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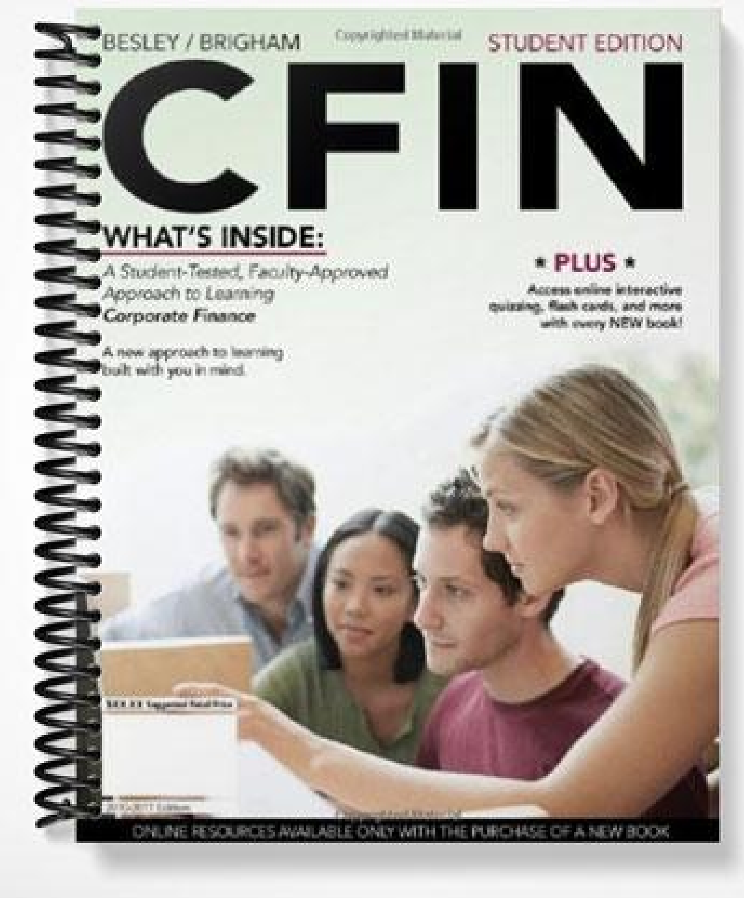
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Chapter 2--Analysis of Financial Statements

Student: ____

1. The income statement measures the flow of funds into (i.e. revenue) and out of (i.e. expenses) the firm over a certain time period. It is always based on accounting data.

   True False

2. The balance sheet is a financial statement measuring the flow of funds into and out of various accounts over time while the income statement measures the progress of the firm at a point in time.

   True False

3. An increase in an asset account is a source of cash, whereas an increase in a liability account is a use of cash.

   True False

4. Depreciation, as shown on the income statement, is regarded as a use of cash because it is an expense.

   True False

5. When a firm pays off a loan using cash, the source of funds is the decrease in the asset account, cash, while the use of funds involves a decrease in a liability account, debt.

   True False

6. Non-cash assets are expected to produce cash over time but the amount of cash they eventually produce could be higher or lower than the values at which the assets are carried on the books.

   True False

7. Taxes, payment patterns, and reporting considerations, as well as credit sales and non-cash costs, are reasons why operating cash flows can differ from accounting profits.

   True False

8. Ratio analysis involves a comparison of the relationships between financial statement accounts so as to analyze the financial position and strength of a firm.

   True False

9. The current ratio and inventory turnover ratio measure the liquidity of a firm. The current ratio measures the relation of a firm's current assets to its current liabilities and the inventory turnover ratio measures how rapidly a firm turns its inventory back into a "quick" asset or cash.

   True False

10. If a firm has high current and quick ratios, this always is a good indication that a firm is managing its liquidity position well.

    True False

11. A decline in the inventory turnover ratio suggests that the firm's liquidity position is improving.

    True False

12. The degree to which the managers of a firm attempt to magnify the returns to owners' capital through the use of financial leverage is captured in debt management ratios.

    True False

13. Profitability ratios show the combined effects of liquidity, asset management, and debt management on operations.

    True False

14. Determining whether a firm's financial position is improving or deteriorating requires analysis of more than one set of financial statements. Trend analysis is one method of measuring a firm's performance over time.

    True False

15. The information contained in the annual report is used by investors to form expectations about future earnings and dividends.

    True False

16. The balance sheet presents a summary of the firm's revenues and expenses over an accounting period.

    True False

17. On the balance sheet, total assets must equal total liabilities plus stockholders equity.

    True False

18. One of the biggest noncash items on the income statement is depreciation which needs to be subtracted from net income to determine cash flows for the firm.

    True False

19. A firm's net income reported on its income statement must equal the operating cash flows on the statement of cash flows.

    True False

20. A statement reporting the impact of a firm's operating, investing, and financing activities on cash flows over an accounting is the statement of cash flows.

    True False

21. When a firm conducts a seasoned equity offering, it increases an equity account which is an example of a source of funds.

    True False

22. When a firm conducts a stock repurchase, it increases an equity account which is an example of a source of funds.

    True False

23. A liquid asset is an asset that can be easily converted into cash without a significant loss of its original value.

    True   False

24. Genzyme Corporation has seen its days sales outstanding (DSO) decline from 38 days last year to 22 days this implying that more of the firm's suppliers are being paid on time.

    True   False

25. Funds supplied by common stockholders mainly includes capital stock, paid-in capital, and retained earnings, while total equity is comprised of common equity plus preferred stock.

    True   False

26. Retained earnings is the cash that has been generated by the firm through its operations which has not been paid out to stockholders as dividends. Retained earnings are kept in cash or near cash accounts and thus, these cash accounts, when added together, will always be equal to the total retained earnings of the firm.

    True   False

27. The financial position of companies whose business is seasonal can be dramatically different depending upon the time of year chosen to construct financial statements. This time sensitivity is especially true with respect to the firm's balance sheet.

    True   False

28. In order to accurately estimate cash flow from operations, depreciation must be added back to net income. The reason for this is that even though depreciation is deducted from revenue it is really a non-cash charge.

    True   False

29. In accounting, emphasis is placed on determining net income. In finance, the primary emphasis also is on net income because that is what investors use to value the firm. However, a secondary consideration is cash flow because that's what is used to run the business.

    True   False

30. Current cash flow from existing assets is highly relevant to the investor. However, the value of the firm depends primarily upon its growth opportunities. As a result, profit projections from those opportunities are the only relevant future flows with which investors are concerned.

    True   False

31. If the current ratio of Firm A is greater than the current ratio of Firm B, we cannot be sure that the quick ratio of Firm A is greater than that of Firm B. However, if the quick ratio of Firm A exceeds that of Firm B, we *can* be assured that Firm A's current ratio also exceeds B's current ratio.

    True   False

32. The inventory turnover and current ratios are related. The combination of a high current ratio and a low inventory turnover ratio relative to the industry norm might indicate that the firm is maintaining too high an inventory level or that part of the inventory is obsolete or damaged.

    True   False

33. We can use the fixed asset turnover ratio to legitimately compare firms in different industries as long as all the firms being compared are using the same proportion of fixed assets to total assets.

True False

34. Suppose two firms with the same amount of assets pay the same interest rate on their debt and earn the same rate of return on their assets, and that ROA is positive. However, one firm has a higher debt ratio. Under these conditions, the firm with the *higher* debt ratio will also have a higher rate of return on common equity.

True False

35. Suppose a firm wants to maintain a specific TIE ratio. If the firm knows the level of its debt, the interest rate it will pay on that debt and the applicable tax rate, the firm can then calculate the earnings level required to maintain its target TIE ratio.

True False

36. The fixed charge coverage ratio recognizes that firms often lease equipment under contract and thus, some firms must meet more than just their scheduled interest payments out of earnings. Therefore, the fixed charge coverage is more inclusive than the TIE ratio.

True False

37. If sales decrease and financial leverage increases, we can say with certainty that the profit margin on sales will decrease.

True False

38. Selling new stock is an equity transaction; it does not affect any asset or liability account and therefore, does not appear on the statement of cash flows.

True False

39. Other things held constant, which of the following will **not** affect the quick ratio? (Assume that current assets equal current liabilities.)

A. Fixed assets are sold for cash.
B. Cash is used to purchase inventories.
C. Cash is used to pay off accounts payable.
D. Accounts receivable are collected.
E. Long-term debt is issued to payoff a short-term bank loan.

40. Changes in balance sheet accounts are necessary for

A. A typical ratio analysis.
B. Pro forma balance sheet construction.
C. Statement of cash flows construction.
D. Profit and loss analysis.
E. Pro forma income statement construction.

41. All of the following represent cash outflows to the firm except

A. Taxes.
B. Interest payments.
C. Dividends.
D. Purchase of plant and equipment.
E. Depreciation.

42. Other things held constant, if a firm holds cash balances in excess of their optimal level in a non-interest bearing account, this will tend to lower the firm's

A. Profit margin.
B. Total asset turnover.
C. Return on equity.
D. All of the above.
E. Answers b and c above.

43. Other things held constant, which of the following will <u>not</u> affect the current ratio, assuming an initial current ratio greater than 1.0?

A. Fixed assets are sold for cash.
B. Long-term debt is issued to pay off current liabilities.
C. Accounts receivable are collected.
D. Cash is used to pay off accounts payable.
E. A bank loan is obtained, and the proceeds are credited to the firm's checking account.

44. The annual report contains all of the following financial statements except

A. income statement.
B. statement of changes in long-term financing.
C. statement of cash flows.
D. balance sheet.
E. statement of retained earnings.

45. Which of the following financial statements shows a firm's financing activities (how funds were generated) and investment activities (how funds were used) over a particular period of time?

A. balance sheet
B. income statement
C. statement of retained earnings
D. statement of cash flows
E. proxy statement

46. Which of the following statements shows the portion of the firm's earnings that has been saved rather than paid out as dividends?

A. balance sheet
B. income statement
C. statement of retained earnings
D. statement of cash flows
E. proxy statement

47. Which of the following financial statements includes information about a firm's assets, equity, and liabilities?

A. Income statement
B. Cash flow statement
C. Balance sheet
D. Statement of retained earnings
E. All of the above

48. When constructing a Statement of Cash Flows, which of the following actions would be considered a *source* of funds?

A. increase in the cash account
B. decrease in accounts payable
C. increase in inventory
D. increase in long-term bonds
E. increase in fixed assets

49. Which of the following groups probably would *not* be interested in the financial statement analysis of a firm?

A. creditors
B. management of the firm
C. stockholders
D. Internal Revenue Service
E. All of the above would be interested in the financial statement analysis.

50. Which of the following ratios measures how effectively a firm is managing its assets?

A. quick ratio
B. times interest earned
C. profit margin
D. inventory turnover ratio
E. price earnings ratio

51. If your goal is determine how effectively a firm is managing its assets, which of the following sets of ratios would you examine?

A. profit margin, current ratio, fixed charge coverage ratio
B. quick ratio, debt ratio, time interest earned
C. inventory turnover ratio, days sales outstanding, fixed asset turnover ratio
D. total assets turnover ratio, price earnings ratio, return on total assets
E. time interest earned, profit margin, fixed asset turnover ratio

52. Which of the following ratios measures the extent to which operating income can decline before the firm is unable to meet its annual interest costs?

A. fixed charge coverage ratio
B. debt ratio
C. times-interest-earned ratio
D. return on equity
E. profit margin

53. An analysis of a firm's financial ratios over time that is used to determine the improvement or deterioration in its financial situation is called

A. sensitivity analysis
B. DuPont chart
C. ratio analysis
D. progress chart
E. trend analysis

54. Which of the following statements is most correct?

A. An increase in a firm's debt ratio, with no changes in its sales and operating costs, could be expected to lower its profit margin on sales.
B. An increase in DSO, other things held constant, would generally lead to an increase in the total asset turnover ratio.
C. An increase on the DSO, other things held constant, would generally lead to an increase in the ROE.
D. In a competitive economy, where all firms earn similar returns on equity, one would expect to find lower profit margins for airlines, which require a lot of fixed assets relative to sales, than for fresh fish markets.
E. It is more important to adjust the Debt/Asset ratio than the inventory turnover ratio to account for seasonal fluctuations.

55. Which of the following statements is correct?

A. The annual report contains four basic financial statements: the income statement; balance sheet; statement of cash flows; and statement of changes in long-term financing.
B. Although the annual report is geared toward the average stockholder, it represents financial analysts' most complete source of financial information about the firm.
C. The key importance of annual report information is that it is used by investors when they form their expectations about the firm's future earnings and dividends and the riskiness of those cash flows.
D. The annual report provides no relevant information for use by financial analysts or by the investing public.
E. None of the above statements is correct.

56. A firm's current ratio has steadily increased over the past 5 years, from 1.9 five years ago to 3.8 today. What would a financial analyst be most justified in concluding?

A. The firm's fixed assets turnover probably has improved.
B. The firm's liquidity position probably has improved.
C. The firm's stock price probably has increased.
D. Each of the above is likely to have occurred.
E. The analyst would be unable to draw any conclusions from this information.

57. Which of the following actions will cause an increase in the quick ratio in the short run?

A. $1,000 worth of inventory is sold, and an account receivable is created. The receivable exceeds the inventory by the amount of profit of the sale, which is added to retained earnings.
B. A small subsidiary which was acquired for $100,000 two years ago and which was generating profits at the rate of 10 percent is sold for $100,000 cash. (Average company profits are 15 percent of assets.)
C. Marketable securities are sold at cost.
D. All of the above.
E. Answers a and b above.

58. Which of the following statements is correct?

A. In the text, depreciation is regarded as a <u>use</u> of cash because it reduces fixed assets, which then must be replaced.
B. If a company uses some of its cash to pay off short-term debt, then its current ratio will always decline, given the way ratio is calculated, other things held constant.
C. During a recession, it is reasonable to think that most companies inventory turnover ratios will change while their fixed asset turnover ratio will remain fairly constant.
D. During a recession, we can be confident that most companies' DSOs (or ACPs) will decline because their sales will probably decline.
E. Each of the above statements is false.

59. As a short-term creditor concerned with a company's ability to meet its financial obligation to you, which one of the following combinations of ratios would you most likely prefer?

	Current ratio	TIE	Debt ratio
A.	0.5	0.5	0.33
B.	1.0	1.0	0.50
C.	1.5	1.5	0.50
D.	2.0	1.0	0.67
E.	2.5	0.5	0.71

60. Which of the following statements about ratio analysis is *incorrect*?

A. Classifying a large, well-diversified firm into a single industry often is difficult because many of the firm's divisions are involved with different products from different industries.
B. As a rule of thumb, it is safe to conclude that any firm with a current ratio greater than 1.0 should be able to meet its current obligations¾that is, pay bills that come due in the current period. [Current ratio = (Current assets) / (Current liabilities)]
C. Sometimes firms attempt to use "window dressing" techniques to make their financial statements look better than they actually are in the current period.
D. Computing the values of the ratios is fairly simple; the toughest and most important part of ratio analysis is interpretation of the values derived from the computations.
E. General conclusions about a firm should not be made by examining one or a few ratios¾ratio analysis should be comprehensive.

61. Yesterday, Bicksler Corporation purchased (and received) raw materials on *credit* from its supplier. All else equal, if Bicksler's current ratio was 2.0 before the purchase, what effect did this transaction have on Bicksler's current ratio?

A. increased
B. decreased
C. stayed the same
D. There is not enough information to answer this question.
E. None of the above is a correct answer.

62. Bubbles Soap Corporation has a quick ratio of 1.0 and a current ratio of 2.0 implying that

A. the value of current assets is equal to the value of inventory.
B. the value of current assets is equal to the value of current liabilities.
C. the value of current liabilities is equal to the value of inventory.
D. All of the above.
E. None of the above.

63. Which of the following statements is most correct?

A. firms with relatively low debt ratios have higher expected returns when the business is good.
B. firms with relatively low debt ratios are exposed to risk of loss when the business is poor.
C. firms with relatively high debt ratios have higher expected returns when the business is bad.
D. firms with relatively high debt ratios have higher expected returns when the business is good.
E. none of the above.

64. All other things constant, an increase in a firm's profit margin would

A. increase the additional funds needed for financing a growth in operations.
B. decrease the additional funds needed for financing a growth in operations.
C. have no effect on the additional funds needed for financing a growth in operations.
D. decrease its taxes.
E. none of the above.

65. Which of the following statements is correct?

A. If Company A has a higher debt ratio that Company B, then we can be sure that A will have a lower times-interest-earned ratio than B.
B. Suppose two companies have identical operations in terms of sales, cost of goods sold, interest rate on debt, and assets. However, Company A used more debt than Company B; that is, Company A has a higher debt ratio. Under these conditions, we would expect B's profit margin to be higher than A's.
C. The ROE of any company which is earning positive profits and which has a positive net worth (or common equity) must exceed the company's ROA.
D. Statements a, b, and c are all true.
E. Statements a, b, and c are all false.

66. Pepsi Corporation's current ratio is 0.5, while Coke Company's current ratio is 1.5. Both firms want to "window dress" their coming end-of-year financial statements. As part of their window dressing strategy, each firm will double its current liabilities by adding short-term debt and placing the funds obtained in the cash account. Which of the statements below best describes the actual results of these transactions?

A. The transactions will have no effect on the current ratios.
B. The current ratios of both firms will be increased.
C. The current ratios of both firms will be decreased.
D. Only Pepsi Corporation's current ratio will be increased.
E. Only Coke Company's current ratio will be increased.

67. The Charleston Company is a relatively small, privately owned firm. Last year the company had after-tax income of $15,000, and 10,000 shares were outstanding. The owners were trying to determine the market value for the stock, prior to taking the company public. A similar firm which is publicly traded had a price/earnings ratio of 5.0. Using only the information given, estimate the market value of one share of Charleston's stock.

A. $10.00
B. $7.50
C. $5.00
D. $2.50
E. $1.50

68. If Boyd Corporation has sales of $2 million per year (all credit) and days sales outstanding of 35 days, what is its average amount of accounts receivable outstanding (assume a 360 day year)?

A. $194,444
B. $57,143
C. $5,556
D. $97,222
E. $285,714

69. A firm has a profit margin of 15 percent on sales of $20,000,000. If the firm has debt of $7,500,000, total assets of $22,500,000, and an after-tax interest cost on total debt of 5 percent, what is the firm's ROA?

A. 8.4%
B. 10.9%
C. 12.0%
D. 13.3%
E. 15.1%

70. Collins Company had the following partial balance sheet and complete income statement information for last year:

Balance Sheet:	
Cash	$ 20
A/R	1,000
Inventories	2,000
Total current assets	$ 3,020
Net fixed assets	2,980
Total assets	$ 6,000
Income Statement:	
Sales	$10,000
Cost of goods sold	9,200
EBIT	$ 800
Interest (10%)	400
EBT	$ 400
Taxes (40%)	160
Net Income	$ 240

The industry average DSO is 30 (360-day basis). Collins plans to change its credit policy so as to cause its DSO to equal the industry average, and this change is expected to have no effect on either sales or cost of goods sold. If the cash generated from reducing receivables is used to retire debt (which was outstanding all last year and which has a 10% interest rate), what will Collins' debt ratio (Total debt/Total assets) be after the change in DSO is reflected in the balance sheet?

A. 33.33%
B. 45.28%
C. 52.75%
D. 60.00%
E. 65.71%

71. A firm has total interest charges of $10,000 per year, sales of $1 million, a tax rate of 40 percent, and a net profit margin of 6 percent. What is the firm's times-interest-earned ratio?

A. 16 times
B. 10 times
C. 7 times
D. 11 times
E. 20 times

72. Alumbat Corporation has $800,000 of debt outstanding, and it pays an interest rate of 10 percent annually on its bank loan. Alumbat's annual sales are $3,200,000; its average tax rate is 40 percent; and its net profit margin on sales is 6 percent. If the company does not maintain a TIE ratio of at least 4 times, its bank will refuse to renew its loan, and bankruptcy will result. What is Alumbat's current TIE ratio?

A. 2.4
B. 3.4
C. 3.6
D. 4.0
E. 5.0

73. Determine the increase or decrease in cash for Rinky Supply Company for last year, given the following information. (Assume no other changes occurred during the past year.)

Decrease in marketable securities	=	$25
Increase in accounts receivables	=	$50
Increase in notes payable	=	$30
Decrease in accounts payable	=	$20
Increase in accrued wages and taxes	=	$15
Increase in inventories	=	$35
Retained earnings	=	$ 5

A. -$50
B. +$40
C. -$30
D. +$20
E. -$10

74. Cannon Company has enjoyed a rapid increase in sales in recent years, following a decision to sell on credit. However, the firm has noticed a recent increase in its collection period. Last year, total sales were $1 million, and $250,000 of these sales were on credit. During the year, the accounts receivable account averaged $41,664. It is expected that sales will increase in the forthcoming year by 50 percent, and, while credit sales should continue to be the same proportion of total sales, it is expected that the days sales outstanding will also increase by 50 percent. If the resulting increase in accounts receivable must be financed by external funds, how much external funding will Cannon need?

A. $41,664
B. $52,086
C. $47,359
D. $106,471
E. $93,750

75. The Meryl Corporation's common stock currently is selling at $100 per share, which represents a P/E ratio of 10. If the firm has 100 shares of common stock outstanding, a return on equity of 20 percent, and a debt ratio of 60 percent, what is its return on total assets (ROA)?

A. 8.0%
B. 10.0%
C. 12.0%
D. 16.7%
E. 20.0%

76. Selzer Inc. sells all its merchandise on credit. It has a profit margin of 4 percent, days sales outstanding equal to 60 days, receivables of $150,000, total assets of $3 million, and a debt ratio of 0.64. What is the firm's return on equity (ROE)?

A. 7.1%
B. 33.3%
C. 3.3%
D. 71.0%
E. 8.1%

77. You are given the following information about a firm: The growth rate equals 8 percent; return on assets (ROA) is 10 percent; the debt ratio is 20 percent; and the stock is selling at $36. What is the return on equity (ROE)?

A. 14.0%
B. 12.5%
C. 15.0%
D. 2.5%
E. 13.5%

78. Assume Meyer Corporation is 100 percent equity financed. Calculate the return on equity, given the following information:

(1) Earnings before taxes = $1,500;
(2) Sales = $5,000;
(3) Dividend payout ratio = 60%;
(4) Total assets turnover = 2.0;
(5) Applicable tax rate = 30%.

A. 25%
B. 30%
C. 35%
D. 42%
E. 50%

79. The Amer Company has the following characteristics:

Sales:	$1,000
Total Assets:	$1,000
Total Debt/Total Assets:	35%
EBIT:	$ 200
Tax rate:	40%
Interest rate on total debt:	4.57%

What is Amer's ROE?

A. 11.04%
B. 12.31%
C. 16.99%
D. 28.31%
E. 30.77%

80. Aurillo Equipment Company (AEC) projected that its ROE for next year would be just 6%. However, the financial staff has determined that the firm can increase its ROE by refinancing some high interest bonds currently outstanding. The firm's total debt will remain at $200,000 and the debt ratio will hold constant at 80%, but the interest rate on the refinanced debt will be 10%. The rate on the old debt is 14%. Refinancing will not affect sales which are projected to be $300,000. EBIT will be 11% of sales, and the firm's tax rate is 40%. If AEC refinances its high interest bonds, what will be its projected new ROE?

A. 3.0%
B. 8.2%
C. 10.0%
D. 15.6%
E. 18.7%

81. Savelots Stores' current financial statements are shown below:

Inventories	$ 500	Accounts payable	$ 100
Other current assets	400	Short-term notes payable	370
Fixed assets	370	Common equity	800
Total assets	$1,270	Total liab. and equity	$1,270

Sales	$2,000
Operating costs	1,843
EBIT	157
Less: Interest	37
EBT	120
Less: Taxes (40%)	48
Net income	72

A recently released report indicates that Savelots' current ratio of 1.9 is in line with the industry average. However, its accounts payable, which have no interest cost and which are due entirely to purchases of inventories, amount to only 20% of inventory versus an industry average of 60%. Suppose Savelots took actions to increase its accounts payable to inventories ratio to the 60% industry average, but it (1) kept all of its assets at their present levels (that is, the asset side of the balance sheet remains constant) and (2) also held its current ratio constant at 1.9. Assume that Savelots' tax rate is 40%, that its cost of short-term debt is 10%, and that the change in payments will not affect operations. In addition, common equity would not change. With the changes, what would be Savelots' new ROE?

A. 10.5%
B. 7.8%
C. 9.0%
D. 13.2%
E. 12.0%

82. Harvey Supplies Inc. has a current ratio of 3.0, a quick ratio of 2.4, and an inventory turnover ratio of 6. Harvey's total assets are $1 million and its debt ratio is 0.20. The firm has no long-term debt. What is Harvey's sales figure if the total cost of goods sold is 75% of sales?

A. $960,000
B. $720,000
C. $1,620,000
D. $120,000
E. $540,000

83. Given the following information, calculate the market price per share of WAM Inc.

Earnings after interest and taxes = $200,000
Earnings per share = $2.00
Stockholders' equity = $2,000,000
Market/Book ratio = 0.20

A. $20.00
B. $8.00
C. $4.00
D. $2.00
E. $1.00

84. On its December 31st balance sheet, LCG Company reported gross fixed assets of $6,500,000 and net fixed assets of $5,000,000. Depreciation for the year was $500,000. Net fixed assets a year earlier on December 31st, had been $4,700,000. What figure for "Cash Flows Associated with Long-Term Investments (Fixed Assets)" should LCG report on its Statement of Cash Flows for the current year?

A. $500,000
B. $600,000
C. $700,000
D. $800,000
E. $900,000

85. Lombardi Trucking Company has the following data:

Assets:	$10,000	Profit margin:	3.0%
Debt ratio:	60.0%	Interest rate:	10.0%
Tax rate:	40%	Total asset turnover:	2.0

What is Lombardi's TIE ratio?

A. 0.95
B. 1.75
C. 2.10
D. 2.67
E. 3.45

86. Retailers Inc. and Computer Corp. each have assets of $10,000 and a return on common equity equal to 15%. Retailers has twice as much debt and twice as many sales relative to Computer Corp. Retailers' net income equals $750, and its total asset turnover is equal to 3. What is Computer Corp.'s profit margin?

A. 2.50%
B. 5.00%
C. 7.50%
D. 10.00%
E. 12.50%

Chapter 2--Analysis of Financial Statements Key

1. The income statement measures the flow of funds into (i.e. revenue) and out of (i.e. expenses) the firm over a certain time period. It is always based on accounting data.

   TRUE

2. The balance sheet is a financial statement measuring the flow of funds into and out of various accounts over time while the income statement measures the progress of the firm at a point in time.

   FALSE

3. An increase in an asset account is a source of cash, whereas an increase in a liability account is a use of cash.

   FALSE

4. Depreciation, as shown on the income statement, is regarded as a use of cash because it is an expense.

   FALSE

5. When a firm pays off a loan using cash, the source of funds is the decrease in the asset account, cash, while the use of funds involves a decrease in a liability account, debt.

   TRUE

6. Non-cash assets are expected to produce cash over time but the amount of cash they eventually produce could be higher or lower than the values at which the assets are carried on the books.

   TRUE

7. Taxes, payment patterns, and reporting considerations, as well as credit sales and non-cash costs, are reasons why operating cash flows can differ from accounting profits.

   TRUE

8. Ratio analysis involves a comparison of the relationships between financial statement accounts so as to analyze the financial position and strength of a firm.

   TRUE

9. The current ratio and inventory turnover ratio measure the liquidity of a firm. The current ratio measures the relation of a firm's current assets to its current liabilities and the inventory turnover ratio measures how rapidly a firm turns its inventory back into a "quick" asset or cash.

   FALSE

10. If a firm has high current and quick ratios, this always is a good indication that a firm is managing its liquidity position well.

   FALSE

11. A decline in the inventory turnover ratio suggests that the firm's liquidity position is improving.

FALSE

12. The degree to which the managers of a firm attempt to magnify the returns to owners' capital through the use of financial leverage is captured in debt management ratios.

TRUE

13. Profitability ratios show the combined effects of liquidity, asset management, and debt management on operations.

TRUE

14. Determining whether a firm's financial position is improving or deteriorating requires analysis of more than one set of financial statements. Trend analysis is one method of measuring a firm's performance over time.

TRUE

15. The information contained in the annual report is used by investors to form expectations about future earnings and dividends.

TRUE

16. The balance sheet presents a summary of the firm's revenues and expenses over an accounting period.

FALSE

17. On the balance sheet, total assets must equal total liabilities plus stockholders equity.

TRUE

18. One of the biggest noncash items on the income statement is depreciation which needs to be subtracted from net income to determine cash flows for the firm.

FALSE

19. A firm's net income reported on its income statement must equal the operating cash flows on the statement of cash flows.

FALSE

20. A statement reporting the impact of a firm's operating, investing, and financing activities on cash flows over an accounting is the statement of cash flows.

TRUE

21. When a firm conducts a seasoned equity offering, it increases an equity account which is an example of a source of funds.

TRUE

22. When a firm conducts a stock repurchase, it increases an equity account which is an example of a source of funds.

FALSE

23. A liquid asset is an asset that can be easily converted into cash without a significant loss of its original value.

TRUE

24. Genzyme Corporation has seen its days sales outstanding (DSO) decline from 38 days last year to 22 days this implying that more of the firm's suppliers are being paid on time.

FALSE

25. Funds supplied by common stockholders mainly includes capital stock, paid-in capital, and retained earnings, while total equity is comprised of common equity plus preferred stock.

TRUE

26. Retained earnings is the cash that has been generated by the firm through its operations which has not been paid out to stockholders as dividends. Retained earnings are kept in cash or near cash accounts and thus, these cash accounts, when added together, will always be equal to the total retained earnings of the firm.

FALSE

27. The financial position of companies whose business is seasonal can be dramatically different depending upon the time of year chosen to construct financial statements. This time sensitivity is especially true with respect to the firm's balance sheet.

TRUE

28. In order to accurately estimate cash flow from operations, depreciation must be added back to net income. The reason for this is that even though depreciation is deducted from revenue it is really a non-cash charge.

TRUE

29. In accounting, emphasis is placed on determining net income. In finance, the primary emphasis also is on net income because that is what investors use to value the firm. However, a secondary consideration is cash flow because that's what is used to run the business.

FALSE

30. Current cash flow from existing assets is highly relevant to the investor. However, the value of the firm depends primarily upon its growth opportunities. As a result, profit projections from those opportunities are the only relevant future flows with which investors are concerned.

FALSE

31. If the current ratio of Firm A is greater than the current ratio of Firm B, we cannot be sure that the quick ratio of Firm A is greater than that of Firm B. However, if the quick ratio of Firm A exceeds that of Firm B, we *can* be assured that Firm A's current ratio also exceeds B's current ratio.

FALSE

32. The inventory turnover and current ratios are related. The combination of a high current ratio and a low inventory turnover ratio relative to the industry norm might indicate that the firm is maintaining too high an inventory level or that part of the inventory is obsolete or damaged.

TRUE

33. We can use the fixed asset turnover ratio to legitimately compare firms in different industries as long as all the firms being compared are using the same proportion of fixed assets to total assets.

FALSE

34. Suppose two firms with the same amount of assets pay the same interest rate on their debt and earn the same rate of return on their assets, and that ROA is positive. However, one firm has a higher debt ratio. Under these conditions, the firm with the *higher* debt ratio will also have a higher rate of return on common equity.

TRUE

35. Suppose a firm wants to maintain a specific TIE ratio. If the firm knows the level of its debt, the interest rate it will pay on that debt and the applicable tax rate, the firm can then calculate the earnings level required to maintain its target TIE ratio.

TRUE

36. The fixed charge coverage ratio recognizes that firms often lease equipment under contract and thus, some firms must meet more than just their scheduled interest payments out of earnings. Therefore, the fixed charge coverage is more inclusive than the TIE ratio.

TRUE

37. If sales decrease and financial leverage increases, we can say with certainty that the profit margin on sales will decrease.

FALSE

38. Selling new stock is an equity transaction; it does not affect any asset or liability account and therefore, does not appear on the statement of cash flows.

FALSE

39. Other things held constant, which of the following will **not** affect the quick ratio? (Assume that current assets equal current liabilities.)

A. Fixed assets are sold for cash.
B. Cash is used to purchase inventories.
C. Cash is used to pay off accounts payable.
D. Accounts receivable are collected.
E. Long-term debt is issued to payoff a short-term bank loan.

40. Changes in balance sheet accounts are necessary for

A. A typical ratio analysis.
B. Pro forma balance sheet construction.
C. Statement of cash flows construction.
D. Profit and loss analysis.
E. Pro forma income statement construction.

41. All of the following represent cash outflows to the firm except

A. Taxes.
B. Interest payments.
C. Dividends.
D. Purchase of plant and equipment.
E. Depreciation.

42. Other things held constant, if a firm holds cash balances in excess of their optimal level in a non-interest bearing account, this will tend to lower the firm's

A. Profit margin.
B. Total asset turnover.
C. Return on equity.
D. All of the above.
E. Answers b and c above.

43. Other things held constant, which of the following will not affect the current ratio, assuming an initial current ratio greater than 1.0?

A. Fixed assets are sold for cash.
B. Long-term debt is issued to pay off current liabilities.
C. Accounts receivable are collected.
D. Cash is used to pay off accounts payable.
E. A bank loan is obtained, and the proceeds are credited to the firm's checking account.

44. The annual report contains all of the following financial statements except

A. income statement.
B. statement of changes in long-term financing.
C. statement of cash flows.
D. balance sheet.
E. statement of retained earnings.

45. Which of the following financial statements shows a firm's financing activities (how funds were generated) and investment activities (how funds were used) over a particular period of time?

A. balance sheet
B. income statement
C. statement of retained earnings
D. statement of cash flows
E. proxy statement

46. Which of the following statements shows the portion of the firm's earnings that has been saved rather than paid out as dividends?

A. balance sheet
B. income statement
C. statement of retained earnings
D. statement of cash flows
E. proxy statement

47. Which of the following financial statements includes information about a firm's assets, equity, and liabilities?

A. Income statement
B. Cash flow statement
C. Balance sheet
D. Statement of retained earnings
E. All of the above

48. When constructing a Statement of Cash Flows, which of the following actions would be considered a *source* of funds?

A. increase in the cash account
B. decrease in accounts payable
C. increase in inventory
D. increase in long-term bonds
E. increase in fixed assets

49. Which of the following groups probably would *not* be interested in the financial statement analysis of a firm?

A. creditors
B. management of the firm
C. stockholders
D. Internal Revenue Service
E. All of the above would be interested in the financial statement analysis.

50. Which of the following ratios measures how effectively a firm is managing its assets?

A. quick ratio
B. times interest earned
C. profit margin
D. inventory turnover ratio
E. price earnings ratio

51. If your goal is determine how effectively a firm is managing its assets, which of the following sets of ratios would you examine?

A. profit margin, current ratio, fixed charge coverage ratio
B. quick ratio, debt ratio, time interest earned
C. inventory turnover ratio, days sales outstanding, fixed asset turnover ratio
D. total assets turnover ratio, price earnings ratio, return on total assets
E. time interest earned, profit margin, fixed asset turnover ratio

52. Which of the following ratios measures the extent to which operating income can decline before the firm is unable to meet its annual interest costs?

A. fixed charge coverage ratio
B. debt ratio
C. times-interest-earned ratio
D. return on equity
E. profit margin

53. An analysis of a firm's financial ratios over time that is used to determine the improvement or deterioration in its financial situation is called

A. sensitivity analysis
B. DuPont chart
C. ratio analysis
D. progress chart
E. trend analysis

54. Which of the following statements is most correct?

A. An increase in a firm's debt ratio, with no changes in its sales and operating costs, could be expected to lower its profit margin on sales.
B. An increase in DSO, other things held constant, would generally lead to an increase in the total asset turnover ratio.
C. An increase on the DSO, other things held constant, would generally lead to an increase in the ROE.
D. In a competitive economy, where all firms earn similar returns on equity, one would expect to find lower profit margins for airlines, which require a lot of fixed assets relative to sales, than for fresh fish markets.
E. It is more important to adjust the Debt/Asset ratio than the inventory turnover ratio to account for seasonal fluctuations.

55. Which of the following statements is correct?

A. The annual report contains four basic financial statements: the income statement; balance sheet; statement of cash flows; and statement of changes in long-term financing.
B. Although the annual report is geared toward the average stockholder, it represents financial analysts' most complete source of financial information about the firm.
C. The key importance of annual report information is that it is used by investors when they form their expectations about the firm's future earnings and dividends and the riskiness of those cash flows.
D. The annual report provides no relevant information for use by financial analysts or by the investing public.
E. None of the above statements is correct.

56. A firm's current ratio has steadily increased over the past 5 years, from 1.9 five years ago to 3.8 today. What would a financial analyst be most justified in concluding?

A. The firm's fixed assets turnover probably has improved.
B. The firm's liquidity position probably has improved.
C. The firm's stock price probably has increased.
D. Each of the above is likely to have occurred.
E. The analyst would be unable to draw any conclusions from this information.

57. Which of the following actions will cause an increase in the quick ratio in the short run?

A. $1,000 worth of inventory is sold, and an account receivable is created. The receivable exceeds the inventory by the amount of profit of the sale, which is added to retained earnings.
B. A small subsidiary which was acquired for $100,000 two years ago and which was generating profits at the rate of 10 percent is sold for $100,000 cash. (Average company profits are 15 percent of assets.)
C. Marketable securities are sold at cost.
D. All of the above.
E. Answers a and b above.

58. Which of the following statements is correct?

A. In the text, depreciation is regarded as a <u>use</u> of cash because it reduces fixed assets, which then must be replaced.
B. If a company uses some of its cash to pay off short-term debt, then its current ratio will always decline, given the way ratio is calculated, other things held constant.
C. During a recession, it is reasonable to think that most companies inventory turnover ratios will change while their fixed asset turnover ratio will remain fairly constant.
D. During a recession, we can be confident that most companies' DSOs (or ACPs) will decline because their sales will probably decline.
E. Each of the above statements is false.

59. As a short-term creditor concerned with a company's ability to meet its financial obligation to you, which one of the following combinations of ratios would you most likely prefer?

	Current ratio	TIE	Debt ratio
A.	0.5	0.5	0.33
B.	1.0	1.0	0.50
C.	1.5	1.5	0.50
D.	2.0	1.0	0.67
E.	2.5	0.5	0.71

60. Which of the following statements about ratio analysis is *incorrect*?

A. Classifying a large, well-diversified firm into a single industry often is difficult because many of the firm's divisions are involved with different products from different industries.
B. As a rule of thumb, it is safe to conclude that any firm with a current ratio greater than 1.0 should be able to meet its current obligations¾that is, pay bills that come due in the current period. [Current ratio = (Current assets) / (Current liabilities)]
C. Sometimes firms attempt to use "window dressing" techniques to make their financial statements look better than they actually are in the current period.
D. Computing the values of the ratios is fairly simple; the toughest and most important part of ratio analysis is interpretation of the values derived from the computations.
E. General conclusions about a firm should not be made by examining one or a few ratios¾ratio analysis should be comprehensive.

61. Yesterday, Bicksler Corporation purchased (and received) raw materials on *credit* from its supplier. All else equal, if Bicksler's current ratio was 2.0 before the purchase, what effect did this transaction have on Bicksler's current ratio?

A. increased
B. decreased
C. stayed the same
D. There is not enough information to answer this question.
E. None of the above is a correct answer.

62. Bubbles Soap Corporation has a quick ratio of 1.0 and a current ratio of 2.0 implying that

A. the value of current assets is equal to the value of inventory.
B. the value of current assets is equal to the value of current liabilities.
C. the value of current liabilities is equal to the value of inventory.
D. All of the above.
E. None of the above.

63. Which of the following statements is most correct?

A. firms with relatively low debt ratios have higher expected returns when the business is good.
B. firms with relatively low debt ratios are exposed to risk of loss when the business is poor.
C. firms with relatively high debt ratios have higher expected returns when the business is bad.
D. firms with relatively high debt ratios have higher expected returns when the business is good.
E. none of the above.

64. All other things constant, an increase in a firm's profit margin would

A. increase the additional funds needed for financing a growth in operations.
B. decrease the additional funds needed for financing a growth in operations.
C. have no effect on the additional funds needed for financing a growth in operations.
D. decrease its taxes.
E. none of the above.

65. Which of the following statements is correct?

A. If Company A has a higher debt ratio that Company B, then we can be sure that A will have a lower times-interest-earned ratio than B.
B. Suppose two companies have identical operations in terms of sales, cost of goods sold, interest rate on debt, and assets. However, Company A used more debt than Company B; that is, Company A has a higher debt ratio. Under these conditions, we would expect B's profit margin to be higher than A's.
C. The ROE of any company which is earning positive profits and which has a positive net worth (or common equity) must exceed the company's ROA.
D. Statements a, b, and c are all true.
E. Statements a, b, and c are all false.

66. Pepsi Corporation's current ratio is 0.5, while Coke Company's current ratio is 1.5. Both firms want to "window dress" their coming end-of-year financial statements. As part of their window dressing strategy, each firm will double its current liabilities by adding short-term debt and placing the funds obtained in the cash account. Which of the statements below best describes the actual results of these transactions?

A. The transactions will have no effect on the current ratios.
B. The current ratios of both firms will be increased.
C. The current ratios of both firms will be decreased.
D. Only Pepsi Corporation's current ratio will be increased.
E. Only Coke Company's current ratio will be increased.

67. The Charleston Company is a relatively small, privately owned firm. Last year the company had after-tax income of $15,000, and 10,000 shares were outstanding. The owners were trying to determine the market value for the stock, prior to taking the company public. A similar firm which is publicly traded had a price/earnings ratio of 5.0. Using only the information given, estimate the market value of one share of Charleston's stock.

A. $10.00
B. $7.50
C. $5.00
D. $2.50
E. $1.50

68. If Boyd Corporation has sales of $2 million per year (all credit) and days sales outstanding of 35 days, what is its average amount of accounts receivable outstanding (assume a 360 day year)?

A. $194,444
B. $57,143
C. $5,556
D. $97,222
E. $285,714

69. A firm has a profit margin of 15 percent on sales of $20,000,000. If the firm has debt of $7,500,000, total assets of $22,500,000, and an after-tax interest cost on total debt of 5 percent, what is the firm's ROA?

A. 8.4%
B. 10.9%
C. 12.0%
D. 13.3%
E. 15.1%

70. Collins Company had the following partial balance sheet and complete income statement information for last year:

Balance Sheet:	
Cash	$ 20
A/R	1,000
Inventories	2,000
Total current assets	$ 3,020
Net fixed assets	2,980
Total assets	$ 6,000
Income Statement:	
Sales	$10,000
Cost of goods sold	9,200
EBIT	$ 800
Interest (10%)	400
EBT	$ 400
Taxes (40%)	160
Net Income	$ 240

The industry average DSO is 30 (360-day basis). Collins plans to change its credit policy so as to cause its DSO to equal the industry average, and this change is expected to have no effect on either sales or cost of goods sold. If the cash generated from reducing receivables is used to retire debt (which was outstanding all last year and which has a 10% interest rate), what will Collins' debt ratio (Total debt/Total assets) be after the change in DSO is reflected in the balance sheet?

A. 33.33%
B. 45.28%
C. 52.75%
D. 60.00%
E. 65.71%

71. A firm has total interest charges of $10,000 per year, sales of $1 million, a tax rate of 40 percent, and a net profit margin of 6 percent. What is the firm's times-interest-earned ratio?

A. 16 times
B. 10 times
C. 7 times
D. 11 times
E. 20 times

72. Alumbat Corporation has $800,000 of debt outstanding, and it pays an interest rate of 10 percent annually on its bank loan. Alumbat's annual sales are $3,200,000; its average tax rate is 40 percent; and its net profit margin on sales is 6 percent. If the company does not maintain a TIE ratio of at least 4 times, its bank will refuse to renew its loan, and bankruptcy will result. What is Alumbat's current TIE ratio?

A. 2.4
B. 3.4
C. 3.6
D. 4.0
E. 5.0

73. Determine the increase or decrease in cash for Rinky Supply Company for last year, given the following information. (Assume no other changes occurred during the past year.)

Decrease in marketable securities	=	$25
Increase in accounts receivables	=	$50
Increase in notes payable	=	$30
Decrease in accounts payable	=	$20
Increase in accrued wages and taxes	=	$15
Increase in inventories	=	$35
Retained earnings	=	$ 5

A. -$50
B. +$40
C. -$30
D. +$20
E. -$10

74. Cannon Company has enjoyed a rapid increase in sales in recent years, following a decision to sell on credit. However, the firm has noticed a recent increase in its collection period. Last year, total sales were $1 million, and $250,000 of these sales were on credit. During the year, the accounts receivable account averaged $41,664. It is expected that sales will increase in the forthcoming year by 50 percent, and, while credit sales should continue to be the same proportion of total sales, it is expected that the days sales outstanding will also increase by 50 percent. If the resulting increase in accounts receivable must be financed by external funds, how much external funding will Cannon need?

A. $41,664
B. $52,086
C. $47,359
D. $106,471
E. $93,750

75. The Meryl Corporation's common stock currently is selling at $100 per share, which represents a P/E ratio of 10. If the firm has 100 shares of common stock outstanding, a return on equity of 20 percent, and a debt ratio of 60 percent, what is its return on total assets (ROA)?

A. 8.0%
B. 10.0%
C. 12.0%
D. 16.7%
E. 20.0%

76. Selzer Inc. sells all its merchandise on credit. It has a profit margin of 4 percent, days sales outstanding equal to 60 days, receivables of $150,000, total assets of $3 million, and a debt ratio of 0.64. What is the firm's return on equity (ROE)?

A. 7.1%
B. 33.3%
C. 3.3%
D. 71.0%
E. 8.1%

77. You are given the following information about a firm: The growth rate equals 8 percent; return on assets (ROA) is 10 percent; the debt ratio is 20 percent; and the stock is selling at $36. What is the return on equity (ROE)?

A. 14.0%
B. 12.5%
C. 15.0%
D. 2.5%
E. 13.5%

78. Assume Meyer Corporation is 100 percent equity financed. Calculate the return on equity, given the following information:

(1) Earnings before taxes = $1,500;
(2) Sales = $5,000;
(3) Dividend payout ratio = 60%;
(4) Total assets turnover = 2.0;
(5) Applicable tax rate = 30%.

A. 25%
B. 30%
C. 35%
D. 42%
E. 50%

79. The Amer Company has the following characteristics:

Sales:	$1,000
Total Assets:	$1,000
Total Debt/Total Assets:	35%
EBIT:	$ 200
Tax rate:	40%
Interest rate on total debt:	4.57%

What is Amer's ROE?

A. 11.04%
B. 12.31%
C. 16.99%
D. 28.31%
E. 30.77%

80. Aurillo Equipment Company (AEC) projected that its ROE for next year would be just 6%. However, the financial staff has determined that the firm can increase its ROE by refinancing some high interest bonds currently outstanding. The firm's total debt will remain at $200,000 and the debt ratio will hold constant at 80%, but the interest rate on the refinanced debt will be 10%. The rate on the old debt is 14%. Refinancing will not affect sales which are projected to be $300,000. EBIT will be 11% of sales, and the firm's tax rate is 40%. If AEC refinances its high interest bonds, what will be its projected new ROE?

A. 3.0%
B. 8.2%
C. 10.0%
D. 15.6%
E. 18.7%

81. Savelots Stores' current financial statements are shown below:

Inventories	$ 500	Accounts payable	$ 100
Other current assets	400	Short-term notes payable	370
Fixed assets	370	Common equity	800
Total assets	$1,270	Total liab. and equity	$1,270

Sales	$2,000
Operating costs	1,843
EBIT	157
Less: Interest	37
EBT	120
Less: Taxes (40%)	48
Net income	72

A recently released report indicates that Savelots' current ratio of 1.9 is in line with the industry average. However, its accounts payable, which have no interest cost and which are due entirely to purchases of inventories, amount to only 20% of inventory versus an industry average of 60%. Suppose Savelots took actions to increase its accounts payable to inventories ratio to the 60% industry average, but it (1) kept all of its assets at their present levels (that is, the asset side of the balance sheet remains constant) and (2) also held its current ratio constant at 1.9. Assume that Savelots' tax rate is 40%, that its cost of short-term debt is 10%, and that the change in payments will not affect operations. In addition, common equity would not change. With the changes, what would be Savelots' new ROE?

A. 10.5%
B. 7.8%
C. 9.0%
D. 13.2%
E. 12.0%

82. Harvey Supplies Inc. has a current ratio of 3.0, a quick ratio of 2.4, and an inventory turnover ratio of 6. Harvey's total assets are $1 million and its debt ratio is 0.20. The firm has no long-term debt. What is Harvey's sales figure if the total cost of goods sold is 75% of sales?

A. $960,000
B. $720,000
C. $1,620,000
D. $120,000
E. $540,000

83. Given the following information, calculate the market price per share of WAM Inc.

Earnings after interest and taxes = $200,000
Earnings per share = $2.00
Stockholders' equity = $2,000,000
Market/Book ratio = 0.20

A. $20.00
B. $8.00
C. $4.00
D. $2.00
E. $1.00

84. On its December 31st balance sheet, LCG Company reported gross fixed assets of $6,500,000 and net fixed assets of $5,000,000. Depreciation for the year was $500,000. Net fixed assets a year earlier on December 31st, had been $4,700,000. What figure for "Cash Flows Associated with Long-Term Investments (Fixed Assets)" should LCG report on its Statement of Cash Flows for the current year?

A. $500,000
B. $600,000
C. $700,000
D. $800,000
E. $900,000

85. Lombardi Trucking Company has the following data:

Assets:	$10,000	Profit margin:	3.0%
Debt ratio:	60.0%	Interest rate:	10.0%
Tax rate:	40%	Total asset turnover:	2.0

What is Lombardi's TIE ratio?

A. 0.95
B. 1.75
C. 2.10
D. 2.67
E. 3.45

86. Retailers Inc. and Computer Corp. each have assets of $10,000 and a return on common equity equal to 15%. Retailers has twice as much debt and twice as many sales relative to Computer Corp. Retailers' net income equals $750, and its total asset turnover is equal to 3. What is Computer Corp.'s profit margin?

A. 2.50%
B. 5.00%
C. 7.50%
D. 10.00%
E. 12.50%