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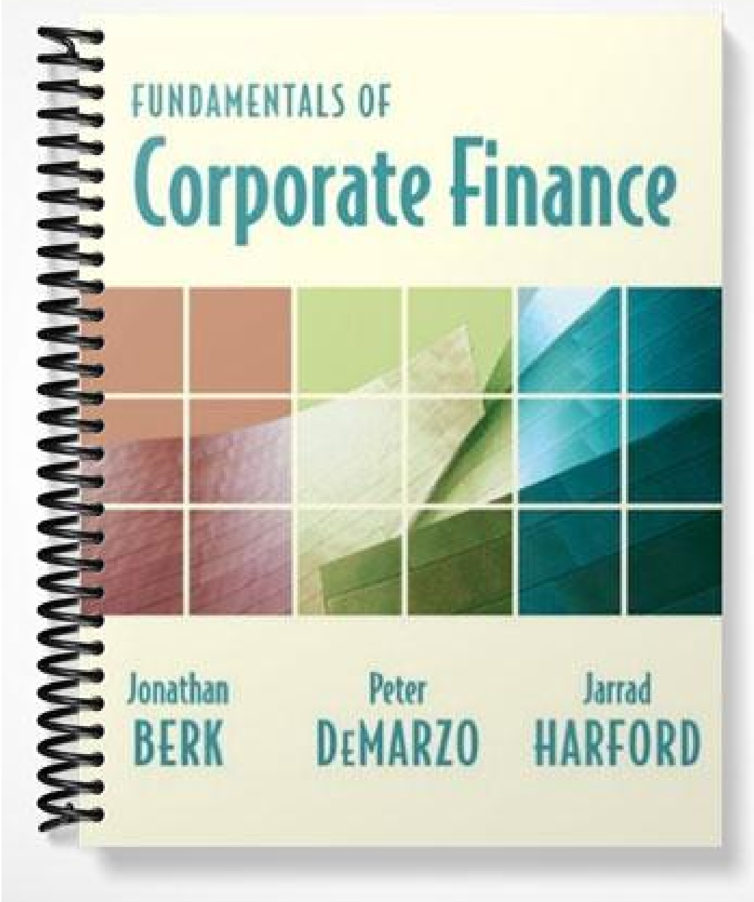
FUNDAMENTALS OF
Corporate Finance
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Fundamentals of Corporate Finance **(Berk)**
Chapter 2 Introduction to Financial Statement Analysis

2.1 Firms' Disclosure of Financial Information

1) In the United States, publicly traded companies can choose whether or not they wish to release periodic financial statements.
Answer: FALSE
Diff: 1
Skill: Conceptual
Author: DS

2) Financial statements are accounting reports issued periodically by a firm which present information on the past performance of the firm, a summary of the firm's assets and the financing of those assets, and a prediction of the firm's future performance.
Answer: FALSE
Diff: 1
Skill: Conceptual
Author: DS

3) What is the main reason that it is necessary for public companies to follow the rules and format set out in the Generally Accepted Accounting Principles (GAAP) when creating financial statements?
A) It is easier to find specific information in such a report if it is laid out in a clear and consistent manner.
B) It ensures that information on the performance of private companies is readily available to the public.
C) It ensures that important information is not omitted and superfluous information is not included.
D) It makes it easier to compare the financial results of different firms.
Answer: D
Diff: 1
Skill: Conceptual
Author: DS

4) Which of the following best describes why firms produce financial statements?
A) to use as a tool when planning future investments within the firm
B) to provide a means of enticing new investors to a firm
C) to provide interested parties, both inside and outside the company, with an overview of the short and long term financial condition of a business
D) to show what activities the company has undertaken in the previous financial year, and what activities are planned for the near future
Answer: C
Diff: 1
Skill: Conceptual
Author: DS

5) The exchanges in which of the following countries or regions do NOT accept the International Financial Reporting Standards set out by the International Accounting Standards Board?
A) Germany
B) France
C) United States
D) United Kingdom
Answer: C
Diff: 1
Skill: Conceptual
Author: DS

6) Which of the following is NOT one of the financial statements that must be produced by a public company?
   A) the balance sheet
   B) the income statement
   C) the statement of cash flows
   D) the statement of activities
Answer: D
Diff: 1
Skill: Conceptual
Author: DS

7) U.S. public companies are required to file their annual financial statements with the U.S. Securities and Exchange Commission on which form?
   A) 10-A
   B) 10-K
   C) 10-Q
   D) 10-SEC
Answer: B
Diff: 1
Skill: Definition
Author: JN

8) 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 stockholders' equity
Answer: B
Diff: 2
Skill: Conceptual
Author: JN

9) The third party who checks annual financial statements to ensure that they are prepared according to Generally Accepted Accounting Principles (GAAP) and verifies that the information reported is reliable is the
   A) NYSE Enforcement Board.
   B) Accounting Standards Board.
   C) Securities and Exchange Commission (SEC).
   D) auditor.
Answer: D
Diff: 1
Skill: Definition
Author: JN

10) 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 Generally Accepted Accounting Principles (GAAP)
3. to verify that the information used in preparing the annual financial statements is reliable

Diff: 2
Skill: Conceptual
Author: JN

11) 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 stockholders' equity
Diff: 2
Skill: Conceptual
Author: JN

2.2 The Balance Sheet

1) The balance sheet shows the assets, liabilities, and stockholders’ equity of a firm over a given length of time.
Answer: FALSE
Diff: 2
Skill: Conceptual
Author: DS

2) Stockholders' equity is the difference between a firm’s assets and liabilities, as shown on the balance sheet.
Answer: TRUE
Diff: 1
Skill: Conceptual
Author: DS

3) Which of the following amounts would NOT be included on the right side of a balance sheet?
A) the value of government bonds held by the company
B) the cash held by the company
C) the amount of deferred tax liability held by the company
D) the amount of money owed to the company by customers who have not yet paid for goods and services they have received
Answer: B
Diff: 2
Skill: Conceptual
Author: DS

4) Which of the following best describes why the left and right sides of a balance sheet are equal?
A) In a properly run business, the value of liabilities will not exceed the assets held by the company.
B) By definition, the assets plus the liabilities will be the same as the stockholders' equity.
C) The assets must equal liabilities plus stockholders' equity, because stockholders' equity is the difference between the assets and the liabilities.
D) By accounting convention, the assets of a company must be equal to the liabilities of that company.
Answer: C
Diff: 1
Skill: Conceptual
Author: DS

5) A company that produces drugs is preparing a balance sheet. Which of the following would be most likely to be considered a long-term asset on this balance sheet?
A) commercial paper held by the company
B) the inventory of chemicals used to produce the drugs made by the company
C) a patent for a drug held by the company
D) the cash reserves of the company
Answer: C
Diff: 1
Skill: Conceptual
Author: DS

6) A delivery company is creating a balance sheet. Which of the following would most likely be considered a short-term liability on this balance sheet?
   A) the depreciation over the last year in the value of the vehicles owned by the company
   B) revenue received for the delivery of items that have not yet been delivered
   C) a loan which must paid back in two years' time
   D) prepaid rent on the offices occupied by the company

Answer: B
Diff: 1
Skill: Conceptual
Author: DS

7) A small company has current assets of $112,000 and current liabilities of $117,000. Which of the following statements about that company are most likely to be true?
   A) Since net working capital is negative, the company will not have enough funds to meet its obligations.
   B) Since net working capital is high, the company will likely have little difficulty meeting its obligations.
   C) Since net working capital is very high, the company will have ample money to invest after it meets its obligations.
   D) Since net working capital is nearly zero, the company is well run and will have little difficulty attracting investors.

Answer: A
Diff: 1
Skill: Conceptual
Author: DS

8) What is the main problem in using a balance sheet to provide an accurate assessment of the value of a company's equity?
   A) Valuable assets such as the company's reputation, the quality of its work force, and the strength of its management are not captured on the balance sheet.
   B) The balance sheet does not accurately represent the book value of assets held by the company.
   C) The equity shown on the balance sheet does not reflect the market capitalization of the company.
   D) Knowing at a single point in time what assets a firm possesses and the liabilities a firm owes does not give any indication of what those assets can produce in the future.

Answer: A
Diff: 2
Skill: Conceptual
Author: DS

Use the table for the question(s) below.

Balance Sheet

Assets		**Liabilities**		
<u>Current Assets</u>		<u>Current Liabilities</u>		
Cash	50	Accounts payable	42	
Accounts receivable	22	Notes payable/short-term debt	7	
Inventories	17			
Total current assets	89	Total current liabilities	49	
<u>Long-Term Assets</u>		<u>Long-Term Liabilities</u>		
Net property, plant, and equipment	121	Long-term debt	128	
Total long-term assets	121	Total long-term liabilities		128
		Total Liabilities	**177**	
		Stockholders' Equity	**33**	
Total Assets	**210**	**Total Liabilities and Stockholders' Equity**	**210**	

9) The above diagram shows a balance sheet for a certain company. All quantities shown are in millions of dollars. What is the company's net working capital?
A) $7 million
B) $32 million
C) $33 million
D) $40 million
Answer: D
Explanation: D) Net working capital = total current assets - total current liabilities, which = 89 - 49 = $40 million as all quantities are expressed in millions of dollars on the table.
Diff: 1
Skill: Analytical
Author: DS

10) The above diagram shows a balance sheet for a certain company. All quantities shown are in millions of dollars. How would the balance sheet change if the company's long-term assets were judged to depreciate at an extra $5 million per year?
A) Net property, plant, and equipment would rise to $126 million, and Total Assets and Stockholders' Equity would be adjusted accordingly.
B) Net property, plant, and equipment would fall to $116 million, and Total Assets and Stockholders' Equity would be adjusted accordingly.
C) Long-Term Liabilities would rise to $182 million, and Total Liabilities and Stockholders' Equity would would be adjusted accordingly.
D) Long-Term Liabilities would fall to $172 million, and Total Liabilities and Stockholders' Equity would be adjusted accordingly.
Answer: B
Diff: 1
Skill: Analytical
Author: DS

11) The above diagram shows a balance sheet for a certain company. All quantities shown are in millions of dollars. If the company has 4 million shares outstanding, and these shares are trading at a price of $8.24 per share, what does this tell you about how investors view this firm's book value?
A) Investors consider that the firm's market value is worth very much less than its book value.
B) Investors consider that the firm's market value is worth less than its book value.
C) Investors consider that the firm's market value and its book value are roughly equivalent.
D) Investors consider that the firm's market value is worth more than its book value.
Answer: C
Diff: 1
Skill: Analytical
Author: DS

12) 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
Skill: Conceptual
Author: JN

13) Cash is a
A) Long-Term Asset.
B) Current Asset.
C) Current Liability.
D) Long-Term Liability.
Answer: B
Diff: 1
Skill: Definition
Author: JN

14) Accounts payable is a
A) Long-Term Liability.
B) Current Asset.
C) Long-Term Asset.
D) Current Liability.
Answer: D
Diff: 1
Skill: Definition
Author: JN

15) 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
Skill: Definition
Author: JN

16) 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 stockholders' equity on the right-hand side.

D) The balance sheet reports liabilities on the left-hand side.

Answer: D

Diff: 2

Skill: Conceptual

Author: JN

Use the table for the question(s) below.

Luther Corporation
Consolidated Balance Sheet
December 31, 2006 and 2005 (in $ millions)

Assets	**2006**	**2005**	**Liabilities and Stockholders' Equity**	**2006**	**2005**
Current Assets			*Current Liabilities*		
Cash	63.6	58.5	Accounts payable	87.6	73.5
Accounts receivable	55.5	39.6	Notes payable / short-term debt	10.5	9.6
Inventories	45.9	42.9	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
Long-Term Assets			*Long-Term 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 long-term liabilities	262.5	191.1
Other long-term assets	63.0	42.0	Total liabilities	406.5	323.1
Total long-term assets	362.1	242.7	Stockholders' Equity	126.6	63.6
Total Assets	**533.1**	**386.7**	**Total liabilities and Stockholders' Equity**	**533.1**	**386.7**

17) Refer to the balance sheet above. What is Luther's net working capital in 2005?

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

Skill: Analytical

Author: JN

18) Refer to the balance sheet above. If in 2006 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
Skill: Analytical
Author: JN

19) Refer to the balance sheet above. When using the book value of equity, the debt-equity ratio for Luther in 2006 is closest to:

A) 2.21
B) 2.29
C) 2.98
D) 3.03

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
Skill: Analytical
Author: JN

20) Refer to the balance sheet above. If in 2006 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-equity ratio for Luther in 2006 is closest to:

A) 1.71
B) 1.78
C) 2.31
D) 2.35

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
Skill: Analytical
Author: JN

21) Refer to the balance sheet above. If in 2006 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
Skill: Analytical
Author: JN

22) Refer to the balance sheet above. Luther's current ratio for 2006 is closest to:

A) 0.84
B) 0.87
C) 1.15
D) 1.19

Answer: D

Explanation: D) current ratio = current assets / current liabilities = 171 / 144 = 1.19

Diff: 2
Skill: Analytical
Author: JN

23) Refer to the balance sheet above. Luther's quick ratio for 2005 is closest to:

A) 0.77
B) 1.31
C) 1.09
D) 0.92

Answer: A

Explanation: A) quick ratio = (current assets - inventory) / current liabilities
quick ratio = (144.0 - 42.9) / 132 = 0.77

Diff: 2
Skill: Analytical
Author: JN

24) Refer to the balance sheet above. The change in Luther's quick ratio from 2005 to 2006 is closest to:

A) a decrease of 0.10
B) an increase of 0.10
C) a decrease of 0.15
D) an increase of 0.15

Answer: B

Explanation: B) quick ratio in 2006 = (171.0 - 45.9) / 144 = 0.87
quick rat io 2005 = (144.0 - 42.9) / 132 = 0.77
So, the quick ratio increased by 0.87 - 0.77 = 0.10.

Diff: 3
Skill: Analytical
Author: JN

25) Refer to the balance sheet above. If on December 31, 2005 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
Skill: Analytical
Author: JN

26) Refer to the balance sheet above. If on December 31, 2005 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
Skill: Analytical
Author: JN

2.3 Balance Sheet Analysis

1) In general, a successful firm will have a market-to-book ratio that is substantially greater than 1.

Answer: TRUE

Diff: 1
Skill: Conceptual
Author: DS

2) A public company has a book value of $128 million. They have 20 million shares outstanding, with a market price of $4 per share. Which of the following statements is true regarding this company?

A) Investors may consider this firm to be a growth company.
B) Investors believe the company's assets are not likely to be profitable its market value is worth less than its book value.
C) The firm's market value is more than its book value.
D) The value of the firm’s assets are greater than their liquidation value.

Answer: B

Diff: 1
Skill: Analytical
Author: DS

3) GenCorp has a total debt of $140 million and stockholders' equity of $50 million. It also has 25 million shares outstanding, with a market price of $3.50 per share. What is GenCorp's market debt-equity ratio?

A) 0.36
B) 0.63
C) 1.02
D) 1.60

Answer: D

Explanation: D) 140 / (3.5 x 25) = 1.60

Diff: 2
Skill: Analytical
Author: DS

4) A company has a share price of $24.50 and $118 million shares outstanding. Its market-to-book ratio is 4.2, its book debt-equity ratio is 3.2, and it has cash of $800 million. How much would it cost to take over this business assuming you pay its enterprise value?
   A) $1.5
   B) $2.8 billion
   C) $3.6 billion
   D) $4.2 billion
   Answer: D
   Explanation: D) Market cap = 24.5 x 118 = $2.891 billion; Book value = 2.891 / 4.2 = 0.688; Debt = 0.688 x 3.2 = 2.203; Enterprise value = 2.891 + 2.203 - 0.800 = 4.2 billion
   Diff: 3
   Skill: Analytical
   Author: DS

5) Convex Industries has inventories of $200 million, current assets of $1.4 billion, and current liabilities of $530 million. What is its quick ratio?
   A) 0.38
   B) 0.44
   C) 2.12
   D) 2.26
   Answer: D
   Explanation: D) (1.4 - 0.2) / 0.53 = 2.26
   Diff: 2
   Skill: Analytical
   Author: DS

6) Which ratio would you use to measure the financial health of a firm by assessing that firm's leverage?
   A) debt-equity or equity multiplier ratio
   B) market-to-book ratio
   C) market debt-equity ratio
   D) current or quick ratio
   Answer: A
   Diff: 1
   Skill: Conceptual
   Author: DS

7) Company A has current assets of $42 billion and current liabilities of $31 billion. Company B has current assets of $2.7 billion and current liabilities of $1.8 billion. Which of the following statements is correct, based on this information?
   A) Company A is less likely than Company B to have sufficient working capital to meet its short-term needs.
   B) Company A has greater leverage than Company B.
   C) Company A has less leverage than Company B.
   D) Company A and Company B have roughly equivalent enterprise values.
   Answer: A
   Diff: 3
   Skill: Analytical
   Author: DS

Use the table for the question(s) below.

Balance Sheet

Assets	**2007**	**2008**	**Liabilities**	**2007**	**2008**
<u>Current Assets</u>			<u>Current Liabilities</u>		
Cash	50	46	Accounts payable	42	48
Accounts receivable	22	12	Notes payable/short-term debt	7	5
Inventories	17	38			
Total current assets	89	96	Total current liabilities	49	53
<u>Long-Term Assets</u>			<u>Long-Term Liabilities</u>		
Net property, plant, and equipment	121	116	Long-term debt	128	136
Total long-term assets	121	116	Total long-term liabilities	128	136
			Total Liabilities	**177**	**189**
			Stockholders' Equity	**33**	**23**
Total Assets	**210**	**212**	**Total Liabilities and Stockholders' Equity**	**210**	**212**

8) If the above balance sheet is for a retail company, what indications about this company would best be drawn from the changes in the balance sheet between 2007 and 2008?
A) The company is having difficulties selling its product.
B) The company has reduced its debt.
C) The company has added a major new asset in terms of plant and equipment.
D) The company has experienced a significant rise in its market value.
Answer: A
Diff: 2
Skill: Analytical
Author: DS

9) If the above balance sheet is for a retail company, what indications about this company would best be drawn from the changes in quick ratio between 2007 and 2008?
A) The company has eliminated the risk that it will experience a cash shortfall in the near future.
B) The company has reduced the risk that it will experience a cash shortfall in the near future.
C) The risk that the company will experience a cash shortfall in the near future is unchanged.
D) The company has increased the risk that it will experience a cash shortfall in the near future.
Answer: D
Diff: 2
Skill: Analytical
Author: DS

10) If the above balance sheet is for a retail company, how has the company's leverage changed between 2007 and 2008?
A) The company has experienced a very significant decrease in its leverage.
B) The company has experienced a significant decrease in its leverage.
C) The company has experienced no significant change in its leverage.
D) The company has experienced a significant increase in its leverage.
Answer: D
Diff: 3
Skill: Analytical
Author: DS

11) 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.

D) The first line of an income statement lists the revenues from the sales of products or services.

Answer: A

Diff: 2

Skill: Conceptual

Author: JN

12) 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: 2

Skill: Conceptual

Author: JN

13) 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: 2

Skill: Conceptual

Author: JN

Use the table for the question(s) below.

Luther Corporation Consolidated Income Statement Year ended December 31 (in $ millions)		
	2006	**2005**
Total sales	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)
Pretax 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
Stock options outstanding (millions)	0.3	0.2
Stockholders' Equity	126.6	63.6
Total Liabilities and Stockholders' Equity	533.1	386.7

14) Refer to the income statement above. For the year ending December 31, 2006 Luther's earnings per share are closest to:
A) $1.01
B) $1.04
C) $1.58
D) $4.04
Answer: B
Explanation: B) EPS = Net income / Shares outstanding = $10.6 / 10.2 = $1.04
Diff: 1
Skill: Analytical
Author: JN

15) Refer to the income statement above. Assuming that Luther has no convertible bonds outstanding, then for the year ending December 31, 2006 Luther's diluted earnings per share are closest to:
A) $1.01
B) $1.04
C) $1.53
D) $3.92
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
Skill: Analytical
Author: JN

16) Refer to the income statement above. Luther's operating margin for the year ending December 31, 2005 is closest to:

A) 1.8%
B) 2.7%
C) 5.4%
D) 16.7%

Answer: C

Explanation: C) Operating margin = Operating income / Sales
OM = 31.3 / 578.3 = 0.054 or 5.4%

Diff: 1
Skill: Analytical
Author: JN

17) Refer to the income statement above. Luther's net profit margin for the year ending December 31, 2005 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 = 0.018 or 1.8%

Diff: 1
Skill: Analytical
Author: JN

18) Refer to the income statement above. Luther's earnings before interest, taxes, depreciation, and amortization (EBITDA) for the year ending December 31, 2006 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 and amortization = 41.2 + 3.6 = $44.8 million

Diff: 1
Skill: Analytical
Author: JN

19) Refer to the income statement above. Luther's return on equity (ROE) for the year ending December 31, 2006 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 = 0.084 or 8.4%

Diff: 2
Skill: Analytical
Author: JN

20) Refer to the income statement above. Luther's return on assets (ROA) for the year ending December 31, 2006 is closest to:
   A) 2.0%
   B) 6.5%
   C) 8.4%
   D) 12.7%
   Answer: A
   Explanation: A) 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 = 0.020 or 2.0%.
   Diff: 3
   Skill: Analytical
   Author: JN

21) How does a firm select the date for preparation of its balance sheet?
   Answer: The balance sheet is prepared on the fiscal closing date for the accounts of a firm that may or may not coincide with the calendar year-end of December 31st.
   Diff: 3
   Skill: Analytical
   Author: SS

22) What will be the effect on the balance sheet if a firm buys a new processing plant through a new loan?
   Answer: The Assets side will increase under Net property, plant, and equipment with the net effect of the new processing plant while the Liabilities side will correspondingly show the new debt that was incurred in paying for the plant.
   Diff: 3
   Skill: Conceptual
   Author: SS

2.4 The Income Statement

1) The income statement reports the firm's revenues and expenses, and it computes the firm's bottom line of net income, or earnings.
   Answer: TRUE
   Diff: 1
   Skill: Analytical
   Author: DS

2) What is a firm's net income?
   A) the difference between the sales and other income generated by the firm, and all costs, taxes, and expenses incurred by the firm in a given period
   B) the last or "bottom" line of the income statement
   C) a measure of the firm's profitability over a given period
   D) all of the above
   Answer: D
   Diff: 3
   Skill: Conceptual
   Author: DS

3) Which of the following is NOT considered to be an operating expense on the income statement?
A) administrative expenses and overhead
B) corporate taxes
C) salaries
D) depreciation and amortization
Answer: B
Diff: 2
Skill: Conceptual
Author: DS

Use the table for the question(s) below.

Income Statement for Xenon Manufacturing:

	2008	**2009**
Total sales	202	212
Cost of sales	-148	-172
Gross Profit	54	40
Selling, general, and administrative expenses	-22	-20
Research and development	-8	-7
Depreciation and amortization	-4	-3
Operating Income	20	10
Other income	4	6
Earnings before interest and taxes (EBIT)	24	16
Interest income (expense)	-7	-4
Pretax income	14	12
Taxes	-4	-3
Net Income	10	9

4) Consider the above Income Statement for Xenon Manufacturing. All values are in millions of dollars. If Xenon Manufacturing has 25 million shares outstanding, what is its EPS in 2009?
A) $0.36
B) $0.40
C) $0.63
D) $0.84
Answer: A
Diff: 2
Skill: Analytical
Author: DS

Use the table for the question(s) below.

Income Statement for CharmCorp:

	2008	**2009**
Total sales	600	540
Cost of sales	-532	-488
Gross Profit	68	52
Selling, general, and administrative expenses	-36	-21
Research and development	-4	-5
Depreciation and amortization	-5	-5
Operating Income	23	21
Other income	1	5
Earnings before interest and taxes (EBIT)	24	26
Interest income (expense)	-7	-7
Pretax income	14	19
Taxes	-4	-5
Net Income	10	14

5) Consider the above Income Statement for CharmCorp. All values are in millions of dollars. If CharmCorp has 6 million shares outstanding, and its managers and employees have stock options for 1 million shares, what is its diluted EPS in 2009?

A) $1.42
B) $1.67
C) $2.00
D) $2.33

Answer: C

Diff: 3
Skill: Analytical
Author: DS

6) How does a firm select the dates for preparation of its income statement?

Answer: The income statement is prepared on the fiscal closing date for the accounts of a firm that may or may not coincide with the calendar year-end of December 31st. Typically the income statement spans the flow between two adjacent balance sheets.

Diff: 3
Skill: Analytical
Author: SS

7) What will be the effect on the income statement if a firm buys a new processing plant through a new loan?

Answer: The effect on the income statement will be in the form of a depreciation expense for the first year on the new processing plant.

Diff: 3
Skill: Conceptual
Author: SS

2.5 Income Statement Analysis

1) Price-earnings ratios tend to be high for fast-growing firms.
Answer: TRUE
Diff: 1
Skill: Conceptual
Author: DS

Use the table for the question(s) below.

Income Statement for Xenon Manufacturing:

	2008	**2009**
Total sales	202	212
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Depreciation and amortization	-4	-3
Operating Income	20	10
Other income	4	6
Earnings before interest and taxes (EBIT)	24	16
Interest income (expense)	-7	-4
Pretax income	14	12
Taxes	-4	-3
Net Income	10	9

2) Consider the above Income Statement for Xenon Manufacturing. All values are in millions of dollars. Calculate the operating margin for 2008 and 2009. What does the change in the operating margin between these two years imply about the company?
A) The efficiency of Xenon Manufacturing has significantly risen between 2008 and 2009.
B) The ability of Xenon Manufacturing to sell its goods and services for more than the costs of producing them rose between 2008 and 2009.
C) The efficiency of Xenon Manufacturing has significantly fallen between 2008 and 2009.
D) The leverage of Xenon Manufacturing fell slightly between 2008 and 2009.
Answer: C
Explanation: C) 24 / 202 = 0.12; 16 / 212 = 0.08
Diff: 3
Skill: Analytical
Author: DS

3) In 2009, an agricultural company introduced a new cropping process which reduced the cost of growing some of its crops. If sales in 2008 and 2009 were steady at $25 million, but the gross margin increased from 2.3% to 3.4% between those years, by what amount was the cost of sales reduced?

A) $275,000
B) $325,000
C) $425,000
D) $575,000

Answer: A

Explanation: A) (25 x 0.034 - 25 x 0.023) x 1,000,000 = $275,000

Diff: 2
Skill: Analytical
Author: DS

4)

Firm A:		Firm B:	
Assets		Assets	
Current assets	4	Current assets	7
Fixed assets	10	Fixed assets	7
Total assets	**14**	**Total assets**	**14**

Firm A:		Firm B:	
Total sales	12	Total sales	12
Cost of sales	-5	Cost of sales	-7
Gross Profit	**7**	**Gross Profit**	**5**

Above are portions of the balance sheet and income statement for two companies in 2008. Based upon this information, which of the following statements is most likely to be true?

A) Asset turnover ratios indicate that firm A is generating greater revenue per dollar of assets than firm B.
B) Fixed asset turnover ratios indicate that firm A generating fewer sales for the assets they employ than firm B.
C) Both asset turnover ratios and fixed asset turnover ratios indicate that firm A is generating greater revenue per dollar of assets than firm B.
D) Fixed asset turnover ratios indicate that firm A generating more sales for the assets they employ than firm B.

Answer: B

Diff: 3
Skill: Analytical
Author: DS

5) **Balance Sheet**

Assets		**Liabilities**	
Current Assets		Current Liabilities	
Cash	50	Accounts payable	42
Accounts receivable	22	Notes payable/short-term debt	7
Inventories	17		
Total current assets	89	Total current liabilities	49
Long-Term Assets		Long-Term Liabilities	
Net property, plant, and equipment	121	Long-term debt	128
Total long-term assets	121	Total long-term liabilities	128
		Total Liabilities	**177**
		Stockholders' Equity	**33**
Total Assets	**210**	**Total Liabilities and Stockholders' Equity**	**210**

Income Statement

Total sales	312
Cost of sales	-210
Gross Profit	102
Selling, general, and administrative expenses	-34
Research and development	-10
Depreciation and amortization	-5
Operating Income	53
Other income	-
Earnings before interest and taxes (EBIT)	53
Interest income (expense)	-20
Pretax income	33
Taxes	-8
Net Income	25

The balance sheet and income statement of a particular firm are shown above. What does the account receivable days ratio tell you about this company?

A) It takes on average about 4 weeks to collect payment from its customers.
B) It takes on average about 6 weeks to collect payment from its customers.
C) It takes on average about 7 weeks to collect payment from its customers.
D) It takes on average about 11 weeks to collect payment from its customers.

Answer: A

Diff: 2
Skill: Analytical
Author: DS

6) Which of the following is the LEAST likely explanation for a firm's high ROE?

A) The firm is growing.

B) The firm is able to find investment opportunities that are very profitable.

C) The firm has very efficient use of its assets.

D) The firm enjoys high sales margins.

Answer: A

Diff: 2

Skill: Analytical

Author: DS

7) Which of the following firms would be expected to have a high ROE based on that firm's high operating efficiency?

A) a medical supply company that provides very precise instruments at a high price to large medical establishments such as hospitals

B) a high-end fashion retailer that has a very high mark-up on all items it sells

C) a brokerage firm that has high levels of leverage

D) a grocery store chain that has very high turnover, selling a many multiples of their assets per year

Answer: D

Diff: 1

Skill: Conceptual

Author: DS

8) Manufacturer A has a profit margin of 2.0%, an asset turnover of 1.7 and an equity multiplier of 4.9. Manufacturer B has a profit margin of 2.3%, an asset turnover of 1.1 and an equity multiplier of 4.7. How much asset turnover should manufacturer B have to match manufacturer A's ROE?

A) 1.54%

B) 3.00%

C) 3.09%

D) 4.77%

Answer: A

Explanation: A) ROEa = 2 x 1.7 x 4.9 = 16.66; ROEb = 2.3 x 1.1 x 4.7 = 11.891; 16.66 / (2.3 x 4.7) = 1.54

Diff: 3

Skill: Analytical

Author: DS

9)

	Firm A	Firm B	Firm C	Firm D
Net Income	$34.1 million	$5.7 million	$31.1 million	$13.2 million
Market Capitalization	$310 million	$53 million	$280 million	$112 million
Earnings per share	$4.10	$4.05	$6.75	$12.70

The above data is for four regional trucking firms. Based on price-earnings ratios, which firm's stock is the best value?

A) Firm A

B) Firm B

C) Firm C

D) Firm D

Answer: B

Diff: 2

Skill: Analytical

Author: DS

10) Why must care be taken when comparing a firm's share price to its operating income?

A) Both share price and operating income are related to the whole firm.

B) Share price is a quantity related to the entire firm, while operating income is an amount that is related solely to equity holders.

C) Both share price and operating income are related solely to equity holders.

D) Share price is a quantity related to equity holders, while operating income is an amount that is related to the whole firm.

Answer: D

Diff: 1
Skill: Conceptual
Author: DS

2.6 The Statement of Cash Flows

1) The firm’s statement of cash flows uses the balance sheet and the income statement to determine the amount of cash a firm has generated and how it has used that cash during a given period.

Answer: TRUE

Diff: 1
Skill: Conceptual
Author: DS

2) Which of the following is NOT a reason that the income statement does not accurately indicate how much cash a firm has earned?

A) It includes entries for the depreciation of assets.

B) It does not include entries for expenditures on inventory.

C) It does not include entries for collection of money from account receivables.

D) It includes cash inflows from services rendered.

Answer: D

Diff: 1
Skill: Conceptual
Author: DS

3) Which of the following is a way that the Operating Activity section of the statement of cash flows adjusts Net Income from the balance sheet?

A) It subtracts all expenses and costs related to the firm's operating activities.

B) It adds all non-cash entries related to the firm’s operating activities.

C) It adds the cash that flows from investors to the firm.

D) It removes the cash used for investment purposes.

Answer: A

Diff: 1
Skill: Conceptual
Author: DS

4) A printing company prints a brochure for a client, and then bills them for this service. At the time the printing company's financial disclosure statements are prepared, the client has not yet paid the bill for this service. How will this transaction be recorded?
   A) The sale will be added to Net Income on the income statement and retained in Net Income on the statement of cash flows.
   B) The sale will be added to Net Income on the income statement but deducted from Net Income on the statement of cash flows.
   C) The sale will not be added to Net Income on the income statement but added to Net Income on the statement of cash flows.
   D) The sale will neither be added to Net Income on the income statement nor used to adjust Net Income on the statement of cash flows.

Answer: A
Diff: 1
Skill: Conceptual
Author: DS

5) A manufacturer of plastic bottles for the medical trade purchases a new compression blow molder for its bottle production plant. How will the cost to the company of this piece of equipment be recorded?
   A) It will be depreciated over time on the income statement and subtracted as a capital expenditure on the statement of cash flows.
   B) It will be depreciated over time on the income statement and subtracted as Inventory on the statement of cash flows.
   C) It will be depreciated over time on the income statement and therefore not be recorded separately on the statement of cash flows.
   D) It will be subtracted from Gross Profit on the income statement and therefore not be recorded separately on the statement of cash flows.

Answer: A
Diff: 1
Skill: Conceptual
Author: DS

6) A software company acquires a smaller company in order to acquire the patents that it holds. Where will the cost of this acquisition be recorded on the statement of cash flows?
   A) as an outflow under Operating Activities
   B) as an outflow under Investment Activities
   C) as an outflow under Financial Activities
   D) The acquisition would not be recorded on the statement of cash flows.

Answer: B
Diff: 1
Skill: Conceptual
Author: DS

Use the table for the question(s) below.

AOS Industries Statement of Cash Flows for 2008

Operating activities	
Net Income	3.2
Depreciation and amortization	1.4
Cash effect of changes in	
Accounts receivable	2.1
Accounts payable	1.1
Inventory	0.8
Cash from operating activities	**2.8**
Investment activities	
Capital expenditures	2.2
Acquisitions and other investing activity	-0.4
Cash from investing activities	**2.6**
Financing activities	
Dividends paid	-1.5
Sale or purchase of stock	2.1
Increase in short-term borrowing	1.4
Increase in long-term borrowing	3.2
Cash from financing activities	**5.2**
Change in Cash and Cash Equivalents	**5.4**

7) Consider the above statement of cash flows. If all amounts shown above are in millions of dollars, what were AOS Industries' retained earnings for 2008?

A) $1.3 million
B) $1.7 million
C) $2.1 million
D) $5.4 million

Answer: B

Explanation: B) 3.2 - 1.5 = $1.7million

Diff: 2
Skill: Analytical
Author: DS

8) Consider the above statement of cash flows. What were AOS Industries' major means of raising money in 2008?

A) from investment activities
B) by sale of stock
C) from its operations
D) by issuing debt

Answer: D

Diff: 1
Skill: Analytical
Author: DS

9) Consider the above statement of cash flows. In 2008, AOS Industries had contemplated buying a new warehouse for $2 million, the cost of which would be depreciated over 10 years. If AOS Industries has a tax rate of 25%, what would be the impact for the amount of cash held by AOS at the the end of the 2008?

A) It would have $2,00,000 less cash at the end of 2008.
B) It would have $1,950,000 less cash at the end of 2008.
C) it would have $150,000 less cash at the end of 2008.
D) it would have an additional $50,000 in cash at the end of 2008.

Answer: B
Explanation: B) -$2,000,000 +200,000 x 0.25 = -$1,950,000
Diff: 3
Skill: Analytical
Author: DS

10) How can we cross check the statement of cash flows?
Answer: The last item in the statement of cash flows should equal the difference in cash balances between two adjacent balance sheets.
Diff: 3
Skill: Conceptual
Author: SS

11) What will be the effect on the statement of cash flows if a firm buys a new processing plant through a new loan?
Answer: The new loan entry should show as a cash inflow for the firm, while the payment for the new processing plant will be entered as a cash outflow.
Diff: 3
Skill: Conceptual
Author: SS

2.7 Other Financial Statement Information

1) The management of public companies are not legally required to disclose any off balance sheet transactions.
Answer: FALSE
Diff: 1
Skill: Conceptual
Author: DS

2) A firm whose primary business is in a line of regional grocery stores would be most likely to have to include which of the following facts, if true, in the firm's management discussion and analysis (MD&A)?

A) that a large number of funds were allocated to advertising to increase awareness of the firm's brand in new areas it had expanded into this year
B) that some senior members of the management team have retired in this financial year
C) that the company has lost a class action suit brought against the firm by its employees and is expected to have to pay a large amount of damages
D) that the firm has plans to expand into the organic food business in the next financial year by purchasing several small organic food retailers

Answer: C
Diff: 2
Skill: Conceptual
Author: DS

3) The notes to the financial statements would be LEAST likely to be used for which of the following purposes?
A) to provide information regarding the context in which these financial numbers were generated
B) to disclose the financial implications of any off balance sheet transactions
C) to show how the value of assets listed in the financial statements were arrived at
D) to explain the method of accounting that was used in the preparation of the financial statements
Answer: B
Diff: 1
Skill: Conceptual
Author: DS

4) What is the need for the notes to the financial statements when the firm's operations are already documented in the financial statements?
Answer: Not all actions of the firm can be directly converted to an entry on the financial statements. For example, the firm may be involved in off balance sheet transactions, which have to be reported through notes to the financial statements.
Diff: 1
Skill: Conceptual
Author: SS

2.8 Financial Reporting in Practice

1) Use of Generally Accepted Accounting Principles (GAAP) and auditors have eliminated the danger of inadvertent or deliberate fraud in financial statements.
Answer: FALSE
Diff: 1
Skill: Conceptual
Author: DS

2) One way Enron manipulated its financial statements was to sell assets at inflated prices to other firms, while giving a promise to buy back those assets at a later date. The incoming cash was recorded as revenue, but the promise to buy back the assets was not disclosed. Which of the following is one of the ways that such a transaction is deceptive?
A) The assets should have been listed on the balance sheet as long term assets.
B) Cash raised by selling assets should not be recorded as revenue.
C) The cash raised should have been recorded as short-term loans.
D) The off balance sheet promises to repurchase assets should have been disclosed in management discussion and analysis (MD&A) or notes to the financial statement.
Answer: D
Diff: 2
Skill: Conceptual
Author: DS

3) WorldCom classified $3.85 billion in operating expenses as long-term investments. How would this make WorldCom's financial statements more attractive to investors?
A) by decreasing depreciation
B) by reducing capital expenditures
C) by raising its reported earnings
D) by boosting its cash flows
Answer: C
Diff: 2
Skill: Conceptual
Author: DS

4) Which of the following is NOT one of the ways that the Sarbanes-Oxley Act sought to improve the accuracy of information given to both boards and shareholders?
   A) by increasing the penalties to firms for providing false information
   B) by increasing the independence of auditors and clients
   C) by decreasing the non-audit fees that an auditor can receive from a client
   D) by forcing companies to audit financial statements they release

Answer: D
Diff: 1
Skill: Conceptual
Author: DS

5) What are the requirements of section 404 of SOX?
   A) It requires that senior management return any profits or bonuses resulting from stock sales during any period covered by financial statements that must later be restated.
   B) It requires that auditors do not perform any non-auditing tasks for the companies they audit..
   C) It requires that audit partners rotate every five years.
   D) It requires that senior management and the boards of public companies attest to the effectiveness and validity of their financial control process.

Answer: D
Diff: 1
Skill: Conceptual
Author: DS

6) Which of the following is the main lesson that analysts and investors should take from the cases of Enron and WorldCom?
   A) The usefulness of financial statements to investors is entirely dependent on the ethics of those constructing them.
   B) It is not possible to effectively evaluate a company unless all the financial statements are fully and correctly prepared.
   C) The information in financial statements should be viewed extremely critically.
   D) Readers of even fraudulent financial statements can spot signs of a firm's financial health if those statements are read fully and with care.

Answer: D
Diff: 1
Skill: Conceptual
Author: DS

7) What role do external auditors play in the firm's financial reporting process?

Answer: As the name implies, external auditors act as third party monitors to the firms' financial reporting process.
Diff: 1
Skill: Conceptual
Author: SS

8) What role does Generally Accepted Accounting Principles (GAAP) play in the accounting process?

Answer: All firms quoted on a U.S. exchange are required to use GAAP in their financial reporting process. This standardization process makes it easier to adjust and/or compare the financial figures across different firms.
Diff: 1
Skill: Conceptual
Author: SS

9) State the names of some of the firms discussed in the chapter that had inaccurate reporting in their financial statements.

Answer: Examples of some firms that had practiced inaccurate reporting are Enron and Worldcom.

Diff: 1
Skill: Conceptual
Author: SS

10) According to the text, did Enron and WorldCom follow Generally Accepted Accounting Principles (GAAP) in their financial reporting process?

Answer: Many of the problems of Enron and WorldCom were kept hidden from boards and shareholders until it was too late. People felt that the accounting statements of these companies, while often remaining true to the letter of GAAP, did not present an accurate picture of the financial health of the company.

Diff: 2
Skill: Conceptual
Author: SS