  - b. Increases in Accounts Receivable and increases in Sales?

**ZZZZ BEST Co., Inc.**

STATEMENT OF INCOME	<u>1985</u>	<u>1986</u>	<u>3 Mos. 7/31/86</u>
Net Sales	\$1,240,524	\$4,845,347	\$5,395,754
Costs of Goods Sold	<u>576,694</u>	<u>2,050,779</u>	<u>2,976,205</u>
Gross Margin	663,830	2,794,568	2,419,549
General Expenses	306,016	1,125,541	622,811
Joint Venture Income	<u>0</u>	<u>186,679</u>	<u>102,066</u>
Operating Income	357,814	1,855,706	1,898,804
Interest Expense	0	43,020	64,097
Income Taxes-Current	36,053	48,027	121,133
Income Taxes-Deferred	<u>0</u>	<u>819,014</u>	<u>817,621</u>
Net Income	<u>\$321,761</u>	<u>\$945,645</u>	<u>\$895,953</u>
Earnings Per Share	<u>\$0.04</u>	<u>\$0.12</u>	<u>\$0.11</u>

**ZZZZ BEST Co., Inc.**

BALANCE SHEET	<u>4/30/85</u>	<u>4/30/86</u>	3 Mos. <u>7/31/86</u>
<b>ASSETS</b>			
Cash	\$ 30,321	\$ 87,014	\$ 9,907
Accounts Receivable	0	693,773	2,461,098
Unbilled Charges			
on Restorations	0	428,810	0
Advances-Joint Venture	0	117,108	0
Advances on Materials	0	136,000	1,330,000
Prepaid Expenses	25,364	125,307	59,392
Other	<u>51,411</u>	<u>139,961</u>	<u>382,592</u>
Total Current Assets	\$ 107,096	\$ 1,727,973	\$ 4,242,989
Fixed Assets	125,519	2,564,632	3,254,191
Accum Depreciation	(68,029)	(163,145)	(268,796)
Capitalized Leases	0	655,733	710,652
Deposits	13,450	235,994	237,189
Other Assets	<u>0</u>	<u>24,484</u>	<u>23,866</u>
TOTAL ASSETS	<u>\$178,036</u>	<u>\$5,045,671</u>	<u>\$8,200,091</u>
<b>LIABILITIES &amp; EQUITY</b>			
Notes Payable - Current	\$ 0	\$ 780,507	\$1,971,624
Equip Purchases Payable	0	575,000	0
Accounts Payable	2,930	237,340	362,916
Current Portion-Leases	0	147,561	157,556
Income Taxes Payable	0	28,027	65,160
Overbilled Charges			
on Restorations	0	0	107,301
Deferred Income Taxes	0	0	1,400,139
Current Portion-Notes	<u>0</u>	<u>0</u>	<u>40,000</u>
Total Current Liabilities	2,930	1,768,435	4,104,696
Notes Payable	0	0	515,000
Leases Payable	0	428,471	418,195
Deferred Income Taxes	<u>0</u>	<u>819,014</u>	<u>236,496</u>
TOTAL LIABILITIES	\$2,930	\$3,015,920	\$5,274,387
Common Stock	55,000	76,675	76,675
Add'l Paid in Capital	55,000	942,325	942,325
Retained Earnings	<u>65,106</u>	<u>1,010,751</u>	<u>1,906,704</u>
TOTAL LIABILITIES & EQUITY	<u>\$178,036</u>	<u>\$5,045,671</u>	<u>\$8,200,091</u>