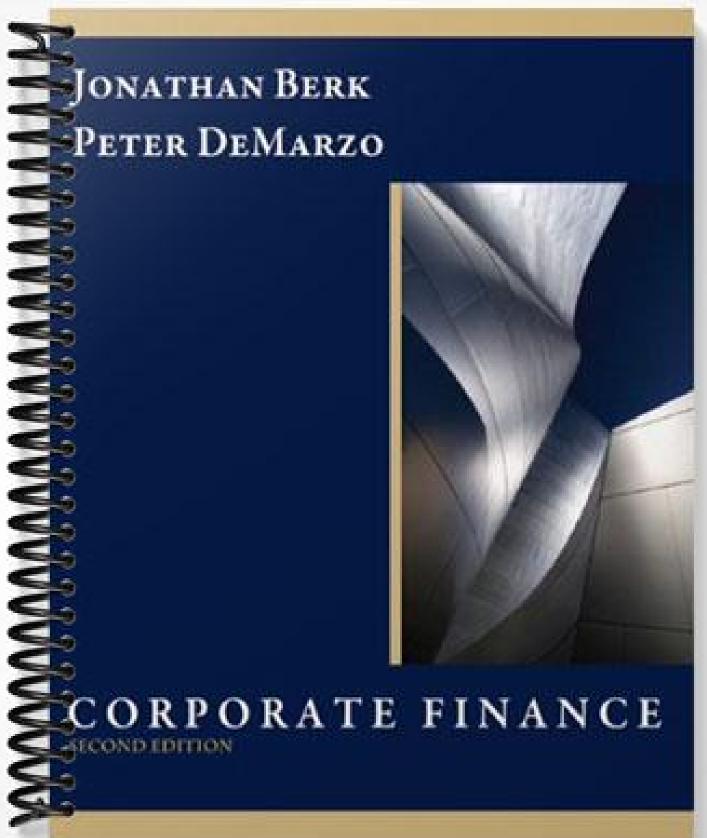
TEST BANK


JONATHAN BERK
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CORPORATE FINANCE
SECOND EDITION

***Corporate Finance, 2e, Global Edition* (Berk/DeMarzo)**
Chapter 2 Introduction to Financial Statement Analysis

2.1 Firm's Disclosure of Financial Information

1) In most countries, publicly listed companies can choose whether or not they wish to release their financial statements.
Answer: FALSE
Diff: 1
Section: 2.1 The Disclosure of Financial Information
Skill: Conceptual

2) Which of the following is not a financial statement that every public company is required to produce?
A) Income statement.
B) Statement of sources and uses of cash.
C) Balance sheet.
D) Statement of changes in shareholders' equity.
Answer: B
Diff: 2
Section: 2.1 The Disclosure of Financial Information
Skill: Conceptual

3) The third party who checks annual financial statements to ensure that they are prepared according to GAAP and verifies that the information reported is reliable is the
A) International Accounting Standards Board.
B) a national Accounting Standards Board.
C) an organized stock exchange
D) auditor.
Answer: D
Diff: 1
Section: 2.1 The Disclosure of Financial Information
Skill: Definition

4) What is the role of an auditor in financial statement analysis?
Answer:
Key points:
1. To ensure that the annual financial statements are prepared accurately.
2. To ensure that the annual financial statements are prepared according to GAAP/IFRS.
3. To verify that the information used in preparing the annual financial statements is reliable.
Diff: 2
Section: 2.1 The Disclosure of Financial Information
Skill: Conceptual

5) What are the four financial statements that all public companies must produce?
Answer:
1. Balance sheet
2. Income statement
3. Statement of cash flows
4. Statement of changes in shareholders' (or stockholders') equity
Diff: 2
Section: 2.1 The Disclosure of Financial Information
Skill: Conceptual

2.2 The Balance Sheet

1) Which of the following balance sheet equations is incorrect?
A) Assets - Liabilities = Shareholders' Equity
B) Assets = Liabilities + Shareholders' Equity
C) Assets - Current Liabilities = Long Term Liabilities
D) Assets - Current Liabilities = Long Term Liabilities + Shareholders' Equity
Answer: C
Diff: 2
Section: 2.2 The Balance Sheet
Skill: Conceptual

2) Cash is a
A) Long-term Asset.
B) Current Asset.
C) Current Liability.
D) Long-term Liability.
Answer: B
Diff: 1
Section: 2.2 The Balance Sheet
Skill: Definition

3) Accounts payable is a
A) Long-term Liability.
B) Current Asset.
C) Long-term Asset.
D) Current Liability.
Answer: D
Diff: 1
Section: 2.2 The Balance Sheet
Skill: Definition

4) A 30 year mortgage loan is a
A) Long-term Liability.
B) Current Liability.
C) Current Asset.
D) Long-term Asset.
Answer: A
Diff: 1
Section: 2.2 The Balance Sheet
Skill: Definition

5) Which of the following statements regarding the balance sheet is incorrect?
A) The balance sheet provides a snapshot of the firm's financial position at a given point in time.
B) The balance sheet lists the firm's assets and liabilities.
C) The balance sheet reports shareholders' equity on the right-hand side.
D) The balance sheet reports liabilities on the left-hand side.
Answer: D
Diff: 2
Section: 2.2 The Balance Sheet
Skill: Conceptual

6) Dustin's Donuts experienced a decrease in the value of the trademark of a company it acquired two years ago. This reduction in value results in
A) an impairment charge.
B) depreciation expense.
C) an operating expense.
D) goodwill.
Answer: A
Diff: 1
Section: 2.2 The Balance Sheet
Skill: Definition

7) Which of the following is an example of an intangible asset?
A) Brand names and trademarks
B) Patents
C) Customer relationships
D) All of the above are intangible assets.
Answer: D
Diff: 1
Section: 2.2 The Balance Sheet
Skill: Definition

8) On the balance sheet, short-term debt appears
A) in the Shareholders' Equity section.
B) in the Operating Expenses section.
C) in the Current Assets section.
D) in the Current Liabilities section.
Answer: D
Diff: 1
Section: 2.2 The Balance Sheet
Skill: Definition

9) On the balance sheet, current maturities of long-term debt appears
A) in the Shareholders' Equity section.
B) in the Operating Expenses section.
C) in the Current Assets section.
D) in the Current Liabilities section.
Answer: D
Diff: 1
Section: 2.2 The Balance Sheet
Skill: Definition

10) The firm's assets and liabilities at a given point in time are reported on the firm's
A) income statement or statement of comprehensive income.
B) income statement or statement of financial position.
C) balance sheet or statement of comprehensive income.
D) balance sheet or statement of financial position.
Answer: D
Diff: 1
Section: 2.2 The Balance Sheet
Skill: Definition

11) The *statement of financial position* is also known as the
A) balance sheet.
B) income statement.
C) statement of cash flows.
D) statement of stockholder's equity.
Answer: A
Diff: 1
Section: 2.2 The Balance Sheet
Skill: Definition

2.3 Balance Sheet Analysis

Use the following information for ECE corporation:

Assets	$200 million
Shareholders' Equity	$100 million
Sales	$300 million

1) If ECE's shares are currently trading at $24.00 and ECE has 25 million shares outstanding, then ECE's market-to-book ratio is closest to:
A) 0.24%
B) 4%
C) 6%
D) 30%
Answer: C
Explanation: C) Market to Book = (MV Equity)/(BV Equity) = ($24 x 25 million)/100 million = 6.0
Diff: 2
Section: 2.3 Balance Sheet Analysis
Skill: Analytical

Use the information for the question(s) below.

In November 2009, Perrigo Co. (PRGO) had a share price of $39.20. They had 91.33 million shares outstanding, a market-to-book ratio of 3.76. In addition, PRGO had $845.01 million in outstanding debt, $163.82 million in net income, and cash of $257.09 million.

2) Perrigo's market capitalization is closest to:
A) $952.16 million
B) $3,580.14 million
C) $4,168.06 million
D) $4,425.15 million
Answer: B
Explanation: B) Market cap = price x shares outstanding = $39.2 x 91.33 million = $3,580.14 million
Diff: 1
Section: 2.3 Balance Sheet Analysis
Skill: Analytical

3) Perrigo's book value of equity is closest to:
A) $952.16 million
B) $3,580.14 million
C) $4,168.06 million
D) $4,425.15 million
Answer: A
Explanation: A) Market to Book = (MV Equity)/(BV Equity) = ($39.2 x 91.33 million)/(BV Equity) = 3.76;
B V Equity = $952.16 million.
Diff: 2
Section: 2.3 Balance Sheet Analysis
Skill: Analytical

4) Perrigo's enterprise value is closest to:
A) $952.16 million
B) $3,580.14 million
C) $4,168.06 million
D) $4,425.15 million
Answer: C
Explanation: C) Enterprise Value = MV Equity + Debt - Cash = $39.2 x 91.33 +$845.01 - $257.09 = $4168.06
Diff: 2
Section: 2.3 Balance Sheet Analysis
Skill: Analytical

5) Perrigo's market debt to equity ratio is closest to:
A) 0.24
B) 0.50
C) 0.75
D) 0.89
Answer: A
Explanation: A) Market Debt to Equity Ratio = Debt/(MV Equity) = $845.01/($39.2 x 91.33) = 0.236
Diff: 2
Section: 2.3 Balance Sheet Analysis
Skill: Analytical

6) Perrigo's debt to equity ratio is closest to:
A) 0.24
B) 0.50
C) 0.75
D) 0.89
Answer: D
Explanation: D) Debt to Equity Ratio = Debt/(BV Equity) = $845.01/(($39.2 x 91.33)/3.76) = 0.887
Diff: 2
Section: 2.3 Balance Sheet Analysis
Skill: Analytical

Use the table for the question(s) below.

Consider the following balance sheet:

Luther Corporation
Consolidated Balance Sheet
December 31, 2009 and 2008 (in $ millions)

Assets	**2009**	**2008**	**Liabilities and Shareholders' Equity**	**2009**	**2008**
Current Assets			*Current Liabilities*		
Inventories	45.9	42.9	Accounts payable	87.6	73.5
Accounts receivable	55.5	39.6	Notes payable / short-term debt	10.5	9.6
Cash	63.6	58.5	Current maturities of long-term debt	39.9	36.9
Other current assets	6.0	3.0	Other current liabilities	6.0	12.0
Total current assets	171.0	144.0	Total current liabilities	144.0	132.0
Non-Current Assets			*Non-Current Liabilities*		
Land	66.6	62.1	Long-term debt	239.7	168.9
Buildings	109.5	91.5	Capital lease obligations	---	---
Equipment	119.1	99.6	Total Debt	239.7	168.9
Less accumulated depreciation	(56.1)	(52.5)	Deferred taxes	22.8	22.2
Net property, plant, and equipment	239.1	200.7	Other long-term liabilities	---	---
Goodwill	60.0	--	Total non-current liabilities	262.5	191.1
Other long-term assets	63.0	42.0	Total liabilities	406.5	323.1
Total non-current assets	362.1	242.7	Shareholders' Equity	126.6	63.6
Total Assets	**533.1**	**386.7**	**Total liabilities and Shareholders' Equity**	**533.1**	**386.7**

7) What is Luther's net working capital in 2008?
A) $12 million
B) $27 million
C) $39 million
D) $63.6 million
Answer: A
Explanation: A) NWC = current assets - current liabilities = 144 - 132 = $12 million
Diff: 2
Section: 2.3 Balance Sheet Analysis
Skill: Analytical

8) If in 2009 Luther has 10.2 million shares outstanding and these shares are trading at $16 per share, then Luther's Market-to-book ratio would be closest to:
A) 0.39
B) 0.76
C) 1.29
D) 2.57
Answer: C
Explanation: C) MTB = market cap / book value of equity = (10.2 million × 16) / 126.6 = 163.2 / 126.6 = 1.289
Diff: 2
Section: 2.3 Balance Sheet Analysis
Skill: Analytical

9) When using the book value of equity, the debt to equity ratio for Luther in 2009 is closest to:
A) 0.43
B) 2.29
C) 2.98
D) 3.57
Answer: B
Explanation: B) D/E = Total Debt / Total Equity
Total Debt = (notes payable (10.5) + current maturities of long-term debt (39.9) + long-term debt (239.7) = 290.1 million
Total Equity = 126.6, so D/E = 290.1 / 126.6 = 2.29
Diff: 2
Section: 2.3 Balance Sheet Analysis
Skill: Analytical

10) If in 2009 Luther has 10.2 million shares outstanding and these shares are trading at $16 per share, then using the market value of equity, the debt to equity ratio for Luther in 2009 is closest to:
A) 1.47
B) 1.78
C) 2.31
D) 4.07
Answer: B
Explanation: B) D/E = Total Debt / Total Equity
Total Debt = (notes payable (10.5) + current maturities of long-term debt (39.9) + long-term debt (239.7) = 290.1 million
Total Equity = 10.2 × $16 = 163.2, so D/E = 290.1 / 163.2 = 1.78
Diff: 2
Section: 2.3 Balance Sheet Analysis
Skill: Analytical

11) If in 2009 Luther has 10.2 million shares outstanding and these shares are trading at $16 per share, then what is Luther's Enterprise Value?
A) -$63.3 million
B) $353.1 million
C) $389.7 million
D) $516.9 million
Answer: C
Explanation: C) Enterprise value = MVE + Debt - Cash = 10.2 × $16 + 290.1 - 63.6 = 389.7
Diff: 2
Section: 2.3 Balance Sheet Analysis
Skill: Analytical

12) Luther's current ratio for 2009 is closest to:
A) 0.84
B) 0.92
C) 1.09
D) 1.19
Answer: D
Explanation: D) current ratio = current assets / current liabilities = 171 / 144 = 1.19
Diff: 2
Section: 2.3 Balance Sheet Analysis
Skill: Analytical

13) Luther's quick ratio for 2008 is closest to:
A) 0.77
B) 0.87
C) 1.15
D) 1.30
Answer: A
Explanation: A) quick ratio = (current assets - inventory) / current liabilities
quick ratio = (144.0 - 42.9) / 132 = 0.77
Diff: 2
Section: 2.3 Balance Sheet Analysis
Skill: Analytical

14) The change in Luther's quick ratio from 2008 to 2009 is closest to:
A) a decrease of .10
B) an increase of .10
C) a decrease of .15
D) an increase of .15
Answer: B
Explanation: B) quick ratio in 2009 = (171.0 - 45.9)/144 = .87
quick ratio 2008 = (144.0 - 42.9) / 132 = .77
so the quick ratio increased by .87 - .77 = .10
Diff: 3
Section: 2.3 Balance Sheet Analysis
Skill: Analytical

15) If on December 31, 2008 Luther has 8 million shares outstanding trading at $15 per share., then what is Luther's market-to-book ratio?
Answer: market-to-book = market value of equity / book value of equity
market-to-book = 8 million × $15 / $63.6 = 1.89
Diff: 2
Section: 2.3 Balance Sheet Analysis
Skill: Analytical

16) If on December 31, 2008 Luther has 8 million shares outstanding trading at $15 per share., then what is Luther's enterprise value?
Answer: Enterprise value = Market value of equity + Debt - Cash
market value of equity = 8 million × $15 = $120 million
Debt = notes payable + current maturities of long-term debt + long-term debt
Debt = 9.6 + 36.9 + 168.9 = 215.4
Cash = 58.5
So, enterprise value = $120 + 215.4 - 58.5 = $276.90
Diff: 2
Section: 2.3 Balance Sheet Analysis
Skill: Analytical

2.4   The Income Statement

1) Which of the following statements regarding the income statement is incorrect?
A) The income statement shows the earnings and expenses at a given point in time.
B) The income statement shows the flow of earnings and expenses generated by the firm between two dates.
C) The last or "bottom" line of the income statement shows the firm's net income (or net profit).
D) The first line of an income statement lists the revenues from the sales of products or services.
Answer: A
Diff: 1
Section: 2.4 The Income Statement
Skill: Conceptual

2) Gross profit is calculated as:
A) Total sales - cost of sales - selling, general and administrative expenses - depreciation and amortization
B) Total sales - cost of sales - selling, general and administrative expenses
C) Total sales - cost of sales
D) None of the above
Answer: C
Diff: 1
Section: 2.4 The Income Statement
Skill: Conceptual

3) Which of the following is not an operating expense?
A) Interest expense
B) Depreciation and amortization
C) Selling, general and administrative expenses
D) Research and development
Answer: A
Diff: 1
Section: 2.4 The Income Statement
Skill: Conceptual

Use the information for the question(s) below.

In November 2009, Perrigo Co. (PRGO) had a share price of $39.20. They had 91.33 million shares outstanding, a market-to-book ratio of 3.76. In addition, PRGO had $845.01 million in outstanding debt, $163.82 million in net income, and cash of $257.09 million.

4) Perrigo's earnings per share (EPS) is closest to:
A) $0.19
B) $1.79
C) $2.81
D) $3.76
Answer: B
Explanation: B) EPS = (Net Income)/(Shares Outstanding) = $163.82/91.33 = 1.7937
Diff: 2
Section: 2.4 The Income Statement
Skill: Analytical

5) Perrigo's price-earnings ratio (P/E) is closest to:
A) 15.96
B) 21.85
C) 29.77
D) 35.64
Answer: B
Explanation: B) price-earnings ratio (P/E) = (M V Equity)/(Net Income) = ($39.2 x 91.33)/$163.82 = 21.85408
Diff: 2
Section: 2.4 The Income Statement
Skill: Analytical

6) The firm's revenues and expenses over a period of time are reported on the firm's
A) Income statement or statement of comprehensive income.
B) Income statement or statement of financial position.
C) Balance sheet or statement of comprehensive income.
D) Balance sheet or statement of financial position.
Answer: A
Diff: 1
Section: 2.4 The Income Statement
Skill: Definition

7) The *statement of comprehensive income* is also known as the
A) balance sheet.
B) Income statement.
C) Statement of cash flows.
D) Statement of changes in shareholders' equity.
Answer: B
Diff: 1
Section: 2.4 The Income Statement
Skill: Definition

Use the table for the question(s) below.

Consider the following income statement and other information:

Luther Corporation Consolidated Income Statement Year ended December 31 (in $ millions)		
	2009	**2008**
Sales revenue	610.1	578.3
Cost of sales	(500.2)	(481.9)
Gross profit	109.9	96.4
Selling, general, and administrative expenses	(40.5)	(39.0)
Research and development	(24.6)	(22.8)
Depreciation and amortization	(3.6)	(3.3)
Operating income	41.2	31.3
Other income	---	---
Earnings before interest and taxes (EBIT)	41.2	31.3
Interest income (expense)	(25.1)	(15.8)
Pre-tax income	16.1	15.5
Taxes	(5.5)	(5.3)
Net income	10.6	10.2
Price per share	$16	$15
Shares outstanding (millions)	10.2	8.0
Share options outstanding (millions)	0.3	0.2
Shareholders' Equity	126.6	63.6
Total Liabilities and Shareholders' Equity	533.1	386.7

8) For the year ending December 31, 2009 Luther's earnings per share are closest to:
A) $0.96
B) $1.04
C) $1.28
D) $1.33
Answer: B
Explanation: B) EPS = Net Income / Shares Outstanding = $10.6 / 10.2 = $1.04
Diff: 1
Section: 2.4 The Income Statement
Skill: Analytical

9) Assuming that Luther has no convertible bonds outstanding, then for the year ending December 31, 2009 Luther's diluted earnings per share are closest to:
A) $1.01
B) $1.04
C) $1.28
D) $1.33
Answer: A
Explanation: A) Diluted EPS = Net Income / (shares outstanding + options contracts outstanding + shares possible from convertible bonds outstanding) = 10.6 / (10.2 + 0.3 + 0.0) = $1.01
Diff: 2
Section: 2.4 The Income Statement
Skill: Analytical

2.5 Income Statement Analysis

Use the table for the question(s) below.

Consider the following income statement and other information:

Luther Corporation Consolidated Income Statement Year ended December 31 (in $ millions)		
	2009	**2008**
Sales revenue	610.1	578.3
Cost of sales	(500.2)	(481.9)
Gross profit	109.9	96.4
Selling, general, and administrative expenses	(40.5)	(39.0)
Research and development	(24.6)	(22.8)
Depreciation and amortization	(3.6)	(3.3)
Operating income	41.2	31.3
Other income	---	---
Earnings before interest and taxes (EBIT)	41.2	31.3
Interest income (expense)	(25.1)	(15.8)
Pre-tax income	16.1	15.5
Taxes	(5.5)	(5.3)
Net income	10.6	10.2
Price per share	$16	$15
Shares outstanding (millions)	10.2	8.0
Share options outstanding (millions)	0.3	0.2
Shareholders' Equity	126.6	63.6
Total Liabilities and Shareholders' Equity	533.1	386.7

1) Luther's Operating Margin for the year ending December 31, 2008 is closest to:
A) 0.5%
B) 0.7%
C) 5.4%
D) 6.8%
Answer: C
Explanation: C) Operating Margin = Operating Income / Sales
OM = 31.3 / 578.3 = .054 or 5.4%
Diff: 1
Section: 2.5 Income Statement Analysis
Skill: Analytical

2) Luther's Net Profit Margin for the year ending December 31, 2008 is closest to:
A) 1.8%
B) 2.7%
C) 5.4%
D) 16.7%
Answer: A
Explanation: A) Net Profit Margin = Net Income / Total Sales = 10.2 / 578.3 = .018 or 1.8%
Diff: 1
Section: 2.5 Income Statement Analysis
Skill: Analytical

3) Luther's earnings before interest, taxes, depreciation, and amortization (EBITDA) for the year ending December 31, 2009 is closest to:
A) 19.7 million
B) 37.6 million
C) 41.2 million
D) 44.8 million
Answer: D
Explanation: D) EBITDA = EBIT + Depreciation & Amortization = 41.2 + 3.6 = $ 44.8 million
Diff: 1
Section: 2.5 Income Statement Analysis
Skill: Analytical

4) Luther's return on equity (ROE) for the year ending December 31, 2009 is closest to:
A) 2.0%
B) 6.5%
C) 8.4%
D) 12.7%
Answer: C
Explanation: C) ROE = Net income / shareholders' equity = 10.6 / 126.6 = .084 or 8.4%
Diff: 2
Section: 2.5 Income Statement Analysis
Skill: Analytical

5) Luther's return on assets (ROA) for the year ending December 31, 2009 is closest to:
A) 1.6%
B) 2.0%
C) 2.3%
D) 2.6%
Answer: B
Explanation: B) ROA = Net income / total assets.
This is a little tricky in that total assets are not given in the problem. The student must remember the basic balance sheet equation A = L + SE. Total Liabilities and Shareholders' Equity is given and this is the same as total assets. So ROA = 10.6 / 533.1 = .0198 or 2.0%
Diff: 3
Section: 2.5 Income Statement Analysis
Skill: Analytical

6) Luther's price - earnings ratio (P/E) for the year ending December 31, 2009 is closest to:
A) 7.9
B) 10.1
C) 15.4
D) 16.0
Answer: C
Explanation: C) P/E = Price / EPS or Market Cap / Earnings = $(10.2 \times \$16) / \$10.6 = 15.4$
Diff: 3
Section: 2.5 Income Statement Analysis
Skill: Analytical

7) Calculate Luther's return of equity (ROE), return of assets (ROA), and price-to-earnings ratio (P/E) for the year ending December 31, 2008.
Answer: ROE = NI / shareholder equity = 10.2 / 63.6 = .160 or 16.0%
ROA = NI/ total assets
Here total assets are not given, but we know that Total Assets = Total Liabilities + Shareholder Equity, so ROA = 10.2 / 386.7 = .026 or 2.6%
P/E = price / EPS or Market Cap / NI = $(8.0 \times \$15) / \$10.2 = 11.8$
Diff: 2
Section: 2.5 Income Statement Analysis
Skill: Analytical

Use the following information for ECE incorporated:

Assets	$200 million
Shareholders’ Equity	$100 million
Sales	$300 million

8) If ECE's return on assets (ROA) is 12%, then ECE's net income is:
A) $6 million
B) $12 million
C) $24 million
D) $36 million
Answer: C
Explanation: C) ROA = (Net Income)/Assets = $ X million/$200 million = 0.12; X = $24 million
Diff: 1
Section: 2.5 Income Statement Analysis
Skill: Analytical

Use the table for the question(s) below.

Consider the following income statement and other information:

Luther Corporation Consolidated Income Statement Year ended December 31 (in $ millions)		
	2009	**2008**
Sales revenue	610.1	578.3
Cost of sales	(500.2)	(481.9)
Gross profit	109.9	96.4
Selling, general, and administrative expenses	(40.5)	(39.0)
Research and development	(24.6)	(22.8)
Depreciation and amortization	(3.6)	(3.3)
Operating income	41.2	31.3
Other income	---	---
Earnings before interest and taxes (EBIT)	41.2	31.3
Interest income (expense)	(25.1)	(15.8)
Pre-tax income	16.1	15.5
Taxes	(5.5)	(5.3)
Net income	10.6	10.2
Price per share	$16	$15
Shares outstanding (millions)	10.2	8.0
Share options outstanding (millions)	0.3	0.2
Shareholders' Equity	126.6	63.6
Total Liabilities and Shareholders' Equity	533.1	386.7

9) If Luther's accounts receivable were $55.5 million in 2009, then calculate Luther's accounts receivable days for 2009.

Answer: Accounts receivable days = $\dfrac{\text{accounts receivable}}{\text{sales / 365}} = \dfrac{55.5}{610.1/365} = 33.2$ days

Diff: 2

Section: 2.5 Income Statement Analysis

Skill: Analytical

10) Luther's EBIT coverage ratio for the year ending December 31, 2008 is closest to:
A) 1.64
B) 1.78
C) 1.98
D) 2.19
Answer: A
Explanation: A) EBIT Coverage ratio = EBIT / (Interest Expense) = 41.2/25.1 = 1.6414
Diff: 1
Section: 2.5 Income Statement Analysis
Skill: Analytical

11) Luther's EBIT coverage ratio for the year ending December 31, 2009 is closest to:
A) 1.64
B) 1.78
C) 1.98
D) 2.19
Answer: C
Explanation: C) EBIT Coverage ratio = EBIT / (Interest Expense) = 31.3/15.8 = 1.981
Diff: 1
Section: 2.5 Income Statement Analysis
Skill: Analytical

12) Wyatt Oil has a net profit margin of 4.0%, a total asset turnover of 2.2, total assets of $525 million, and a book value of equity of $220 million. Wyatt Oil's current return-on-equity (ROE) is closest to:
A) 8.8%
B) 9.5%
C) 21.0%
D) 22.8%
Answer: C
Explanation: C) ROE = net profit margin x total asset turnover x leverage
ROE = 0.04 x 2.2 x (525/220) = 0.21 = 21%
Diff: 2
Section: 2.5 Income Statement Analysis
Skill: Analytical

Use the table for the question(s) below.

Consider the following income statement and other information:

Luther Corporation Consolidated Income Statement Year ended December 31 (in $ millions)		
	2009	**2008**
Sales revenue	610.1	578.3
Cost of sales	(500.2)	(481.9)
Gross profit	109.9	96.4
Selling, general, and administrative expenses	(40.5)	(39.0)
Research and development	(24.6)	(22.8)
Depreciation and amortization	(3.6)	(3.3)
Operating income	41.2	31.3
Other income	---	---
Earnings before interest and taxes (EBIT)	41.2	31.3
Interest income (expense)	(25.1)	(15.8)
Pre-tax income	16.1	15.5
Taxes	(5.5)	(5.3)
Net income	10.6	10.2
Price per share	$16	$15
Shares outstanding (millions)	10.2	8.0
Share options outstanding (millions)	0.3	0.2
Shareholders' Equity	126.6	63.6
Total Liabilities and Shareholders' Equity	533.1	386.7

13) Luther's EBITDA coverage ratio for the year ending December 31, 2009 is closest to:
A) 1.64
B) 1.78
C) 1.98
D) 2.19
Answer: B
Explanation: B) EBITDA Coverage ratio = (EBIT + Dep & Amort) / (Interest Expense) = (41.2 + 3.6)/25.1 = 1.7849
Diff: 1
Section: 2.5 Income Statement Analysis
Skill: Analytical

14) Wyatt Oil has a net profit margin of 4.0%, a total asset turnover of 2.2, total assets of $525 million, and a book value of equity of $220 million. Wyatt Oil's current return-on-assets (ROA) is closest to:
A) 8.8%
B) 9.5%
C) 21.0%
D) 22.8%
Answer: A
Explanation: A) ROA = net profit margin x total asset turnover = 0.04 x 2.2 = 0.088 = 8.8%
Diff: 2
Section: 2.5 Income Statement Analysis
Skill: Analytical

Use the information for the question(s) below.

In November 2009, Perrigo Co. (PRGO) had a share price of $39.20. They had 91.33 million shares outstanding, a market-to-book ratio of 3.76. In addition, PRGO had $845.01 million in outstanding debt, $163.82 million in net income, and cash of $257.09 million.

15) Perrigo's return on equity (ROE) is closest to:
A) 4.6%
B) 9.1%
C) 17.2%
D) 27%
Answer: C
Explanation: C) ROE = (Net Income)/(B V Equity) = $163.82/(($39.20 x 91.33)/3.76) = 0.172 = 17.2%
Diff: 2
Section: 2.5 Income Statement Analysis
Skill: Analytical

Use the following information for ECE incorporated:

Assets	$200 million
Shareholders' Equity	$100 million
Sales	$300 million

16) If ECE reported $15 million in net income, then ECE's Return on Equity (ROE) is:
A) 5.0%
B) 7.5%
C) 10.0%
D) 15.0%
Answer: D
Explanation: D) ROE = (Net Income)/(Shareholder Equity) = $15 million /$100 million = 0.15 = 15%
Diff: 2
Section: 2.5 Income Statement Analysis
Skill: Analytical

17) If ECE's return on assets (ROA) is 12%, then ECE's return on equity (ROE) is:
A) 10%
B) 12%
C) 18%
D) 24%
Answer: D
Explanation: D) ROA = (Net Income)/Assets = $X million/$200 million = 0.12; X = $24 million;
ROE = (Net Income)/(Shareholder Equity) = $24 million/$100 million = 0.24 = 24%
Diff: 2
Section: 2.5 Income Statement Analysis
Skill: Analytical

18) If ECE's net profit margin is 8% , then ECE's return on equity (ROE) is:
A) 10%
B) 12%
C) 24%
D) 30%
Answer: C
Explanation: C) net profit margin = (Net Income)/Sales = $X million/$300 million = 0.08; X = $24 million;
ROE = (Net Income)/(Shareholder Equity) = $24 million/$100 million = 0.24 = 24%
Diff: 2
Section: 2.5 Income Statement Analysis
Skill: Analytical

19) The firm's asset turnover measures
A) the value of assets held per dollar of shareholder equity.
B) the return the firm has earned on its past investments.
C) the firm's ability to sell a product for more than the cost of producing it.
D) how efficiently the firm is utilizing its assets to generate sales.
Answer: D
Diff: 1
Section: 2.4 The Income Statement
Skill: Definition

20) If Firm A and Firm B are in the same industry and use the same production method, and Firm A's asset turnover is higher than that of Firm B, then all else equal we can conclude
A) Firm A is more efficient than Firm B.
B) Firm A has a lower dollar amount of assets than Firm B.
C) Firm A has higher sales than Firm B.
D) Firm A has a lower ROE than Firm B.
Answer: A
Diff: 1
Section: 2.5 Income Statement Analysis
Skill: Definition

21) The firm's equity multiplier measures
A) the value of assets held per euro or dollar of shareholder equity.
B) the return the firm has earned on its past investments.
C) the firm's ability to sell a product for more than the cost of producing it.
D) how efficiently the firm is utilizing its assets to generate sales.
Answer: A
Diff: 1
Section: 2.5 Income Statement Analysis
Skill: Definition

22) If Alex Corporation takes out a bank loan to purchase a machine used in production and everything else stays the same, its equity multiplier will ________, and its ROE will ________.
A) increase; increase
B) decrease; decrease
C) increase; decrease
D) decrease; increase
Answer: A
Diff: 2
Section: 2.5 Income Statement Analysis
Skill: Conceptual

23) The DuPont Identity expresses the firm's ROE in terms of
A) profitability, asset efficiency, and leverage.
B) valuation, leverage, and interest coverage.
C) profitability, margins, and valuation.
D) equity, assets, and liabilities.
Answer: A
Diff: 1
Section: 2.5 Income Statement Analysis
Skill: Definition

24) Suppose Novak Company experienced a reduction in its ROE over the last year. This fall could be attributed to
A) an increase in Net Profit Margin.
B) a decrease in Asset Turnover.
C) an increase in Leverage.
D) a decrease in Equity.
Answer: B
Diff: 1
Section: 2.5 Income Statement Analysis
Skill: Definition

25) If Moon Corporation has an increase in sales, which of the following would result in no change in its EBIT margin?
A) A proportional increase in its net income
B) A proportional decrease in its EBIT
C) A proportional increase in its EBIT
D) An increase in its operating expenses
Answer: C
Diff: 2
Section: 2.5 Income Statement Analysis
Skill: Definition

26) If Moon Corporation's gross margin declined, which of the following is true?
A) Its cost of goods sold increased.
B) Its cost of goods sold as a percent of sales increased.
C) Its sales increased.
D) Its net profit margin was unaffected by the decline.
Answer: B
Diff: 1
Section: 2.5 Income Statement Analysis
Skill: Definition

27) The inventory days ratio measures
A) the average length of time it takes a company to sell its inventory.
B) the average length of time it takes the company's suppliers to deliver its inventory.
C) the level of sales required to keep a company's average inventory on the books.
D) the percentage change in inventory over the past year.
Answer: A
Diff: 2
Section: 2.5 Income Statement Analysis
Skill: Definition

2.6 The Statement of Cash Flows

1) Which of the following is not a section on the cash flow statement?
A) Income generating activities
B) Investing activities
C) Operating activities
D) Financing activities
Answer: A
Diff: 1
Section: 2.6 The Statement of Cash Flows
Skill: Conceptual

2) Which of the following statements regarding net income transferred to retained earnings is correct?
A) Net income = net income transferred to retained earnings - dividends
B) Net income transferred to retain earnings = net income + dividends
C) Net income = net income transferred to retain earnings + dividends
D) Net income transferred to retain earnings - net income = dividends
Answer: C
Diff: 2
Section: 2.6 The Statement of Cash Flows
Skill: Conceptual

3) Which of the following is not a reason why cash flow may not equal net income?
A) Amortization is added in when calculating net income.
B) Changes in inventory will change cash flows but not income.
C) Capital expenditure is not recorded on the income statement.
D) Depreciation is deducted when calculating net income.
Answer: A
Diff: 1
Section: 2.6 The Statement of Cash Flows
Skill: Conceptual

4) Which of the following adjustments to net income is not correct if you are trying to calculate cash flow from operating activities?
A) Add increases in accounts payable
B) Add back depreciation
C) Add increases in accounts receivable
D) Deduct increases in inventory
Answer: C
Diff: 2
Section: 2.6 The Statement of Cash Flows
Skill: Conceptual

5) Which of the following adjustments is not correct if you are trying to calculate cash flow from financing activities?
A) Add dividends paid
B) Add any increase in long term borrowing
C) Add any increase in short-term borrowing
D) Add proceeds from the sale of shares
Answer: A
Diff: 2
Section: 2.6 The Statement of Cash Flows
Skill: Conceptual

Use the tables for the question(s) below.

Consider the following financial information:

Luther Corporation
Consolidated Balance Sheet
December 31, 2009 and 2008 (in $ millions)

Assets	**2009**	**2008**	**Liabilities and Shareholders' Equity**	**2009**	**2008**
Current Assets			*Current Liabilities*		
Inventories	45.9	42.9	Accounts payable	87.6	73.5
Accounts receivable	55.5	39.6	Notes payable / short-term debt	10.5	9.6
Cash	63.6	58.5	Current maturities of long-term debt	39.9	36.9
Other current assets	6.0	3.0	Other current liabilities	6.0	12.0
Total current assets	171.0	144.0	Total current liabilities	144.0	132.0
Non-Current Assets			*Non-Current Liabilities*		
Land	66.6	62.1	Long-term debt	239.7	168.9
Buildings	109.5	91.5	Capital lease obligations	---	---
Equipment	119.1	99.6	Total Debt	239.7	168.9
Less accumulated depreciation	(56.1)	(52.5)	Deferred taxes	22.8	22.2
Net property, plant, and equipment	239.1	200.7	Other long-term liabilities	---	---
Goodwill	60.0	--	Total non-current liabilities	262.5	
Other long-term assets	63.0	42.0	Total liabilities	406.5	323.1
Total non-current assets	362.1	242.7	Shareholders' Equity	126.6	63.6
Total Assets	**533.1**	**386.7**	**Total liabilities and Shareholders' Equity**	**533.1**	**386.7**

Luther Corporation Consolidated Income Statement Year ended December 31 (in $ millions)		
	2009	**2008**
Sales revenue	610.1	578.3
Cost of sales	(500.2)	(481.9)
Gross profit	109.9	96.4
Selling, general, and administrative expenses	(40.5)	(39.0)
Research and development	(24.6)	(22.8)
Depreciation and amortization	(3.6)	(3.3)
Operating income	41.2	31.3
Other income	---	---
Earnings before interest and taxes (EBIT)	41.2	31.3
Interest income (expense)	(25.1)	(15.8)
Pre-tax income	16.1	15.5
Taxes	(5.5)	(5.3)
Net income	10.6	10.2
Dividends Paid	5.1	5.0
Price per Share	$16	$15
Shares outstanding (millions)	10.2	8.0
Shares options outstanding (millions)	0.3	0.2
Shareholders' Equity	126.6	63.6
Total Liabilities and Shareholders' Equity	533.1	386.7

6) For the year ending December 31, 2009 Luther's cash flow from operating activities is ?
Answer: Operating cash flow = NI + Depreciation - chg in AR + chg in AP - chg in INV
Operating cash flow = 10.6 + 3.6 - (55.5 - 39.6) + (87.6 - 73.5) - (45.9 - 42.9) = 9.4
Diff: 3
Section: 2.6 The Statement of Cash Flows
Skill: Analytical

7) For the year ending December 31, 2009 Luther's cash flow from financing activities is?
Answer: Cash flow from financing:

- dividends paid	(5.1)
+ sale or (purchase) of shares	57.5*
+ increase in ST borrowing	3.9
+ increase in LT borrowing	70.8
Cash flow from financing	127.1

NI transferred to RE(2006) = NI - Dividends paid = 10.6 - 5.1 = 5.6

sale of shares = Equity(2006) - NI transferred to RE(2006) - Equity(2005)
= 126.6 - 5.5 - 63.6 = 57.5

increase in ST borrowing = chg in notes payable + chg in current portion of LT debt
= (10.5 - 9.6) + (39.9 - 36.9) = 3.9

increase in LT borrowing = 239.7 - 168.9 = 70.8
Diff: 3
Section: 2.6 The Statement of Cash Flows
Skill: Analytical

2.7 Other Financial Statement Information

1) In addition to the balance sheet, income statement, and the statement of cash flows, a firm's complete financial statements will include all of the following except:
A) Management discussion and analysis
B) Notes to the financial statements
C) Securities and Exchange Commission's (SEC) commentary
D) Statement of changes in shareholders' equity
Answer: C
Diff: 1
Section: 2.7 Other Financial Statement Information
Skill: Conceptual

2) Off-balance sheet transactions are required to be disclosed
A) in the management discussion and analysis.
B) in the auditor's report.
C) in the Securities and Exchange Commission's commentary.
D) in the statement of stockholders' equity.
Answer: A
Diff: 2
Section: 2.7 Other Financial Statement Information
Skill: Conceptual

3) Details of acquisitions, spin-offs, leases, taxes, and risk management activities are given
A) in the management discussion and analysis.
B) in the Securities and Exchange Commission's commentary.
C) in the auditor's report.
D) in the notes to the financial statements.
Answer: D
Diff: 2
Section: 2.7 Other Financial Statement Information
Skill: Conceptual

2.8 Financial Reporting in Practice

1) The Sarbanes-Oxley Act (SOX) was passed by the U.S. Congress in 2002, in response to
A) financial scandals, including WorldCom and Enron.
B) financial scandals, including Bernie Madoff and AIG.
C) financial scandals, including General Motors and Chrysler.
D) the Troubled Asset Relief Program (TARP).
Answer: A
Diff: 1
Section: 2.8 Financial Reporting in Practice
Skill: Definition

2) The Sarbanes-Oxley Act (SOX) stiffened penalties for providing false information by
A) requiring the CEO and CFO to return bonuses or profits from the sale of stock (shares) that are later shown to be due to misstated financial reports.
B) imposing large compliance costs on small companies.
C) requiring auditing firms to have long-standing relationships with their clients and receive lucrative auditing and consulting fees from them.
D) putting strict limits on the amount of non-audit fees (consulting or otherwise) that an accounting firm can earn from a firm that it audits.
Answer: A
Diff: 1
Section: 2.8 Financial Reporting in Practice
Skill: Definition

3) The Sarbanes-Oxley Act (SOX) overhauled incentives and the independence in the auditing process by
A) requiring the CEO and CFO to return bonuses or profits from the sale of stock that are later shown to be due to misstated financial reports.
B) imposing large compliance costs on small companies.
C) requiring auditing firms to have long-standing relationships with their clients and receive lucrative auditing and consulting fees from them.
D) putting strict limits on the amount of non-audit fees (consulting or otherwise) that an accounting firm can earn from a firm that it audits.
Answer: D
Diff: 1
Section: 2.8 Financial Reporting in Practice
Skill: Definition

4) The Sarbanes-Oxley Act (SOX) forced companies to validate their internal financial control processes by
A) putting strict limits on the amount of non-audit fees (consulting or otherwise) that an accounting firm can earn from a firm that it audits.
B) requiring the CEO and CFO to return bonuses or profits from the sale of stock (shares) that are later shown to be due to misstated financial reports.
C) requiring auditing firms to have long-standing relationships with their clients and receive lucrative auditing and consulting fees from them.
D) requiring senior management and the boards of public companies to validate and certify the process through which funds are allocated and controlled.
Answer: D
Diff: 1
Section: 2.8 Financial Reporting in Practice
Skill: Definition