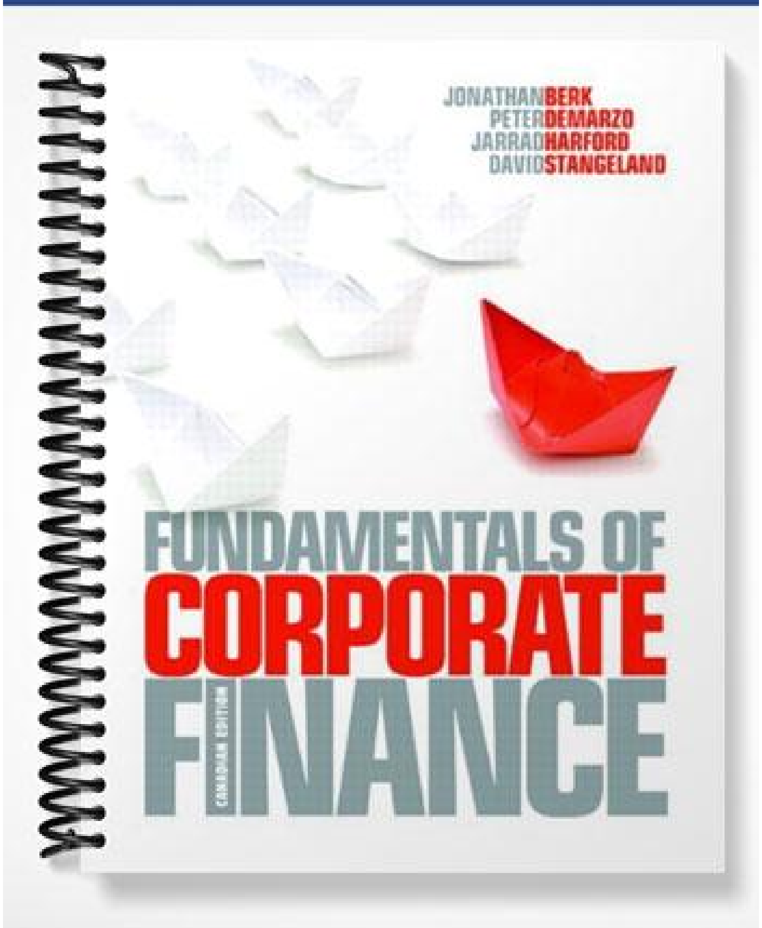
TEST BANK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FUNDAMENTALS OF
CORPORATE
FINANCE
CANADIAN EDITION

***Fundamentals of Corporate Finance, Cdn. Ed.* (Berk et al.)**
Chapter 2 Introduction to Financial Statement Analysis

2.1 Firms' Disclosure of Financial Information

1) In Canada, publicly traded companies can choose whether or not they wish to release periodic financial statements.
Answer: FALSE
Diff: 1 Type: TF Page Ref: 28
Skill: Conceptual
Author: DS

2) Financial statements are accounting reports issued periodically by a firm that 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 Type: TF Page Ref: 28
Skill: Conceptual
Author: DS

3) International Financial Reporting Standards are taking root throughout the world. However, it is unlikely that the Canada will report according to IFRS before the second half of the twenty-first century.
Answer: FALSE
Diff: 1 Type: TF Page Ref: 28
Skill: Conceptual
Author: JP

4) 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.
E) To make sure they satisfy the auditor.
Answer: D
Diff: 1 Type: MC Page Ref: 29
Skill: Conceptual
Author: DS

5) 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
E) to determine managerial performance
Answer: C
Diff: 1 Type: MC Page Ref: 28
Skill: Conceptual
Author: DS

6) 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) TSX Enforcement Board.
B) Accounting Standards Board.
C) provincial securities commission.
D) auditor.
E) GAAP commission.
Answer: D
Diff: 1 Type: MC Page Ref: 29
Skill: Definition
Author: JN

7) 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 Type: ES Page Ref: 29
Skill: Conceptual
Author: JN

8) 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 Type: ES Page Ref: 29
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 Type: TF Page Ref: 29
Skill: Conceptual
Author: DS

2) Shareholders' equity is the difference between a firm's assets and liabilities, as shown on the balance sheet.
Answer: TRUE
Diff: 1 Type: TF Page Ref: 29
Skill: Conceptual
Author: DS

3) Which of the following amounts would 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
E) the value of inventories held by the company
Answer: C
Diff: 2 Type: MC Page Ref: 30
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.
E) Assets must always exceed liabilities or the company will be bankrupt.
Answer: C
Diff: 1 Type: MC Page Ref: 30
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
E) money owed to the firm by customers who have purchased goods on credit
Answer: C
Diff: 1 Type: MC Page Ref: 30
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
E) money owed to the firm by customers who have purchased goods on credit
Answer: B
Diff: 1 Type: MC Page Ref: 31
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 is 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.
E) Since net working capital is negative, the company will likely have little difficulty meeting its obligations.
Answer: A
Diff: 1 Type: MC Page Ref: 31
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.
E) The balance sheet does not provide enough detail about the company's equity.
Answer: A
Diff: 2 Type: MC Page Ref: 32
Skill: Conceptual
Author: DS

9) The major components of shareholders' equity are
A) cash, common stock, and paid-in surplus.
B) common stock, paid-in surplus, and net income.
C) common stock, paid-in surplus, and retained earnings.
D) common stock, liabilities, and retained earnings.
E) cash, paid-in surplus, and retained earnings.
Answer: C
Diff: 2 Type: MC Page Ref: 30-32
Skill: Conceptual
Author: JP

Use the table for the question(s) below.

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**
		Shareholders' Equity	**33**
Total Assets	**210**	**Total Liabilities and Shareholders' Equity**	**210**

10) 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
E) $20 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 Type: MC Page Ref: 31
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 pays back all of its accounts payable today using cash, what will its net working capital be?
A) $7 million
B) $32 million
C) $33 million
D) $40 million
E) $82 million
Answer: D
Explanation: D) Both cash and accounts payable would fall by the same amount, leaving net working capital the same: $47 - $7 = $40
Diff: 1 Type: MC Page Ref: 31
Skill: Analytical
Author: JP

12) The above diagram shows a balance sheet for a certain company. All quantities shown are in millions of dollars. If the company buys new property, plant and equipment today using its entire cash balance, what will its net working capital be?
A) -$10 million
B) $10 million
C) -$3 million
D) $40 million
E) $90 million
Answer: A
Explanation: A) Current assets would fall by $50, with no change in current liabilities: $39 - $49 = -$10
Diff: 1 Type: MC Page Ref: 31
Skill: Analytical
Author: JP

13) 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.
E) Net property, plant, and equipment would be unchanged, and Total Assets and Stockholders' Equity would also remain the same.
Answer: B
Diff: 1 Type: MC Page Ref: 30-31
Skill: Analytical
Author: DS

14) 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.
E) Investors consider that the firm's market value is worth much more than its book value.
Answer: C
Diff: 1 Type: MC Page Ref: 31
Skill: Analytical
Author: DS

15) Which of the following balance sheet equations is correct?
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
E) Assets + Current Liabilities = Long Term Liabilities - Shareholders' Equity
Answer: A
Diff: 2 Type: MC Page Ref: 30
Skill: Conceptual
Author: DN

16) Cash is a
A) Long-Term Asset.
B) Current Asset.
C) Current Liability.
D) Long-Term Liability.
E) component of Shareholders' Equity
Answer: B
Diff: 1 Type: MC Page Ref: 30
Skill: Definition
Author: JN

17) Accounts payable is a
A) Long-Term Liability.
B) Current Asset.
C) Long-Term Asset.
D) Current Liability.
E) component of Shareholders' Equity
Answer: D
Diff: 1 Type: MC Page Ref: 31
Skill: Definition
Author: JN

18) A 30-year mortgage loan is a
A) Long-Term Liability.
B) Current Liability.
C) Current Asset.
D) Long-Term Asset.
E) component of Shareholders' Equity
Answer: A
Diff: 1 Type: MC Page Ref: 31
Skill: Definition
Author: JN

Use the table for the question(s) below.

Luther Corporation
Consolidated Balance Sheet
December 31, 2011 and 2010 (in $ millions)

Assets	**2011**	**2010**	**Liabilities and Stockholders' Equity**	**2011**	**2010**
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	Shareholders' Equity	126.6	63.6
Total Assets	**533.1**	**386.7**	**Total liabilities and Shareholders' Equity**	**533.1**	**386.7**

19) Refer to the balance sheet above. What is Luther's net working capital in 2010?
A) $12 million
B) $27 million
C) $39 million
D) $45 million
E) $63.6 million
Answer: A
Explanation: A) NWC = Current assets - Current liabilities = 144 - 132 = $12 million
Diff: 2 Type: MC Page Ref: 31
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 Type: TF Page Ref: 33
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 since 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.
E) The firm's market-to-book ratio is greater than 1.
Answer: B
Diff: 1 Type: MC Page Ref: 33
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
E) 0.57
Answer: D
Explanation: D) $140 / (3.5 \times 25) = 1.60$
Diff: 2 Type: MC Page Ref: 33
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 billion
B) $2.8 billion
C) $3.6 billion
D) $4.3 billion
E) $2.9 billion
Answer: D
Explanation: D) Market cap = 24.5×118 = $2.891 billion; Book value = $2.891 / 4.2 = 0.688$;
Debt = $0.688 \times 3.2 = 2.203$; Enterprise value = $2.891 + 2.203 - 0.800 = 4.3$ billion
Diff: 3 Type: MC Page Ref: 33-34
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
E) 2.64
Answer: D
Explanation: D) (1.4 - 0.2) / 0.53 = 2.26
Diff: 2 Type: MC Page Ref: 35
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
E) price-to-book ratio
Answer: A
Diff: 1 Type: MC Page Ref: 33-35
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.
E) Company A is more likely than Company B to have sufficient working capital to meet its short-term needs.
Answer: A
Diff: 3 Type: MC Page Ref: 35
Skill: Analytical
Author: DS

Use the table for the question(s) below.

Luther Corporation
Consolidated Balance Sheet
December 31, 2011 and 2010 (in $ millions)

Assets	**2011**	**2010**	**Liabilities and Stockholders' Equity**	**2011**	**2010**
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	Shareholders' Equity	126.6	63.6
Total Assets	**533.1**	**386.7**	**Total liabilities and Shareholders' Equity**	**533.1**	**386.7**

8) Refer to the balance sheet above. Luther's quick ratio for 2010 is closest to:
A) 0.77
B) 1.31
C) 1.09
D) 0.92
E) 0.87
Answer: A
Explanation: A) quick ratio = (current assets - inventory) / current liabilities
quick ratio = (144.0 - 42.9) / 132 = 0.77
Diff: 2 Type: MC Page Ref: 35
Skill: Analytical
Author: JN

9) Refer to the balance sheet above. The change in Luther's quick ratio from 2010 to 2011 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
E) being unchanged
Answer: B
Explanation: B) quick ratio in 2011 = (171.0 - 45.9) / 144 = 0.87
quick ratio 2010 = (144.0 - 42.9) / 132 = 0.77
So, the quick ratio increased by 0.87 - 0.77 = 0.10.
Diff: 3 Type: MC Page Ref: 35
Skill: Analytical
Author: JN

10) Refer to the balance sheet above. If in 2011 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
E) 0.31
Answer: C
Explanation: C) MTB = market cap / book value of equity = (10.2 million × 16) / 126.6 = 163.2 / 126.6 = 1.29
Diff: 2 Type: MC Page Ref: 33
Skill: Analytical
Author: JN

11) Refer to the balance sheet above. If in 2011 Luther has 10.2 million shares outstanding and these shares are trading at $16 per share, then Luther's stock would be considered to be
A) undervalued.
B) overvalued.
C) a growth stock.
D) a value stock.
E) worthless.
Answer: D
Explanation: D) MTB = market cap / book value of equity = (10.2 million × 16) / 126.6 = 163.2 / 126.6 = 1.29. This is a low market-to-book ratio, and thus it would be considered a value stock.
Diff: 3 Type: MC Page Ref: 33
Skill: Analytical
Author: DN

12) Refer to the balance sheet above. When using the book value of equity, the debt-equity ratio for Luther in 2011 is closest to:
A) 2.21
B) 2.29
C) 2.98
D) 3.03
E) 4.39
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 Type: MC Page Ref: 33
Skill: Analytical
Author: JN

13) Refer to the balance sheet above. If in 2011 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 2011 is closest to:
A) 1.71
B) 1.78
C) 2.31
D) 2.35
E) 2.29
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 Type: MC Page Ref: 35
Skill: Analytical
Author: JN

14) Refer to the balance sheet above. If in 2011 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
E) $163.2 million
Answer: C
Explanation: C) Enterprise value = MVE + Debt - Cash = 10.2 × $16 + 290.1 - 63.6 = 389.7
Diff: 2 Type: MC Page Ref: 34-35
Skill: Analytical
Author: JN

15) Refer to the balance sheet above. Luther's current ratio for 2011 is closest to:
A) 0.84
B) 0.87
C) 1.15
D) 1.19
E) 0.77
Answer: D
Explanation: D) current ratio = current assets / current liabilities = 171 / 144 = 1.19
Diff: 2 Type: MC Page Ref: 35
Skill: Analytical
Author: JN

16) Refer to the balance sheet above. If on December 31, 2010 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 Type: ES Page Ref: 33
Skill: Analytical
Author: JN

17) Refer to the balance sheet above. If on December 31, 2010 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 Type: ES Page Ref: 34
Skill: Analytical
Author: JN

Use the table for the question(s) below.

Balance Sheet

Assets	**2010**	**2011**	**Liabilities**	**2010**	**2011**
Current Assets			Current Liabilities		
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
Long-Term Assets			Long-Term Liabilities		
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**
			Shareholders' Equity	**33**	**23**
Total Assets	**210**	**212**	**Total Liabilities and Shareholders' Equity**	**210**	**212**

18) 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 2010 and 2011?
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.
E) The company has reduced its net working capital.
Answer: A
Diff: 2 Type: MC Page Ref: 35
Skill: Analytical
Author: DS

19) 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 2010 and 2011?
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.
E) The company has greatly reduced the risk that it will experience a cash shortfall in the near future.
Answer: D
Diff: 2 Type: MC Page Ref: 35
Skill: Analytical
Author: DS

20) If the above balance sheet is for a retail company, how has the company's leverage changed between 2010 and 2011?
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.
E) The company has experienced a slight decrease in its leverage.
Answer: D
Diff: 3 Type: MC Page Ref: 33
Skill: Analytical
Author: DS

21) If the above balance sheet is for a retail company, what indications about this company would best be drawn from the changes in leverage between 2010 and 2011?
A) The company's risk has decreased.
B) The company's risk is unchanged.
C) The company may have a problem in meeting borrowing obligations in the future.
D) The company has excellent growth prospects.
E) The company is bankrupt.
Answer: C
Diff: 2 Type: MC Page Ref: 35
Skill: Conceptual
Author: DN

22) If the above balance sheet is for a retail company, what indications about this company would best be drawn from the changes in shareholders' equity between 2010 and 2011?
A) The company is very profitable because it is obviously collecting receivables faster.
B) The company is selling its property, plant, and equipment, which may result in a long-term deficiency in production capacity.
C) The company's net income in 2008 was negative.
D) The company's enterpris value declined.
E) The company has experienced a significant rise in its market value.
Answer: C
Diff: 2 Type: MC Page Ref: 31-32
Skill: Analytical
Author: JP

23) 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 Type: SA Page Ref: 33-35
Skill: Analytical
Author: SS

24) 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 Type: SA Page Ref: 33-35
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 Type: TF Page Ref: 35
Skill: Analytical
Author: DS

2) What is a firm's net income?
A) earnings before interest and taxes are deducted
B) the third line of an income statement that represents the difference between sales revenues and costs
C) a measure of the firm's profitability over a given period
D) net sales less cost of sales
E) earnings after interest is deducted but before taxes are deducted
Answer: C
Diff: 3 Type: MC Page Ref: 35
Skill: Conceptual
Author: DS

3) What is a firm's gross profit?
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 difference between sales revenues and the costs associated with those sales
C) the difference between sales revenues and cash expenditures associated with those sales
D) earnings before interest and taxes are deducted
E) earnings after interest is deducted but before taxes are deducted
Answer: B
Diff: 3 Type: MC Page Ref: 36
Skill: Conceptual
Author: JP

4) 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) Total sales - Cost of sales - Interest expense.
E) Total sales - Cost of sales - Interest expense -Taxes.
Answer: C
Diff: 2 Type: MC Page Ref: 36
Skill: Conceptual
Author: JN

Use the table for the question(s) below.

Income Statement for Xenon Manufacturing:

	2010	**2011**
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

5) 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 2011?
A) $0.36
B) $0.40
C) $0.63
D) $0.84
E) $0.64
Answer: A
Explanation: A) EPS = Net income/# shares outstanding = 9/25 = 0.36
Diff: 2 Type: MC Page Ref: 37
Skill: Analytical
Author: DS

Use the table for the question(s) below.

Income Statement for CharmCorp:

	2010	**2011**
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

6) 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 2011?
A) $1.42
B) $1.67
C) $2.00
D) $2.33
E) $3.71
Answer: C
Explanation: C) Diluted EPS = Net income / (# shares outstanding + # options) = 14 / (6 + 1)
Diff: 3 Type: MC Page Ref: 37
Skill: Analytical
Author: DS

7) 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 Type: SA Page Ref: 35-37
Skill: Analytical
Author: SS

8) 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 Type: SA Page Ref: 35-37
Skill: Conceptual
Author: SS

Use the table for the question(s) below.

Luther Corporation
Consolidated Income Statement
Year ended December 31 (in $ millions)

	2011	**2010**
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
Shareholders' Equity	126.6	63.6
Total Liabilities and Shareholders' Equity	533.1	386.7

9) Refer to the income statement above. For the year ending December 31, 2011 Luther's earnings per share are closest to:
A) $1.01
B) $1.04
C) $1.58
D) $4.04
E) $10.77
Answer: B

Explanation: B) EPS = Net income / Shares outstanding = $10.6 / 10.2 = $1.04
Diff: 1 Type: MC Page Ref: 37
Skill: Analytical
Author: JN

10) Refer to the income statement above. Assuming that Luther has no convertible bonds outstanding, then for the year ending December 31, 2011 Luther's diluted earnings per share are closest to:
A) $1.01
B) $1.04
C) $1.53
D) $3.92
E) $4.04
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 Type: MC Page Ref: 37
Skill: Analytical
Author: JN

11) Refer to the income statement above. Luther has convertible bonds outstanding that would allow bondholders to convert their bonds into 700,000 shares of Luther stock. For the year ending December 31, 2011 Luther's diluted earnings per share are closest to:
A) $0.95
B) $1.01
C) $1.04
D) $1.53
E) $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 + 0.2) = $0.95
Diff: 2 Type: MC Page Ref: 37
Skill: Analytical
Author: DN

2.5 Income Statement Analysis

1) Price-earnings ratios tend to be high for fast-growing firms.
Answer: TRUE
Diff: 1 Type: TF Page Ref: 42
Skill: Conceptual
Author: DS

Use the table for the question(s) below.

Luther Corporation
Consolidated Income Statement
Year ended December 31 (in $ millions)

	2011	**2010**
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
Shareholders' Equity	126.6	63.6
Total Liabilities and Shareholders' Equity	533.1	386.7

2) Refer to the income statement above. Luther's operating margin for the year ending December 31, 2010 is closest to:
A) 1.8%
B) 2.7%
C) 5.4%
D) 6.8%
E) 16.7%
Answer: C
Explanation: C) Operating margin = Operating income / Sales
OM = 31.3 / 578.3 = 0.054 or 5.4%
Diff: 1 Type: MC Page Ref: 38
Skill: Analytical
Author: JN

3) Refer to the income statement above. Luther's net profit margin for the year ending December 31, 2010 is closest to:
A) 1.8%
B) 2.7%
C) 5.4%
D) 16.7%
E) 18.3%
Answer: A
Explanation: A) Net profit margin = Net income / Total sales = 10.2 / 578.3 = 0.018 or 1.8%
Diff: 1 Type: MC Page Ref: 38
Skill: Analytical
Author: JN

4) Refer to the income statement above. Luther's earnings before interest, taxes, depreciation, and amortization (EBITDA) for the year ending December 31, 2011 is closest to:
A) $10.6 million
B) $19.7 million
C) $37.6 million
D) $41.2 million
E) $44.8 million
Answer: E
Explanation: E) EBITDA = EBIT + Depreciation and amortization = 41.2 + 3.6 = $44.8 million
Diff: 1 Type: MC Page Ref: 39
Skill: Analytical
Author: JN

5) Refer to the income statement above. Luther's return on equity (ROE) for the year ending December 31, 2011 is closest to:
A) 2.0%
B) 6.5%
C) 8.4%
D) 12.7%
E) 32.5%
Answer: C
Explanation: C) ROE = Net income / Shareholders' equity = 10.6 / 126.6 = 0.084 or 8.4%
Diff: 2 Type: MC Page Ref: 40
Skill: Analytical
Author: JN

6) Refer to the income statement above. Luther's return on assets (ROA) for the year ending December 31, 2011 is closest to:
A) 2.0%
B) 6.5%
C) 8.4%
D) 12.7%
E) 32.5%
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 Type: MC Page Ref: 40
Skill: Analytical
Author: JN

Use the table for the question(s) below.

Income Statement for Xenon Manufacturing:

	2010	**2011**
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

7) Consider the above Income Statement for Xenon Manufacturing. All values are in millions of dollars. Calculate the operating margin for 2010 and 2011. 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 2010 and 2011.
B) The ability of Xenon Manufacturing to sell its goods and services for more than the costs of producing them rose between 2010 and 2011.
C) The efficiency of Xenon Manufacturing has significantly fallen between 2010 and 2011.
D) The leverage of Xenon Manufacturing fell slightly between 2010 and 2011.
E) The revenues available to equity holders fell slightly between 2010 and 2011.
Answer: C
Explanation: C) 24 / 202 = 0.12; 16 / 212 = 0.08
Diff: 3 Type: MC Page Ref: 38
Skill: Analytical
Author: DS

8) Consider the above Income Statement for Xenon Manufacturing. All values are in millions of dollars. Calculate the gross margin for 2010 and 2011. What does the change in the gross margin between these two years imply about the company?
A) The efficiency of Xenon Manufacturing has significantly risen between 2010 and 2011.
B) The ability of Xenon Manufacturing to sell its goods and services for more than the costs of producing them rose between 2010 and 2011.
C) The ability of Xenon Manufacturing to sell its goods and services for more than the costs of producing them fell between 2010 and 2011.
D) The leverage of Xenon Manufacturing fell slightly between 2010 and 2011.
E) The revenues available to equity holders fell slightly between 2010 and 2011.
Answer: C
Diff: 3 Type: MC Page Ref: 37
Skill: Analytical
Author: JP

9) Consider the above Income Statement for Xenon Manufacturing. All values are in millions of dollars. Calculate the gross margin for 2010 and 2011. What does the change in the net profit margin between these two years imply about the company?
A) The efficiency of Xenon Manufacturing has significantly risen between 2010 and 2011.
B) The ability of Xenon Manufacturing to sell its goods and services for more than the costs of producing them rose between 2010 and 2011.
C) The ability of Xenon Manufacturing to sell its goods and services for more than the costs of producing them fell between 2010 and 2011.
D) The leverage of Xenon Manufacturing fell slightly between 2010 and 2011.
E) The revenues available to equity holders fell slightly between 2010 and 2011.
Answer: E
Diff: 3 Type: MC Page Ref: 38
Skill: Analytical
Author: DN

10) In 2011, an agricultural company introduced a new cropping process which reduced the cost of growing some of its crops. If sales in 2010 and 2011 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
E) $850,000
Answer: A
Explanation: A) $(25 \times 0.034 - 25 \times 0.023) \times 1{,}000{,}000 = \$275{,}000$
Diff: 2 Type: MC Page Ref: 37
Skill: Analytical
Author: DS

11) A retail company reported an increase in sales from $25 million in 2010 to $27 million in 2011. The net profit margin increased from 2.1% to 3.8% between those years. By what amount did net income increase?
A) $340,000
B) $425,000
C) $501,000
D) $525,000
E) $567,000
Answer: C
Explanation: C) (27 × 0.038 - 25 × 0.021) × 1,000,000 = $501,000
Diff: 2 Type: MC Page Ref: 38
Skill: Analytical
Author: DN

12)

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 2011. 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.
E) Asset turnover ratios indicate that firm A is generating less revenue per dollar of assets than firm B.
Answer: B
Diff: 3 Type: MC Page Ref: 38
Skill: Analytical
Author: DS

Use the tables for the question(s) below.

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**
		Shareholders' Equity	**33**
Total Assets	**210**	**Total Liabilities and Shareholders' 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

13) The balance sheet and income statement of a particular firm are shown above. What does the accounts 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 8 weeks to collect payment from its customers.
E) It takes on average about 11 weeks to collect payment from its customers.
Answer: A

Explanation: A) 22 / (312 / 365) = 25.7 days, or approximately 4 weeks
Diff: 2 Type: MC Page Ref: 39
Skill: Analytical
Author: DS

14) The balance sheet and income statement of a particular firm are shown above. What does the accounts payable days ratio tell you about this company?
A) It takes on average about 4 weeks to pay its suppliers.
B) It takes on average about 6 weeks to pay its suppliers.
C) It takes on average about 7 weeks to pay its suppliers.
D) It takes on average about 8 weeks to pay its suppliers.
E) It takes on average about 10 weeks to pay its suppliers.
Answer: E
Explanation: E) 42 / (210 / 365) = 73 days, or approximately 10 weeks
Diff: 2 Type: MC Page Ref: 39
Skill: Analytical
Author: DN

15) 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 many multiples of its assets per year
E) a mining firm that is mostly engaged in exploration for new deposits
Answer: D
Diff: 1 Type: MC Page Ref: 40
Skill: Conceptual
Author: DS

16) Which of the following firms would be expected to have a high ROE based on that firm's high profitability?
A) a medical supply company that provides very precise instruments at a high price to large medical establishments such as hospitals
B) a low-end retailer that has a low 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 many multiples of its assets per year
E) a mining firm that is mostly engaged in exploration for new deposits
Answer: A
Diff: 1 Type: MC Page Ref: 40
Skill: Conceptual
Author: JP

17) 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
E) 1.10
Answer: A
Explanation:
A) ROEa = 2 × 1.7 × 4.9 = 16.66; ROEb = 2.3 × 1.1 × 4.7 = 11.891; 16.66 / (2.3 × 4.7) = 1.54
Diff: 3 Type: MC Page Ref: 40
Skill: Analytical
Author: DS

18)

	Firm A	**Firm B**	**Firm C**	**Firm D**	**Firm E**
Net Income	$34.1 million	$5.7 million	$31.1 million	$13.2 million	$23 million
Market Capitalization	$310 million	$53 million	$280 million	$112 million	$198 million
Earnings per share	$4.10	$4.05	$6.75	$12.70	$7.85

The above data is for five 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
E) Firm E
Answer: B
Diff: 2 Type: MC Page Ref: 42
Skill: Analytical
Author: DS

19) 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.
E) Share price is a quantity related to the enterprise value of the firm, while operating income is related to the equity holders.
Answer: D
Diff: 1 Type: MC Page Ref: 42
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 Type: TF Page Ref: 45
Skill: Conceptual
Author: DS

2) 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.
E) It adds cash received from investments.
Answer: B
Diff: 1 Type: MC Page Ref: 45
Skill: Conceptual
Author: DS

3) Allen Company bought a new copy machine to be depreciated straight line for three years for use by sales personnel. Where would this purchase be reflected on the Statement of Cash Flows?
A) It would be an expense on the income statement, so it would be reflected in operating cash flows.
B) It would be an addition to property, plant and equipment, so it would be an investing activity.
C) It would be an addition to cash, so would be reflected in the change in cash.
D) It would be an increase in borrowing, so would be reflected in financing activities.
E) It would be a change in inventory, so would be reflected in operating activities.
Answer: B
Diff: 1 Type: MC Page Ref: 46-47
Skill: Conceptual
Author: JP

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.
E) The sale will be deducted from Net Income on the income statement but added to Net Income on the statement of cash flows.
Answer: B
Diff: 1 Type: MC Page Ref: 45-46
Skill: Conceptual
Author: DS

5) A manufacturer of plastic bottles for the medical trade purchases a new compression blow moulder 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.
E) It will be depreciated over time on the income statement and added as accounts payable on the statement of cash flows.
Answer: A
Diff: 1 Type: MC Page Ref: 46-47
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.
E) as an inflow under Financial Activities.
Answer: B
Diff: 1 Type: MC Page Ref: 46-47
Skill: Conceptual
Author: DS

Use the table for the question(s) below.

AOS Industries Statement of Cash Flows for 2011

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 was AOS Industries' change in retained earnings for 2011?
A) $1.3 million
B) $1.7 million
C) $2.1 million
D) $5.4 million
E) $3.2 million
Answer: B
Explanation: B) 3.2 - 1.5 = $1.7 million
Diff: 2 Type: MC Page Ref: 47
Skill: Analytical
Author: DS

8) Consider the above statement of cash flows. What were AOS Industries' major means of raising money in 2011?
A) from investment activities
B) by sale of stock
C) from its operations
D) by issuing debt
E) from short-term bank loans
Answer: D
Diff: 1 Type: MC Page Ref: 47
Skill: Analytical
Author: DS

9) Consider the above statement of cash flows. Which of the following is true of AOS Industries' operating cash flows?
A) It collected more cash from its customers than they charged.
B) It sold more inventory than it bought.
C) It charged more on its accounts payable than it paid back.
D) It charged less on its accounts payable than it paid back.
E) It used $1.4 million of its cash on depreciation and amortization.
Answer: C
Diff: 1 Type: MC Page Ref: 45-46
Skill: Analytical
Author: JP

10) Consider the above statement of cash flows. In 2011, 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 on the amount of cash held by AOS at the the end of the 2011?
A) It would have $2,00,000 less cash at the end of 2011.
B) It would have $1,950,000 less cash at the end of 2011.
C) It would have $150,000 less cash at the end of 2011.
D) It would have an additional $50,000 in cash at the end of 2011.
E) It would have $1,800,000 less cash at the end of 2011.
Answer: B
Explanation: B) $-\$2,000,000 + 200,000 \times 0.25 = -\$1,950,000$
Diff: 3 Type: MC Page Ref: 47-48
Skill: Analytical
Author: DS

11) 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 Type: SA Page Ref: 45-47
Skill: Conceptual
Author: SS

12) 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 in financing activities, while the payment for the new processing plant will be entered as a cash outflow in investing activities.
Diff: 3 Type: SA Page Ref: 46-47
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 Type: TF Page Ref: 49
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
E) that food prices have increased, increasing the firm's costs
Answer: C
Diff: 2 Type: MC Page Ref: 48
Skill: Conceptual
Author: DS

3) Which type of transactions must be disclosed in the management discussion and analysis?
A) transactions that significantly affect the firm's leverage
B) off balance sheet transactions
C) off income statement transactions
D) very large transactions
E) transactions that reduce the firm's net income
Answer: B
Diff: 1 Type: MC Page Ref: 48
Skill: Conceptual
Author: DN

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: 2 Type: SA Page Ref: 49
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 Type: TF Page Ref: 49
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.
E) The promise to buy back the assets should have been listed under accounts payable.
Answer: D
Diff: 2 Type: MC Page Ref: 49-50
Skill: Conceptual
Author: DS

3) Which of the following is one of the ways that the Sarbanes-Oxley Act sought to improve the accuracy of information given to both boards and shareholders?
A) by reducing the penalties to firms for providing false information
B) by increasing the independence of auditors and clients
C) by increasing the non-audit fees that an auditor can receive from a client
D) by forcing companies to audit financial statements they release
E) by removing the requirement that CEOs and CFOs certify the accuracy of their firm's financial statements
Answer: D
Diff: 1 Type: MC Page Ref: 50
Skill: Conceptual
Author: DN

4) 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.
E) It requires that senior management compensation be directly related to firm performance as measured by financial ratios.
Answer: D
Diff: 1 Type: MC Page Ref: 51-52
Skill: Conceptual
Author: DS

5) Which of the following is the main lesson that analysts and investors should take from the case of Enron?
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.
E) Financial statements are too easily manipulated and cannot be taken at face value.
Answer: D
Diff: 1 Type: MC Page Ref: 49-50
Skill: Conceptual
Author: DS

6) 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 Type: SA Page Ref: 50
Skill: Conceptual
Author: SS

7) What role does Generally Accepted Accounting Principles (GAAP) play in the accounting process?
Answer: All firms quoted on a Canadian 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 Type: SA Page Ref: 29
Skill: Conceptual
Author: SS

8) According to the text, did Enron follow Generally Accepted Accounting Principles (GAAP) in its financial reporting process?
Answer: Many of Enron's problems were kept hidden from boards and shareholders until it was too late. People felt that the accounting statements of the company, while often remaining true to the letter of GAAP, did not present an accurate picture of the financial health of the company.
Diff: 2   Type: SA   Page Ref: 49-50
Skill: Conceptual
Author: SS