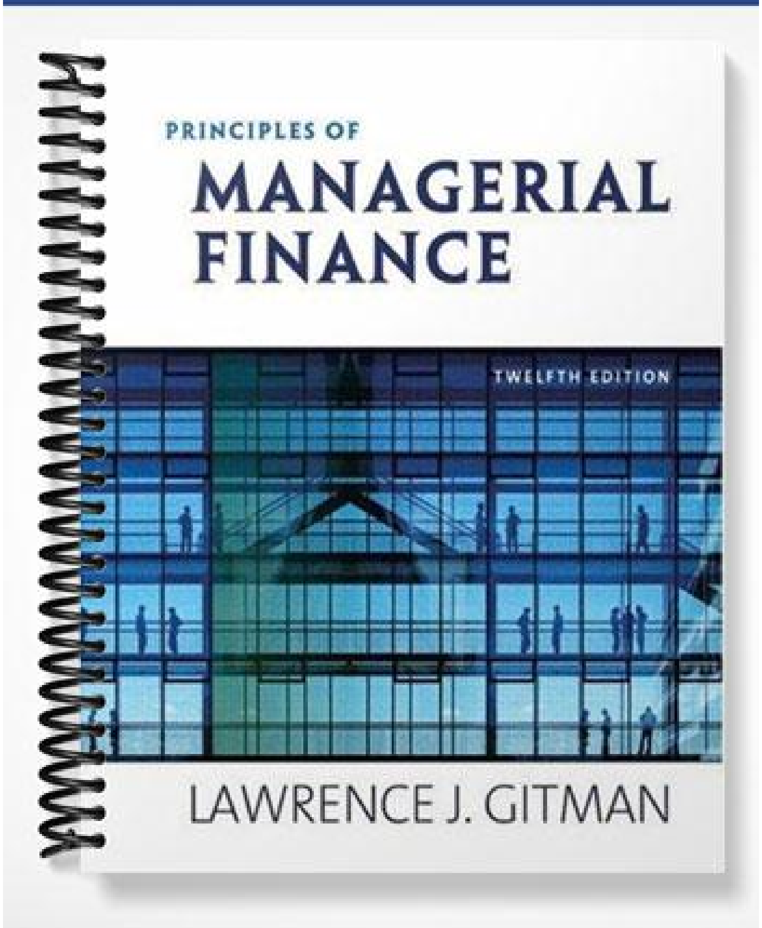
TEST BANK


PRINCIPLES OF
MANAGERIAL
FINANCE
TWELFTH EDITION
LAWRENCE J. GITMAN

Principles of Managerial Finance, 12e (Gitman)
Chapter 2   Financial Statements and Analysis

Learning Goal 1: Review the contents of the stockholders' report and the procedures for consolidating international financial statements.

1) The Financial Accounting Standards Board (FASB) is the federal regulatory body that governs the sale and listing of securities.
Answer: FALSE
Topic: Accounting Standards and Regulation
Question Status: Previous Edition

2) GAAP is the accounting profession's rule-setting body.
Answer: FALSE
Topic: Accounting Standards and Regulation
Question Status: Previous Edition

3) Generally-accepted accounting principles are authorized by the Financial Accounting Standards Board (FASB).
Answer: TRUE
Topic: Accounting Standards and Regulation
Question Status: Previous Edition

4) Publicly-owned corporations are those which are financed by the proceeds from the treasury securities.
Answer: FALSE
Topic: Accounting Standards and Regulation
Question Status: Previous Edition

5) Publicly-owned corporations are required by the Securities and Exchange Commission (SEC) and individual state securities commissions to provide their stockholders with an annual stockholders' report.
Answer: TRUE
Topic: Accounting Standards and Regulation
Question Status: Previous Edition

6) The president's letter, as the first component of the stockholders' report, is the primary communication from management to the firm's employees.
Answer: FALSE
Topic: Stockholders' Report
Question Status: Previous Edition

7) Common stock dividends paid to stockholders are equal to the earnings available for common stockholders divided by the number of shares of common stock outstanding.
Answer: FALSE
Topic: Dividends
Question Status: Previous Edition

8) The income statement is a financial summary of the firm's operating results during a specified period while the balance sheet is a summary statement of the firm's financial position at a given point in time.
Answer: TRUE
Topic: Income Statement
Question Status: Previous Edition

9) The par value of common stock is an arbitrarily assigned per share value used primarily for accounting purposes.
Answer: TRUE
Topic: Balance Sheet
Question Status: Previous Edition

10) Paid-in capital in excess of par represents the firm's book value received from the original sale of common stock.
Answer: FALSE
Topic: Balance Sheet
Question Status: Previous Edition

11) Earnings per share represents amount earned during the period on each outstanding share of common stock.
Answer: TRUE
Topic: Earnings
Question Status: Previous Edition

12) Net fixed assets represent the difference between gross fixed assets and the total expense recorded for the depreciation over then entire lives of the firm's fixed assets.
Answer: TRUE
Topic: Balance Sheet
Question Status: Previous Edition

13) Earnings per share results from dividing earnings available for common stockholders by the number of shares of common stock authorized.
Answer: FALSE
Topic: Earnings
Question Status: Previous Edition

14) Retained earnings represent the cumulative total of all earnings retained and reinvested in the firm since its inception.
Answer: TRUE
Topic: Balance Sheet
Question Status: Previous Edition

15) The balance sheet is a statement which balances the firm's assets (what it owns) against its debt (what it has borrowed).
Answer: FALSE
Topic: Balance Sheet
Question Status: Previous Edition

16) The amount paid in by the original purchasers of common stock is shown by two entries in the firm's balance sheet common stock and paid-in capital in excess of par on common stock.
Answer: TRUE
Topic: Balance Sheet
Question Status: Previous Edition

17) The original price per share received by the firm on a single issue of common stock is equal to the sum of the common stock and paid-in capital in excess of par accounts divided by the number of shares outstanding.
Answer: TRUE
Topic: Balance Sheet
Question Status: Previous Edition

18) The statement of cash flows reconciles the net income earned during a given year, and any cash dividends paid, with the change in retained earnings between the start and end of that year.
Answer: FALSE
Topic: Statement of Cash Flows
Question Status: Previous Edition

19) The cumulative translation adjustment is an equity reserve account on the parent company's books in which translation gains and losses are accumulated.
Answer: TRUE
Topic: International Accounting
Question Status: Previous Edition

20) The statement of cash flows provides insight into the firm's assets and liabilities and reconciles them with changes in its cash and marketable securities during the period of concern.
Answer: FALSE
Topic: Statement of Cash Flows
Question Status: Previous Edition

21) A U.S. parent company's foreign equity accounts are translated into dollars using the exchange rate that prevailed when the parent's equity investment was made (the historical rate).
Answer: TRUE
Topic: International Accounting
Question Status: Previous Edition

22) A U.S. parent company's foreign retained earnings are adjusted to reflect gains and losses resulting from currency movements as well as each year's operating profits or losses.
Answer: FALSE
Topic: International Accounting
Question Status: Previous Edition

23) The Financial Accounting Standards Board (FASB) Standard No. 52 mandates that U.S.-based companies translate their foreign-currency-denominated assets and liabilities into dollars using the current rate (translation) method.
Answer: TRUE
Topic: International Accounting
Question Status: Previous Edition

24) The McCain-Feingold Act of 2002 was passed to eliminate many of the disclosure and conflict of interest problems of corporations.
Answer: FALSE
Topic: Accounting Standards and Regulation
Question Status: Previous Edition

25) The Sarbanes-Oxley Act of 2002 was passed to eliminate many of the disclosure and conflict of interest problems of corporations.
Answer: TRUE
Topic: Accounting Standards and Regulation
Question Status: Previous Edition

26) The Sarbanes-Oxley Act of 2002 established the Public Company Accounting Oversight Board (PCAOB) which is a not-for-profit corporation that oversees auditors of public corporations.
Answer: TRUE
Topic: Accounting Standards and Regulation
Question Status: Previous Edition

27) The Sarbanes-Oxley Act of 2002 established the Private Company Accounting Oversight Board (PCAOB) which is a for-profit corporation that oversees CEOs of public corporations.
Answer: FALSE
Topic: Accounting Standards and Regulation
Question Status: Previous Edition

28) One of the most influential documents issued by a publicly-held corporation is the
A) letter to stockholders.
B) annual report.
C) cash flow statement.
D) income statement.
Answer: B
Topic: Stockholders' Report
Question Status: Previous Edition

29) The rule-setting body, which authorizes generally accepted accounting principles is
A) GAAP.
B) FASB.
C) SEC.
D) Federal Reserve System.
Answer: B
Topic: Accounting Standards and Regulation
Question Status: Previous Edition

30) Accounting practices and procedures used to prepare financial statements are called
A) SEC.
B) FASB.
C) GAAP.
D) IRB.
Answer: C
Topic: Accounting Standards and Regulation
Question Status: Previous Edition

31) The federal regulatory body governing the sale and listing of securities is called the
A) IRS.
B) FASB.
C) GAAP.
D) SEC.
Answer: D
Topic: Accounting Standards and Regulation
Question Status: Previous Edition

32) The stockholder's annual report must include
A) a statement of cash flows.
B) an income statement.
C) a balance sheet.
D) a statement of retained earnings.
E) all of the above.
Answer: E
Topic: Stockholders' Report
Question Status: Previous Edition

33) The stockholder's report may include all of the following EXCEPT
A) a cash budget.
B) an income statement.
C) a statement of cash flows.
D) a statement of retained earnings.
Answer: A
Topic: Stockholders' Report
Question Status: Previous Edition

34) Total assets less net fixed assets equals
A) gross assets.
B) current assets.
C) depreciation.
D) liabilities and equity.
Answer: B
Topic: Balance Sheet
Question Status: Previous Edition

35) The ________ provides a financial summary of the firm's operating results during a specified period.

A) income statement

B) balance sheet

C) statement of cash flows

D) statement of retained earnings

Answer: A

Topic: Income Statement

Question Status: Previous Edition

36) Gross profits are defined as

A) operating profits minus depreciation.

B) operating profits minus cost of goods sold.

C) sales revenue minus operating expenses.

D) sales revenue minus cost of goods sold.

Answer: D

Topic: Income Statement

Question Status: Previous Edition

37) Operating profits are defined as

A) gross profits minus operating expenses.

B) sales revenue minus cost of goods sold.

C) earnings before depreciation and taxes.

D) sales revenue minus depreciation expense.

Answer: A

Topic: Income Statement

Question Status: Previous Edition

38) Net profits after taxes are defined as

A) gross profits minus operating expenses.

B) sales revenue minus cost of goods sold.

C) EBIT minus interest.

D) EBIT minus interest and taxes.

Answer: D

Topic: Income Statement

Question Status: Previous Edition

39) Operating profits are defined as

A) sales revenue minus cost of goods sold.

B) earnings before interest and taxes.

C) earnings before depreciation and taxes.

D) earnings after tax.

Answer: B

Topic: Income Statement

Question Status: Previous Edition

40) Earnings available to common shareholders are defined as net profits
A) after taxes.
B) after taxes minus preferred dividends.
C) after taxes minus common dividends.
D) before taxes.
Answer: B
Topic: Income Statement
Question Status: Previous Edition

41) All of the following are examples of current assets EXCEPT
A) accounts receivable.
B) cash.
C) accruals.
D) inventory.
Answer: C
Topic: Balance Sheet
Question Status: Previous Edition

42) All of the following are examples of fixed assets EXCEPT
A) automobiles.
B) buildings.
C) marketable securities.
D) equipment.
Answer: C
Topic: Balance Sheet
Question Status: Previous Edition

43) All of the following are examples of current liabilities EXCEPT
A) accounts receivable.
B) accounts payable.
C) accruals.
D) notes payable.
Answer: A
Topic: Balance Sheet
Question Status: Previous Edition

44) The net value of fixed assets is also called its
A) market value.
B) par value.
C) book value.
D) price.
Answer: C
Topic: Balance Sheet
Question Status: Previous Edition

45) The ________ represents a summary statement of the firm's financial position at a given point in time.

A) income statement
B) balance sheet
C) statement of cash flows
D) statement of retained earnings

Answer: B
Topic: Balance Sheet
Question Status: Previous Edition

46) The ________ summarizes the firm's funds flow over a given period of time

A) income statement
B) balance sheet
C) statement of cash flows
D) statement of retained earnings

Answer: C
Topic: Statement of Cash Flows
Question Status: Previous Edition

47) The statement of cash flows may also be called the

A) sources and uses statement.
B) statement of retained earnings.
C) bank statement.
D) funds statement.

Answer: A
Topic: Statement of Cash Flows
Question Status: Previous Edition

48) FASB Standard No. 52 mandates that U.S. based companies must translate their foreign-currency-denominated assets and liabilities into dollars using the

A) historical rate.
B) current rate.
C) average rate.
D) none of the above.

Answer: B
Topic: International Accounting
Question Status: Previous Edition

49) Retained earnings on the balance sheet represents

A) net profits after taxes.
B) cash.
C) net profits after taxes minus preferred dividends.
D) the cumulative total of earnings reinvested in the firm.

Answer: D
Topic: Balance Sheet
Question Status: Previous Edition

50) The statement of retained earnings reports all of the following EXCEPT
A) net profits after taxes.
B) interest.
C) common stock dividends.
D) preferred stock dividends.
Answer: B
Topic: Statement of Retained Earnings
Question Status: Previous Edition

51) When preparing a statement of cash flows, retained earnings adjustments are required so that which of the following are separated on the statement?
A) Revenue and cost.
B) Assets and liabilities.
C) Depreciation and purchases.
D) Net profits and dividends.
Answer: D
Topic: Statement of Cash Flows
Question Status: Previous Edition

52) A firm had the following accounts and financial data for 2005.

Sales Revenue	$3,060	Cost of goods sold	$1,800
Accounts Receivable	500	Preferred stock dividends	18
Interest expense	126	Tax rate	40%
Total oper. expenses	600	Number of shares of common stocks outstanding	1,000
Accounts payable	240		

The firm's earnings available to common shareholders for 2005 were ________.
A) -$224.25
B) $195.40
C) $302.40
D) $516.60
Answer: C
Topic: Income Statement
Question Status: Previous Edition

53) A firm had the following accounts and financial data for 2005:

Sales Revenue	$3,060	Cost of goods sold	$1,800
Accounts receivable	500	Preferred stock dividends	18
Interest expense	126	Tax rate	40%
Total operating expenses	600	Number of common shares	1,000
Accounts payable	240	outstanding	

The firm's earnings per share, rounded to the nearest cent, for 2005 was ________.

A) $0.5335

B) $0.5125

C) $0.3204

D) $0.3024

Answer: D

Topic: Income Statement

Question Status: Previous Edition

54) A firm had the following accounts and financial data for 2005.

Sales Revenue	$3,060	Cost of goods sold	$1,800
Accounts receivable	500	Preferred stock dividends	18
Interest expense	126	Tax rate	40%
Total operating expenses	600	Number of common shares	1,000
Accounts payable	240	outstanding	

The firm's net profit after taxes for 2005 was ______.

A) -$206.40

B) $213.80

C) $320.40

D) $206.25

Answer: C

Topic: Income Statement

Question Status: Previous Edition

55) On the balance sheet net fixed assets represent

A) gross fixed assets at cost minus depreciation expense.

B) gross fixed assets at market value minus depreciation expense.

C) gross fixed assets at cost minus accumulated depreciation.

D) gross fixed assets at market value minus accumulated deprecation.

Answer: C

Topic: Balance Sheet

Question Status: Previous Edition

56) Paid-in-capital in excess of par represents the amount of proceeds

A) from the original sale of stock.

B) in excess of the par value from the original sale of common stock.

C) at the current market value of common stock.

D) at the current book value of common stock.

Answer: B

Topic: Balance Sheet

Question Status: Previous Edition

57) Firm ABC had operating profits of $100,000, taxes of $17,000, interest expense of $34,000 and preferred dividends of $5,000. What was the firm's net profit after taxes?
A) $66,000
B) $49,000
C) $44,000
D) $83,000
Answer: B
Topic: Income Statement
Question Status: Previous Edition

58) Candy Corporation had pretax profits of $1.2 million, an average tax rate of 34 percent, and it paid preferred stock dividends of $50,000. There were 100,000 shares outstanding and no interest expense. What were Candy Corporation's earnings per share?
A) $3.91
B) $4.52
C) $7.42
D) $7.59
Answer: C
Topic: Income Statement
Question Status: Previous Edition

59) A firm had year end 2004 and 2005 retained earnings balances of $670,000 and $560,000, respectively. The firm paid $10,000 in dividends in 2005. The firm's net profit after taxes in 2002 was ________.
A) -$100,000
B) -$110,000
C) $100,000
D) $110,000
Answer: A
Topic: Income Statement
Question Status: Previous Edition

60) A corporation had year end 2004 and 2005 retained earnings balances of $320,000 and $400,000, respectively. The firm reported net profits after taxes of $100,000 in 2005. The firm paid dividends in 2005 of ________.
A) $0
B) $20,000
C) $80,000
D) $100,000
Answer: B
Topic: Statement of Retained Earnings
Question Status: Previous Edition

61) A corporation had a year end 2004 retained earnings balance of $220,000. The firm reported net profits after taxes of $50,000 in 2005 and paid dividends in 2005 of $30,000. The firm's retained earnings balance at year end 2005 was ________.

A) $240,000
B) $250,000
C) $270,000
D) $300,000

Answer: A

Topic: Statement of Retained Earnings
Question Status: Previous Edition

62) A firm had year end 2004 and 2005 retained earnings balance of $670,000 and $560,000, respectively. The firm reported net profits after taxes of $100,000 in 2005. The firm paid dividends in 2005 of ________.

A) $10,000
B) $100,000
C) $110,000
D) $210,000

Answer: D

Topic: Statement of Retained Earnings
Question Status: Previous Edition

63) The 2002 law that established the Public Company Accounting Oversight Board (PCAOB) was called

A) the McCain-Feingold Act.
B) the Harkins-Oxley Act.
C) the Sarbanes-Harkins Act.
D) the Sarbanes-Oxley Act.

Answer: D

Topic: Accounting Standards and Regulation
Question Status: Previous Edition

64) The 2002 Sarbanes-Oxley Act was designed to

A) limit the compensation that could be paid to corporate CEOs.
B) eliminate the many disclosure and conflict of interest problems of corporations.
C) provide uniform international accounting standards.
D) two of the above.

Answer: B

Topic: Accounting Standards and Regulation
Question Status: Previous Edition

65) The Public Company Accounting Oversight Board (PCAOB)

A) is a not-for-profit corporation that oversees auditors of public corporations.
B) is a not-for-profit corporation that oversees managers of public corporations.
C) is a for-profit corporation that oversees auditors of public corporations.
D) is a for-profit corporation that oversees managers of public corporations.

Answer: A

Topic: Accounting Standards and Regulation
Question Status: Previous Edition

66) Ag Silver Mining, Inc. has $500,000 of earnings before interest and taxes at the year end. Interest expenses for the year were $10,000. The firm expects to distribute $100,000 in dividends. Calculate the earnings after taxes for the firm assuming a 40 percent tax on ordinary income.

Answer:

Earnings before interest and taxes	$500,000
Less: Interest	10,000
Earnings before taxes	$490,000
Less: Taxes (40%)	196,000
Earnings after taxes	$294,000

Topic: Income Statement
Question Status: Previous Edition

67) At the end of 2005, the Long Life Light Bulb Company announced it had produced a gross profit of $1 million. The company has also established that over the course of this year it has incurred $345,000 in operating expenses and $125,000 in interest expenses. The company is subject to a 30% tax rate and has declared $57,000 total preferred stock dividends.

(a) How much is the earnings available for common stockholders?

(b) Compute the increased retained earnings for 2005 if the company were to declare a $4.25 common stock dividend. The company has 15,000 shares of common stock outstanding.

Answer:

(a)	Gross Profits	$1,000,000
	Less: Operating expenses	(345,000)
	Operating Profits	$ 655,000
	Less: Interest	(125,000)
	Net Profits before taxes	$ 530,000
	Less: Taxes (30%)	(159,000)
	Net Profits After Taxes	$ 371,000
	Less: Preferred Stock Dividend	(57,000)
	Earnings Available for Common Stock	$ 314,000
(b)	Earnings Available for Common Stock	$ 314,000
	Dividend = (4.25)(15,000 shares)	(63,750)
	Increased Retained Earnings	$ 250,250

Topic: Income Statement
Question Status: Previous Edition

68) Reliable Auto Parts has 5,000 shares of common stock outstanding. The company also has the following amounts in revenue and expense accounts.

Sales revenue	$ 85,000
General and administrative expense	7,500
Interest expense	3,500
Depreciation expense	5,000
Preferred stock dividends	500
Selling expense	4,000
Cost of goods sold	50,000

Calculate
(a) gross profits.
(b) operating profits.
(c) net profits before taxes.
(d) net profits after taxes (assume a 40 percent tax rate).
(e) cash flow from operations.
(f) earnings available to common stockholders.
(g) earnings per share.

Answer:

(a) Sales revenue		$85,000
– cost of goods sold		–50,000
Gross profits		$35,000
(b) Gross profits		$35,000
– operating expenses		
Selling expense	4,000	
General & adm. expense	7,500	
Depreciation expense	5,000	$16,500
Operating profits		$18,500
(c) Operating profits		$18,500
– interest expense		–3,500
Net profits before taxes		$15,000
(d) Net profits before taxes		$15,000
– taxes (40%)		–6,000
Net profits after taxes		$9,000
(e) Net profits after taxes		$9,000
+ depreciation expense		+5,000
Cash flow from operations		$14,000
(f) Net profits after taxes		$9,000
– preferred dividends		–500
earnings available for C.S.		$8,500
(g) Earnings available for C.S.		$8,500
______________________=		= $1.70/share
# of common shares outstanding		5,000

Topic: Income Statement
Question Status: Previous Edition

69) Colonial Furniture's net profits before taxes for 2002 totaled $354,000. The company's total retained earnings were $338,000 for 2004 year end and $389,000 for 2005 year end. Colonial is subject to a 26 percent tax rate. How large was the cash dividend declared by Colonial Furniture in 2005?

Answer:

Net Profits Before Taxes	$354,000
Less: Taxes (26%)	92,040
Net Profits After Taxes	$261,960
Retained Earnings (2004)	$338,000
Net Profits After Taxes (2005)	261,960
Dividends	X
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Retained Earnings (2005)	$389,000
Dividends = $210,960	

Topic: Statement of Retained Earnings
Question Status: Previous Edition

70) On December 31, 2004, the Bradshaw Corporation had $485,000 as an ending balance for its retained earnings account. During 2005, the corporation declared a $3.50/share dividend to its stockholders. The Bradshaw Corporation has 35,000 shares of common stock outstanding. When the books were closed for 2005 year end, the corporation had a final retained earnings balance of $565,000. What was the net profit earned by Bradshaw Corporation during 2005?

Answer:

Dividends = ($3.50/share)(35,000 shares)	=	$122,500
Retained Earnings (2004)		$485,000
Net Profits After Taxes (2005)		X
Dividends		122,500
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Retained Earnings (2005)		$565,000
Net Profits After Taxes= $202,500		

Topic: Statement of Retained Earnings
Question Status: Previous Edition

71) The Sunshine Company had a retained earnings balance of $850,000 at the beginning of 2005. By the end of 2005, the company's retained earnings balance was $950,000. During 2005, the company earned $245,000 as net profits after paying its taxes. The company was then able to pay its preferred stockholders $45,000. Compute the common stock dividend per share in 2005 assuming 10,000 shares of common stock outstanding.

Answer:

Retained Earnings (2004)	$850,000
Net Profits After Taxes (2005)	245,000
Preferred Stock Dividend	(45,000)
Common Stock Dividend	X
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Retained Earnings (2005)	$950,000

Total common stock dividend= $100,000

Common stock dividend per share=100,000/10,000= $10

Topic: Statement of Retained Earnings
Question Status: Previous Edition

Learning Goal 2: Understand who uses financial ratios, and how.

1) Time-series analysis is the evaluation of the firm's financial performance in comparison to other firm(s) at the same point in time.
Answer: FALSE
Topic: Ratio Analysis Basics
Question Status: Previous Edition

2) As a rule, the necessary inputs to an effective financial analysis include, at minimum, the income statement and the statement of cash flow.
Answer: FALSE
Topic: Ratio Analysis Basics
Question Status: Previous Edition

3) Cross-sectional ratio analysis involves comparing the firm's ratios to those of firms in other industries at the same point in time.
Answer: FALSE
Topic: Ratio Analysis Basics
Question Status: Previous Edition

4) Benchmarking is a type of cross-sectional analysis in which the firm's ratio values are compared to those of firms in other industries, primarily to identify areas for improvement.
Answer: FALSE
Topic: Ratio Analysis Basics
Question Status: Previous Edition

5) Time-series analysis evaluates performance of firms at the same point in time using financial ratios.
Answer: FALSE
Topic: Ratio Analysis Basics
Question Status: Previous Edition

6) The firm's creditors are primarily interested in the short-term liquidity of the company and its ability to make interest and principal payments.
Answer: TRUE
Topic: Liquidity Analysis
Question Status: Previous Edition

7) Benchmarking is a type of time-series analysis in which the firm's ratio values are compared to those of a key competitor or group of competitors, primarily to isolate areas of opportunity for improvement.
Answer: FALSE
Topic: Ratio Analysis Basics
Question Status: Previous Edition

8) Ratio analysis merely directs the analyst to potential areas of concern; it does not provide conclusive evidence as to the existence of a problem.
Answer: TRUE
Topic: Ratio Analysis Basics
Question Status: Previous Edition

9) In a cross-sectional comparison of firms operating in several lines of business, the industry average ratios of any of the firm's product lines may be used to analyze the multiproduct firm's financial performance.
Answer: FALSE
Topic: Ratio Analysis Basics
Question Status: Previous Edition

10) Due to inflationary effects, inventory costs and depreciation write-offs can differ from their true values, thereby distorting profits.
Answer: TRUE
Topic: Ratio Analysis Basics
Question Status: Previous Edition

11) In ratio analysis, the financial statements being used for comparison should be dated at the same point in time during the year. If not, the effect of seasonality may produce erroneous conclusions and decisions.
Answer: TRUE
Topic: Ratio Analysis Basics
Question Status: Previous Edition

12) The use of the audited financial statements for ratio analysis may not be preferable because there may be no reason to believe that the data contained in them reflect the firm's true financial condition.
Answer: FALSE
Topic: Ratio Analysis Basics
Question Status: Previous Edition

13) Both present and prospective shareholders are interested in the firm's current and future level of risk and return. These two dimensions directly affect share price.
Answer: TRUE
Topic: Ratio Analysis Basics
Question Status: Previous Edition

14) The comparison of a particular ratio to the standard (industry average) is made in order to isolate any deviations from the norm. In the case of ratios for which higher values are preferred, as long as the firm that is being analyzed has a value in excess of the industry average it can be viewed favorably.
Answer: FALSE
Topic: Ratio Analysis Basics
Question Status: Previous Edition

15) The use of differing accounting treatments□especially relative to inventory and depreciation□can distort the results of ratio analysis, regardless of whether cross-sectional or time-series analysis is used.
Answer: TRUE
Topic: Ratio Analysis Basics
Question Status: Previous Edition

16) Inflationary effects typically have a greater impact the larger the differences in the age of the assets of the firms being compared. Without adjustment, inflation tends to cause older firms (with older fixed assets) to appear more efficient and profitable than newer firms (with newer fixed assets).
Answer: TRUE
Topic: Ratio Analysis Basics
Question Status: Previous Edition

17) Present and prospective shareholders and lenders pay close attention to the firm's degree of indebtedness and ability to repay debt. Shareholders are concerned since the claims of creditors must be satisfied prior to the distribution of earnings to them. Lenders are concerned since the more indebted the firm, the higher the probability that the firm will be unable to satisfy the claims of all its creditors.
Answer: TRUE
Topic: Leverage Analysis
Question Status: Previous Edition

18) Ratios provide a ________ measure of a company's performance and condition.
A) definitive
B) gross
C) relative
D) qualitative
Answer: C
Topic: Ratio Analysis Basics
Question Status: Previous Edition

19) ________ analysis involves the comparison of different firms' financial ratios at the same point in time.
A) Time-series
B) Cross-sectional
C) Marginal
D) Quantitative
Answer: B
Topic: Ratio Analysis Basics
Question Status: Previous Edition

20) ________ analysis involves comparison of current to past performance and the evaluation of developing trends.

A) Time-series
B) Cross-sectional
C) Marginal
D) Quantitative

Answer: A
Topic: Ratio Analysis Basics
Question Status: Previous Edition

21) The primary concern of creditors when assessing the strength of a firm is the firm's

A) profitability.
B) leverage.
C) short-term liquidity.
D) share price.

Answer: C
Topic: Liquidity Analysis
Question Status: Previous Edition

22) Present and prospective shareholders are mainly concerned with a firm's

A) risk and return.
B) profitability.
C) leverage.
D) liquidity.

Answer: A
Topic: Ratio Analysis Basics
Question Status: Previous Edition

23) To analyze the firm's financial performance, the following types of ratio analyses EXCEPT ________ may be used.

A) time-series analysis
B) cross-section analysis
C) combined analysis
D) marginal analysis

Answer: D
Topic: Ratio Analysis Basics
Question Status: Previous Edition

24) Time-series analysis is often used to

A) assess developing trends.
B) correct errors of judgment.
C) reflect performance relative to some norm.
D) standardize results.

Answer: A
Topic: Ratio Analysis Basics
Question Status: Previous Edition

25) In ratio analysis, a comparison to a standard industry ratio is made to isolate ________ deviations from the norm.

A) positive
B) negative
C) any
D) standard

Answer: C

Topic: Ratio Analysis Basics
Question Status: Previous Edition

26) ________ evidence of the existence of a problem or outstanding management performance is provided by ratio analysis.

A) Conclusive
B) Inconclusive
C) Complete
D) Definitive

Answer: B

Topic: Ratio Analysis Basics
Question Status: Previous Edition

27) The analyst should be careful when conducting ratio analysis to ensure that

A) the overall performance of the firm is not judged on a single ratio.
B) the dates of the financial statements being compared are the same.
C) audited statements are used.
D) the same accounting procedures were used.
E) all of the above.

Answer: E

Topic: Ratio Analysis Basics
Question Status: Previous Edition

28) The analyst should be careful when evaluating a ratio analysis that

A) pre-audited statements are used.
B) the dates of the financial statements being compared are the same time.
C) neither A nor B.
D) both A and B.

Answer: B

Topic: Ratio Analysis Basics
Question Status: Previous Edition

29) ________ is where the firm's ratio values are compared to those of a key competitor or group of competitors, primarily to identify areas for improvement.

A) Time-series analysis
B) Benchmarking
C) Combined analysis
D) None of the above

Answer: B

Topic: Ratio Analysis Basics
Question Status: Previous Edition

30) Cross-sectional ratio analysis is used to

A) correct expected problems in operations.
B) isolate the causes of problems.
C) provide conclusive evidence of the existence of a problem.
D) reflect the symptoms of a possible problem.

Answer: D
Topic: Ratio Analysis Basics
Question Status: Previous Edition

31) Inflation can distort

A) inventory costs.
B) cost of goods sold.
C) interest write-offs.
D) salaries and wages.

Answer: A
Topic: Ratio Analysis Basics
Question Status: Previous Edition

32) Without adjustment, inflation may tend to cause ________ firms to appear more efficient and profitable than ________ firms, all else being the same.

A) large; smaller
B) older; newer
C) smaller; larger
D) newer; older

Answer: B
Topic: Ratio Analysis Basics
Question Status: Previous Edition

33) The following groups of ratios primarily measure risk.

A) liquidity, activity, and profitability
B) liquidity, activity, and common stock
C) liquidity, activity, and debt
D) activity, debt, and profitability

Answer: C
Topic: Ratio Analysis Basics
Question Status: Previous Edition

34) The ________ ratios are primarily measures of return.

A) liquidity
B) activity
C) debt
D) profitability

Answer: D
Topic: Profitability Analysis
Question Status: Previous Edition

35) Discuss the limitations of ratio analysis and the cautions which must be taken when reviewing a cross-sectional and time-series analysis.

Answer: In summarizing a large number of ratios, all aspects of the firm's activities can be assessed. However, limitations of ratio analysis must be recognized. A comparison of current and past ratios may reveal mismanagement. But, the ratio does not give definitive cause to the problem. Additional investigation is necessary to confirm the possible problem. The analyst must be cautious of the following points: 1) a single ratio does not provide sufficient information to judge the overall performance of the firm, 2) the dates of the financial statements should be the same, 3) audited statements should be used, 4) similar accounting treatment of comparative data is essential, and 5) inflation and differing asset ages can distort ratio comparisons.

Topic: Ratio Analysis Basics
Question Status: Previous Edition

Learning Goal 3: Use ratios to analyze a firm's liquidity and activity.

1) The liquidity of a business firm refers to the solvency of the firm's overall financial position.
Answer: TRUE
Topic: Liquidity Analysis
Question Status: Previous Edition

2) The liquidity of a business firm is measured by its ability to satisfy its long-term obligations as they come due.
Answer: FALSE
Topic: Liquidity Analysis
Question Status: Previous Edition

3) The current ratio provides a better measure of overall liquidity only when a firm's inventory cannot easily be converted into cash. If inventory is liquid, the quick ratio is a preferred measure of overall liquidity.
Answer: FALSE
Topic: Liquidity Analysis
Question Status: Previous Edition

4) Since the differences in the composition of a firm's current assets and liabilities can significantly affect the firm's "true" liquidity, it is important to look beyond measures of overall liquidity to assess the activity (liquidity) of specific current accounts.
Answer: TRUE
Topic: Liquidity Analysis
Question Status: Previous Edition

5) The average age of inventory is viewed as the average length of time inventory is held by the firm or as the average number of days' sales in inventory.
Answer: TRUE
Topic: Activity Analysis
Question Status: Previous Edition

6) Total asset turnover commonly measures the liquidity of a firm's total assets.
Answer: FALSE
Topic: Activity Analysis
Question Status: Previous Edition

7) The average age of inventory can be calculated as inventory divided by 365.
Answer: FALSE
Topic: Activity Analysis
Question Status: Previous Edition

8) The average age of inventory can be calculated as inventory turnover divided by 365.
Answer: FALSE
Topic: Activity Analysis
Question Status: Previous Edition

9) The average age of inventory can be calculated as 365 divided by inventory turnover.
Answer: TRUE
Topic: Activity Analysis
Question Status: Previous Edition

10) The average payment period can be calculated as accounts payable divided by average sales per day.
Answer: FALSE
Topic: Activity Analysis
Question Status: Previous Edition

11) The average payment period can be calculated as accounts payable divided by average purchases per day.
Answer: TRUE
Topic: Activity Analysis
Question Status: Previous Edition

12) The ________ of a business firm is measured by its ability to satisfy its short-term obligations as they come due.
A) activity
B) liquidity
C) debt
D) profitability
Answer: B
Topic: Liquidity Analysis
Question Status: Previous Edition

13) ________ ratios are a measure of the speed with which various accounts are converted into sales or cash.
A) Activity
B) Liquidity
C) Debt
D) Profitability
Answer: A
Topic: Activity Analysis
Question Status: Previous Edition

14) The ________ is useful in evaluating credit and collection policies.

A) average payment period
B) current ratio
C) average collection period
D) current asset turnover

Answer: C

Topic: Activity Analysis
Question Status: Previous Edition

15) The ________ measures the activity, or liquidity, of a firm's inventory.

A) average collection period
B) inventory turnover
C) quick ratio
D) current ratio

Answer: B

Topic: Activity Analysis
Question Status: Previous Edition

16) The two basic measures of liquidity are

A) inventory turnover and current ratio.
B) current ratio and quick ratio.
C) gross profit margin and ROE.
D) current ratio and total asset turnover.

Answer: B

Topic: Liquidity Analysis
Question Status: Previous Edition

17) The ________ is a measure of liquidity which excludes ________, generally the least liquid asset.

A) current ratio; accounts receivable
B) quick ratio; accounts receivable
C) current ratio; inventory
D) quick ratio; inventory

Answer: D

Topic: Liquidity Analysis
Question Status: Previous Edition

18) The ________ ratio may indicate the firm is experiencing stockouts and lost sales.

A) average payment period
B) inventory turnover
C) average collection period
D) quick

Answer: B

Topic: Activity Analysis
Question Status: Previous Edition

19) The ________ ratio may indicate poor collections procedures or a lax credit policy.
A) average payment period
B) inventory turnover
C) average collection period
D) quick
Answer: C
Topic: Activity Analysis
Question Status: Previous Edition

20) ABC Corp. extends credit terms of 45 days to its customers. Its credit collection would likely be considered poor if its average collection period was
A) 30 days.
B) 36 days.
C) 47 days.
D) 57 days.
Answer: D
Topic: Activity Analysis
Question Status: Previous Edition

21) Which of the following ratios is difficult for creditors of a firm to analyze because the data are usually not available in published financial statements?
A) Operating leverage.
B) Average payment period.
C) Quick ratio.
D) Average age of inventory.
Answer: A
Topic: Leverage Analysis
Question Status: Previous Edition

22) ________ are especially interested in the average payment period, since it provides them with a sense of the bill-paying patterns of the firm.
A) Customers
B) Stockholders
C) Lenders and suppliers
D) Borrowers and buyers
Answer: C
Topic: Activity Analysis
Question Status: Previous Edition

23) A firm has a current ratio of 1; in order to improve its liquidity ratios, this firm might
A) improve its collection practices, thereby increasing cash and increasing its current and quick ratios.
B) improve its collection practices and pay accounts payable, thereby decreasing current liabilities and increasing the current and quick ratios.
C) decrease current liabilities by utilizing more long-term debt, thereby increasing the current and quick ratios.
D) increase inventory, thereby increasing current assets and the current and quick ratios.
Answer: C
Topic: Liquidity Analysis
Question Status: Previous Edition

24) As a firm's cash flows become more predictable,

A) the current ratio should expand.
B) the return on equity should increase.
C) current liabilities should decrease.
D) current assets should decrease.

Answer: D
Topic: Liquidity Analysis
Question Status: Previous Edition

25) If the inventory turnover is divided into 365, it becomes a measure of

A) sales efficiency.
B) the average age of the inventory.
C) sales turnover.
D) the average collection period.

Answer: B
Topic: Activity Analysis
Question Status: Previous Edition

26) The ________ is useful in evaluating credit and collection policies.

A) average payment period
B) current ratio
C) average collection period
D) current asset turnover

Answer: C
Topic: Activity Analysis
Question Status: Previous Edition

27) The two categories of ratios that should be utilized to assess a firm's true liquidity are the

A) current and quick ratios.
B) liquidity and profitability ratios.
C) liquidity and debt ratios.
D) liquidity and activity ratios.

Answer: D
Topic: Liquidity Analysis
Question Status: Previous Edition

28) A firm with a total asset turnover that is lower than industry standard but with a current ratio which meets industry standard must have excessive

A) fixed assets.
B) inventory.
C) accounts receivable.
D) debt.

Answer: A
Topic: Activity Analysis
Question Status: Previous Edition

29) A firm with a total asset turnover lower than industry standard may have
A) excessive debt.
B) excessive cost of goods sold.
C) insufficient sales.
D) insufficient fixed assets.
Answer: C
Topic: Activity Analysis
Question Status: Previous Edition

30) If Nico Corporation has cost of goods sold of $300,000 and inventory of $30,000, then the inventory turnover is ________ and the average age of inventory is ________.
A) 36.5; 10
B) 10; 36.5
C) 36.0; 10
D) 10; 36.0
Answer: B
Topic: Activity Analysis
Question Status: Previous Edition

31) If Nico Corporation has annual purchases of $300,000 and accounts payable of $30,000, then average purchases per day are ________ and the average payment period is ________.
A) 36.5; 821.9
B) 36.0; 833.3
C) 821.9; 36.5
D) 833.3; 36.0
Answer: C
Topic: Activity Analysis
Question Status: Previous Edition

Learning Goal 4: Discuss the relationship between debt and financial leverage and the ratios used to analyze a firm's debt.

1) The magnification of risk and return introduced through the use of fixed-cost financing such as debt and preferred stock is called financial leverage.
Answer: TRUE
Topic: Leverage Analysis
Question Status: Previous Edition

2) The less fixed-cost debt (financial leverage) a firm uses, the greater will be its risk and return.
Answer: FALSE
Topic: Leverage Analysis
Question Status: Previous Edition

3) The higher the value of the times interest earned ratio, the higher the proportion of the firm's interest income compared to its contractual interest payments.
Answer: FALSE
Topic: Leverage Analysis
Question Status: Previous Edition

4) In general, the more debt (other people's money) a firm uses in relation to its assets, the smaller its financial leverage.
Answer: FALSE
Topic: Leverage Analysis
Question Status: Previous Edition

5) The lower the fixed-payment coverage ratio, the lower is the firm's financial leverage.
Answer: FALSE
Topic: Leverage Analysis
Question Status: Previous Edition

6) The higher the debt ratio, the more financial leverage a firm has and, thus, the greater will be its risk and return.
Answer: TRUE
Topic: Leverage Analysis
Question Status: Previous Edition

7) Typically, higher coverage ratios are preferred, but too high a ratio may indicate under-utilization of fixed-payment obligations, which may result in unnecessarily low risk and return.
Answer: TRUE
Topic: Leverage Analysis
Question Status: Previous Edition

8) The ________ ratio measures the proportion of total assets financed by the firm's creditors.
A) total asset turnover
B) fixed asset turnover
C) current
D) debt
Answer: D
Topic: Leverage Analysis
Question Status: Previous Edition

9) The ________ ratio measures the firm's ability to pay contractual interest payments.
A) times interest earned
B) fixed-payment coverage
C) debt
D) average payment period
Answer: A
Topic: Leverage Analysis
Question Status: Previous Edition

10) The ________ ratio may indicate that the firm will not be able to meet interest obligations due on outstanding debt.
A) debt
B) net profit margin
C) return on total assets
D) times interest earned
Answer: D
Topic: Leverage Analysis
Question Status: Previous Edition

11) The higher the value of ________ ratio, the better able the firm is to fulfill its interest obligations.

A) debt
B) average collection period
C) times interest earned
D) average payment period

Answer: C

Topic: Leverage Analysis
Question Status: Previous Edition

Table 2.1

Balance Sheet Cole Eagan Enterprises December 31, 2005			
Cash	$4,500	Accounts Payable	$10,000
Accounts Receivable		Notes Payable	
Inventory		Accruals	1,000
Total Current Assets		Total Current Liabilities	
Net Fixed Assets		Long-Term Debt	
Total Assets		Stockholders' Equity	
		Total Liabilities & S.E.	

Information (2005 values)

1. Sales totaled $110,000
2. The gross profit margin was 25 percent.
3. Inventory turnover was 3.0.
4. There are 360 days in the year.
5. The average collection period was 65 days.
6. The current ratio was 2.40.
7. The total asset turnover was 1.13.
8. The debt ratio was 53.8 percent.

12) Inventory for CEE in 2005 was ________. (See Table 2.1)

A) $36,667
B) $32,448
C) $27,500
D) $ 9,167

Answer: C

Topic: Balance Sheet and Activity Analysis
Question Status: Previous Edition

13) Notes payable for CEE in 2005 was ________. (See Table 2.1)

A) $113,466
B) $ 52,372
C) $ 41,372
D) $ 10,609

Answer: D

Topic: Balance Sheet and Activity Analysis
Question Status: Revised

14) Accounts receivable for CEE in 2005 was ________. (See Table 2.1)
A) $14,056
B) $19,861
C) $14,895
D) $18,333
Answer: B
Topic: Balance Sheet and Activity Analysis
Question Status: Previous Edition

15) Net fixed assets for CEE in 2005 were ________. (See Table 2.1)
A) $45,484
B) $48,975
C) $54,511
D) $69,341
Answer: A
Topic: Balance Sheet and Activity Analysis
Question Status: Previous Edition

16) Total assets for CEE in 2005 were ________. (See Table 2.1)
A) $ 45,895
B) $124,300
C) $ 58,603
D) $ 97,345
Answer: D
Topic: Balance Sheet and Activity Analysis
Question Status: Previous Edition

17) Long-term debt for CEE in 2005 was ________. (See Table 2.1)
A) $30,763
B) $52,372
C) $10,608
D) $41,372
Answer: A
Topic: Balance Sheet and Activity Analysis
Question Status: Revised

18) ________ is a term used to describe the magnification of risk and return introduced through the use of fixed cost financing such as preferred stock and long-term debt.
A) Financial leverage
B) Operating leverage
C) Fixed-payment coverage
D) The acid-test
Answer: A
Topic: Leverage Analysis
Question Status: Previous Edition

19) When assessing the fixed-payment coverage ratio,
A) the lower its value the more risky is the firm.
B) the lower its value, the lower is the firm's financial leverage.
C) preferred stock dividend payments can be disregarded.
D) the higher its value, the higher is the firm's liquidity.
Answer: A
Topic: Leverage Analysis
Question Status: Previous Edition

Learning Goal 5: Use ratios to analyze a firm's profitability and its market value.

1) Earnings per share represent the dollar amount earned and distributed to shareholders.
Answer: FALSE
Topic: Profitability Analysis
Question Status: Previous Edition

2) Gross profit margin measures the percentage of each sales dollar left after the firm has paid for its goods and operating expenses.
Answer: FALSE
Topic: Profitability Analysis
Question Status: Previous Edition

3) Net profit margin measures the percentage of each sales dollar remaining after all costs and expenses, including interest, taxes, and common stock dividends, have been deducted.
Answer: FALSE
Topic: Profitability Analysis
Question Status: Previous Edition

4) Return on total assets (ROA) measures the overall effectiveness of management in generating profits with the owners' investment in the firm.
Answer: FALSE
Topic: Profitability Analysis
Question Status: Previous Edition

5) The price/earnings (P/E) ratio represents the degree of confidence that investors have in the firm's future performance.
Answer: TRUE
Topic: Market Value Analysis
Question Status: Previous Edition

6) The ________ is a popular approach for evaluating profitability in relation to sales by expressing each item on the income statement as a percent of sales.
A) retained earnings statement
B) source and use statement
C) common-size income statement
D) profit and loss statement
Answer: C
Topic: Common Size Analysis
Question Status: Previous Edition

7) The ________ indicates the percentage of each sales dollar remaining after the firm has paid for its goods.
   A) net profit margin
   B) operating profit margin
   C) gross profit margin
   D) earnings available to common shareholders
   Answer: C
   Topic: Profitability Analysis
   Question Status: Previous Edition

8) The ________ measures the percentage of profit earned on each sales dollar before interest and taxes.
   A) net profit margin
   B) operating profit margin
   C) gross profit margin
   D) earnings available to common shareholders
   Answer: B
   Topic: Profitability Analysis
   Question Status: Previous Edition

9) The ________ measures the percentage of each sales dollar remaining after ALL expenses, including taxes, have been deducted.
   A) net profit margin
   B) operating profit margin
   C) gross profit margin
   D) earnings available to common shareholders
   Answer: A
   Topic: Profitability Analysis
   Question Status: Previous Edition

10) The ________ measures the overall effectiveness of management in generating profits with its available assets.
   A) net profit margin
   B) price/earnings ratio
   C) return on equity
   D) return on total assets
   Answer: D
   Topic: Profitability Analysis
   Question Status: Previous Edition

11) The ________ measures the return on owners' (both preferred and common stockholders) investment in the firm.
   A) net profit margin
   B) price/earnings ratio
   C) return on equity
   D) return on total assets
   Answer: C
   Topic: Profitability Analysis
   Question Status: Previous Edition

12) The ________ ratio is commonly used to assess the owner's appraisal of the share value.

A) debt

B) price/earnings

C) return on equity

D) return on total assets

Answer: B

Topic: Market Value Analysis
Question Status: Previous Edition

13) Two frequently cited ratios of profitability that can be read directly from the common-size income statement are

A) the earnings per share and the return on total assets.

B) the gross profit margin and the earnings per share.

C) the gross profit margin and the return on total assets.

D) the gross profit margin and the net profit margin.

Answer: D

Topic: Profitability Analysis
Question Status: Previous Edition

14) A firm with a gross profit margin which meets industry standard and a net profit margin which is below industry standard must have excessive

A) general and administrative expenses.

B) cost of goods sold.

C) dividend payments.

D) principal payments.

Answer: A

Topic: Profitability Analysis
Question Status: Previous Edition

15) A firm with sales of $1,000,000, net profits after taxes of $30,000, total assets of $1,500,000, and total liabilities of $750,000 has a return on equity of

A) 20 percent.

B) 15 percent.

C) 3 percent.

D) 4 percent.

Answer: D

Topic: Dupont System Analysis
Question Status: Previous Edition

Learning Goal 6: Use a summary of financial ratios and the DuPont system of analysis to perform a complete ratio analysis.

1) The financial leverage multiplier is the ratio of the firm's total assets to stockholders' equity.

Answer: TRUE

Topic: Leverage Analysis
Question Status: Previous Edition

2) The DuPont formula allows the firm to break down its return into the net profit margin, which measures the firm's profitability on sales, and its total asset turnover, which indicates how efficiently the firm has used its assets to generate sales.
Answer: TRUE
Topic: Dupont System Analysis
Question Status: Previous Edition

3) The DuPont system allows the firm to break its return on equity into a profit-on-sales component, an efficiency-of-asset-use component, and a use-of-leverage component.
Answer: TRUE
Topic: Dupont System Analysis
Question Status: Previous Edition

4) The DuPont system merges the income statement and balance sheet into two summary measures of profitability:
A) net profit margin and return on total assets.
B) net profit margin and return on equity.
C) return on total assets and return on equity.
D) net profit margin and price/earning ratio.
Answer: C
Topic: Dupont System Analysis
Question Status: Previous Edition

5) ________ is used by financial managers as a structure for dissecting the firm's financial statements to assess its financial condition.
A) Statement of cash flows
B) The DuPont system of analysis
C) A common-size income statement
D) Cross-sectional analysis
Answer: B
Topic: Dupont System Analysis
Question Status: Previous Edition

6) In the DuPont system, the return on total assets (asset) is equal to
A) (return on equity) × (financial leverage multiplier).
B) (return on equity) × (total asset turnover).
C) (net profit margin) × (fixed asset turnover).
D) (net profit margin) × (total asset turnover).
Answer: D
Topic: Dupont System Analysis
Question Status: Previous Edition

7) The modified DuPont formula relates the firm's return on total assets (ROA) to the
A) return on equity (ROE).
B) financial leverage multiplier.
C) net profit margin.
D) total asset turnover.
Answer: A
Topic: Dupont System Analysis
Question Status: Previous Edition

8) In the DuPont system, the return on equity is equal to
A) (net profit margin) × (total asset turnover).
B) (stockholders' equity) × (financial leverage multiplier).
C) (return on total assets) × (financial leverage multiplier).
D) (return on total assets) × (total asset turnover).
Answer: C
Topic: Dupont System Analysis
Question Status: Previous Edition

9) A firm with a substandard net profit margin can improve its return on total assets by
A) increasing its debt ratio.
B) increasing its total asset turnover.
C) decreasing its fixed asset turnover.
D) decreasing its total asset turnover.
Answer: B
Topic: Dupont System Analysis
Question Status: Previous Edition

10) A decrease in total asset turnover will result in ________ in the return on equity.
A) an increase
B) a decrease
C) no change
D) an undetermined change
Answer: B
Topic: Dupont System Analysis
Question Status: Previous Edition

11) A firm with a substandard return on total assets can improve its return on equity, all else remaining the same, by
A) increasing its debt ratio.
B) increasing its total asset turnover.
C) decreasing its debt ratio.
D) decreasing its total asset turnover.
Answer: A
Topic: Dupont System Analysis
Question Status: Previous Edition

12) The three summary ratios basic to the DuPont system of analysis are
A) net profit margin, total asset turnover, and return on investment.
B) net profit margin, total asset turnover, and return on equity.
C) net profit margin, total asset turnover, and equity multiplier.
D) net profit margin, financial leverage multiplier, and return on equity.
Answer: C
Topic: Dupont System Analysis
Question Status: Previous Edition

13) The financial leverage multiplier is an indicator of how much ________ a corporation is utilizing.

A) operating leverage
B) long-term debt
C) total debt
D) total assets

Answer: C

Topic: Leverage Analysis
Question Status: Previous Edition

14) The financial leverage multiplier is an indicator of

A) operating leverage.
B) financial leverage.
C) long-term debt.
D) current liabilities.

Answer: B

Topic: Leverage Analysis
Question Status: Previous Edition

15) Using the DuPont system of analysis and holding other factors constant, an increase in financial leverage will result in ________ in the return on equity.

A) an increase
B) a decrease
C) no change
D) an undetermined change

Answer: A

Topic: Dupont System Analysis
Question Status: Previous Edition

16) A firm with a total asset turnover lower than the industry standard and a current ratio which meets the industry standard may have

A) excessive fixed assets.
B) excessive inventory.
C) excessive accounts receivable.
D) excessive debt.

Answer: A

Topic: Activity Analysis
Question Status: Previous Edition

17) A firm with a total asset turnover lower than the industry standard may have

A) excessive debt.
B) excessive cost of goods sold.
C) insufficient sales.
D) insufficient fixed assets.

Answer: C

Topic: Activity Analysis
Question Status: Previous Edition

Table 2.2

Dana Dairy Products Key Ratios

	Industry Average	Actual 2004	Actual 2005
Current Ratio	1.3	1.0	
Quick Ratio	0.8	0.75	
Average collection Period	23 days	30 days	
Inventory Turnover	21.7	19	
Debt Ratio	64.7%	50%	
Times Interest Earned	4.8	5.5	
Gross Profit Margin	13.6%	12.0%	
Net Profit Margin	1.0%	0.5%	
Return on total assets	2.9%	2.0%	
Return on Equity	8.2%	4.0%	

Income Statement
Dana Dairy Products
For the Year Ended December 31, 2005

Sales Revenue	$100,000
Less: Cost of Goods Sold	87,000
Gross Profits	$13,000
Less: Operating Expenses	11,000
Operating Profits	$2,000
Less: Interest Expense	500
Net Profits Before Taxes	$1,500
Less: Taxes (40%)	600
Net Profits After Taxes	$900

Balance Sheet
Dana Dairy Products
December 31, 2005

Assets		
Cash		$ 1,000
Accounts Receivable		8,900
Inventories		4,350
Total Current Assets		$14,250
Gross Fixed Assets	$35,000	
Less: Accumulated Depreciation	13,250	
Net Fixed Assets		21,750
Total Assets		$36,000
Liabilities & Stockholders' Equity		
Accounts Payable		$ 9,000
Accruals		6,675
Total Current Liabilities		$15,675
Long-term Debt		4,125
Total Liabilities		$19,800
Common Stock		1,000
Retained Earnings		15,200
Total Stockholders' Equity		$16,200
Total Liabilities & Stockholders Equity		$36,000

18) The current ratio for Dana Dairy Products in 2005 was ________. (See Table 2.2)
A) 1.58
B) 0.63
C) 1.10
D) 0.91
Answer: D
Topic: Liquidity Analysis
Question Status: Previous Edition

19) Since 2004, the liquidity of Dana Dairy Products ________. (See Table 2.2)
A) has deteriorated
B) remained the same
C) has improved
D) cannot be determined
Answer: A
Topic: Liquidity Analysis
Question Status: Previous Edition

20) The net working capital for Dana Dairy Products in 2005 was ________. (See Table 2.2)
A) $10,325
B) $ 1,425
C) -$ 1,425
D) $14,250
Answer: C
Topic: Liquidity Analysis
Question Status: Previous Edition

21) The inventory turnover for Dana Dairy Products in 2005 was ________. (See Table 2.2)
A) 43
B) 5
C) 20
D) 25
Answer: C
Topic: Activity Analysis
Question Status: Previous Edition

22) The inventory management at Dana Dairy Products ________ since 2004. (See Table 2.2)
A) has deteriorated
B) remained the same
C) has improved slightly
D) cannot be determined
Answer: C
Topic: Activity Analysis
Question Status: Previous Edition

23) The average collection period for Dana Dairy Products in 2005 was (See Table 2.2)
   A) 32.5 days.
   B) 11.8 days.
   C) 25.3 days.
   D) 35.9 days.
   Answer: A
   Topic: Activity Analysis
   Question Status: Previous Edition

24) If Dana Dairy Products has credit terms which specify that accounts receivable should be paid in 25 days, the average collection period ________ since 2004. (See Table 2.2)
   A) has deteriorated
   B) remained the same
   C) has improved
   D) cannot be determined
   Answer: A
   Topic: Activity Analysis
   Question Status: Previous Edition

25) Dana Dairy Products had a ________ degree of financial leverage than the industry standard, resulting in ________. (See Table 2.2)
   A) lower; lower return on total assets
   B) lower; lower return on equity
   C) higher; higher return on equity
   D) higher; higher return on total assets
   Answer: B
   Topic: Leverage Analysis
   Question Status: Previous Edition

26) The debt ratio for Dana Dairy Products in 2005 was (See Table 2.2)
   A) 50 percent.
   B) 11 percent.
   C) 55 percent.
   D) 44 percent.
   Answer: C
   Topic: Leverage Analysis
   Question Status: Previous Edition

27) Dana Dairy Products' gross profit margin was inferior to the industry standard. This may have resulted from (See Table 2.2)
   A) a high sales price.
   B) the high cost of goods sold.
   C) excessive selling and administrative expenses.
   D) excessive interest expense.
   Answer: B
   Topic: Profitability Analysis
   Question Status: Previous Edition

28) The gross profit margin and net profit margin for Dana Dairy Products in 2005 were (See Table 2.2)

A) 13 percent and 0.9 percent, respectively.
B) 13 percent and 1.5 percent, respectively.
C) 2 percent and 0.9 percent, respectively.
D) 2 percent and 1.5 percent, respectively.

Answer: A
Topic: Profitability Analysis
Question Status: Previous Edition

29) The return on total assets for Dana Dairy Products for 2005 was (See Table 2.2)

A) 0.9 percent.
B) 5.5 percent.
C) 25 percent.
D) 2.5 percent.

Answer: D
Topic: Profitability Analysis
Question Status: Previous Edition

30) The return on equity for Dana Dairy Products for 2005 was (See Table 2.2)

A) 0.6 percent.
B) 5.6 percent.
C) 0.9 percent.
D) 50 percent.

Answer: B
Topic: Profitability Analysis
Question Status: Previous Edition

31) Using the modified DuPont formula allows the analyst to break Dana Dairy Products return on equity into 3 components: the net profit margin, the total asset turnover, and a measure of leverage (the financial leverage multiplier). Which of the following mathematical expressions represents the modified DuPont formula relative to Dana Dairy Products' 2005 performance? (See Table 2.2)

A) 5.6(ROE) = 2.5(ROA) × 2.24(Financial leverage multiplier)
B) 5.6(ROE) = 3.3(ROA) × 1.70(Financial leverage multiplier)
C) 4.0(ROE) = 2.0(ROA) × 2.00(Financial leverage multiplier)
D) 2.5(ROE) = 5.6(ROA) × 0.44(Financial leverage multiplier)

Answer: A
Topic: Dupont System Analysis
Question Status: Previous Edition

32) As the financial leverage multiplier increases this may result in

A) an increase in the net profit margin and return on investment, due to the decrease in interest expense as debt decreases.

B) an increase in the net profit margin and return on investment, due to the increase in interest expense as debt increases.

C) a decrease in the net profit margin and return on investment, due to the increase in interest expense as debt increases.

D) a decrease in the net profit margin and return on investment, due to the decrease in interest expense as debt decreases.

Answer: C

Topic: Dupont System Analysis

Question Status: Previous Edition

33) **Key Financial Data**

Ratio (% of Sales)	**Dreamscape, Inc. For the Year Ended December 31, 2004**	**Industry Average For the Year Ended December 31, 2005**
Cost of goods sold	74.5%	70.0%
Gross profits	25.5	30.0
Selling expense	8.0	7.0
Gen. & admin. expense	5.1	4.9
Depreciation expense	2.4	2.0
Total operating expense	15.5	13.9
Operating profits	10.0	16.1
Interest expense	1.4	1.0
Net profits before taxes	8.6	15.1
Taxes	2.4	6.0
Net profits after taxes	5.2	9.1

Income Statement, Dreamscape, Inc.
For the Year Ended December 31, 2005

Sales revenue	$1,000,000
Less: Cost of goods sold	750,000
Gross profits	$ 250,000
Less: Operating expenses	
Selling Expense	$70,000
Gen. & admin. expense	48,000
Depreciation expense	20,000
Total operating expense	$ 138,000
Operating profits	$ 112,000
Less: Interest expense	$ 20,000
Net profits before taxes	$ 92,000
Less: Taxes	$ 36,800
Net profits after taxes	$ 55,200

Prepare a common-size income statement for Dreamscape, Inc. for the year ended December 31, 2005. Evaluate the company's performance against industry average ratios and against last year's results.

Answer: **Common-Size Income Statement**

Dreamscape, Inc.

For the Year Ended December 31, 2005

Sales revenue		100%
Less: Cost of goods sold		75%
Gross profits		25%
Less: Operating expenses		
Selling Expense	7.0%	
Gen. & admin. expense	4.8%	
Depreciation expense	2.0%	
Total operating expense		13.8%
Operating profits		11.2%
Less: Interest expense		2.0%
Net profits before taxes		9.2%
Less: Taxes		3.68%
Net profits after taxes		5.52%

Dreamscape, Inc. performs significantly below industry average. All profitability ratios (gross profit margin, operating profit margin, and net profit margin) trail the industry norms. In 2004 expenses as a percent of sales were high.
Dreamscape, Inc. improved the management of operating expenses in 2005 meeting industry averages. However, cost of goods sold as a percent of sales increased and is a full 5 percent above the industry average, further reducing the gross profit margin. Interest expense is two times the average indicating high cost of debt or a high debt level. The firm must concentrate on reducing the cost of goods sold and interest expense to improve performance.

Topic: Common Size Statement Analysis
Question Status: Previous Edition

34) In an effort to analyze Clockwork Company finances, Jim realized that he was missing the company's net profits after taxes for the current year. Find the company's net profits after taxes using the following information.

Return on total assets = 2%

Total Asset Turnover = 0.5

Cost of Goods Sold = $105,000

Gross Profit Margin = 0.30

Answer: Sales = CGS/(1 - GPM) = 105,000/(1 - 0.30) = $150,000

Total Assets = Sales/(Total Asset Turnover)

= 150,000/0.50 = $300,000

Net Profits After Taxes = (ROA) × (Total Assets)

= (0.02) × (300,000) = $6,000

Topic: Ratio and Financial Statement Analysis

Question Status: Previous Edition

35) Construct the DuPont system of analysis using the following financial data for Key Wahl Industries and determine which areas of the firm need further analysis.

Key Financial Data	
Key Wahl Industries:	
Sales	$4,500,000
Net profits after taxes	337,500
Total assets	6,750,000
Total liabilities	3,375,000
Industry Averages:	
Total asset turnover	0.71
Debt ratio	33.00%
Financial leverage multiplier	1.50
Return on total assets	6.75%
Return on equity	10.00%
Net profit margin	9.50%

Answer: Ratios for Key Wahl Industries

$$\text{Total asset turnover} = \frac{4{,}500{,}000}{6{,}750{,}000} = 0.67$$

$$\text{Debt ratio} = \frac{3{,}375{,}000}{6{,}750{,}000} = 50\%$$

$$\text{Financial leverage multiplier} = \frac{1}{1 - 0.5} = 2$$

$$\text{ROA} = \frac{337{,}500}{6{,}750{,}000} = 5\%$$

ROE = ROA × Financial leverage multiplier = 10%

$$\text{Net profit margin} = \frac{337{,}500}{4{,}500{,}000} = 7.5\%$$

DuPont System of Analysis: Key Wahl Industries performs equally to industry averages according to the return on equity. However, when dissecting the financial data further into the three key components of the DuPont system (a profit-on-sale, efficiency-of-asset use, and a use-of-leverage component), some areas of improvement may be highlighted. Key Wahl Industries has a lower net profit margin and return on total assets than industry averages. Nevertheless, the firm makes up for the low profit margin through excessive use of leverage (a 50 percent debt ratio versus 33 percent for the industry). Financial risk could be reduced resulting in the same return on equity by increasing the net profit margin and reducing debt.

Topic: Dupont System Analysis
Question Status: Previous Edition

36) Given the following balance sheet, income statement, historical ratios and industry averages, calculate the Pulp, Paper, and Paperboard, Inc. financial ratios for the most recent year. Analyze its overall financial situation for the most recent year. Analyze its overall financial situation from both a cross-sectional and time-series viewpoint. Break your analysis into an evaluation of the firm's liquidity, activity, debt, and profitability.

Income Statement
Pulp, Paper and Paperboard, Inc.
For the Year Ended December 31, 2005

Sales Revenue	$2,080,976
Less: Cost of Goods Sold	1,701,000
Gross Profits	$379,976
Less: Operating Expenses	273,846
Operating Profits	$106,130
Less: Interest Expense	19,296
Net Profits Before Taxes	$86,834
Less: Taxes (40%)	34,810
Net Profits After Taxes	$52,024

Balance Sheet
Pulp, Paper and Paperboard, Inc.
December 31, 2005

Assets	
Cash	$ 95,000
Accounts receivable	237,000
Inventories	243,000
Total current assets	$ 575,000
Gross fixed assets	500,000
Less: Accumulated depreciation	75,000
Net fixed assets	$ 425,000
Total assets	$1,000,000
Liabilities and stockholders' equity	
Current liabilities	
Accounts payable	$ 89,000
Notes payable	169,000
Accruals	87,000
Total current liabilities	$ 345,000
Long-term debt	188,000
Total liabilities	$ 533,000
Stockholders' equity	
Common stock	255,000
Retained earnings	212,000
Total stockholders' equity	$ 467,000
Total liabilities and stockholders' equity	$1,000,000

Historical and Industry Average Ratios
Pulp, Paper and Paperboard, Inc.

Ratio	2003	2004	2005	Industry 2005
Current Ratio	1.6	1.7	–	1.6
Quick Ratio	0.9	1.0	–	0.9
Inventory Turnover	8.1	9.3	–	8.4
Average Collection Period	33 days	37 days	–	39 days
Total Asset Turnover	2.3	2.2	–	2.2
Debt Ratio	60%	56%	–	58%
Times Interest Earned	2.5	3.5	–	2.3
Gross Profit Margin	21%	19.7%	–	20.4%
Operating Profit Margin	4.7%	4.8%	–	4.7%
Net Profit Margin	1.8%	1.6%	–	1.4%
Return on total assets	4.1%	3.5%	–	3.08%
Return on Equity	10.3%	7.9%	–	7.3%

Answer:

Historical and Industry Average Ratios
Pulp, Paper and Paperboard, Inc.

Ratio	2003	2004	2005	Industry 2005
Current Ratio	1.6	1.7	1.67	1.6
Quick Ratio	0.9	1.0	0.96	0.9
Inventory Turnover	8.1	9.3	7.0	8.4
Average Collection Period	33 days	37 days	42 days	39 days
Total Asset Turnover	2.3	2.2	2.1	2.2
Debt Ratio	60%	56%	53%	58%
Times Interest Earned	2.5	3.5	5.5%	2.3
Gross Profit Margin	21%	19.7%	18.3%	20.4%
Operating Profit Margin	4.7%	4.8%	5.1%	4.7%
Net Profit Margin	1.8%	1.6%	2.5%	1.4%
Return on total assets	4.1%	3.5%	5.2%	3.08%
Return on Equity	0.3%	7.9%	11.1%	7.3%

LIQUIDITY: The liquidity of 3P is on target with the industry standard in 2005 and shows no trend since 2000.
ACTIVITY: Inventory and accounts receivable management has deteriorated since 2004 and is inferior when compared to the industry standard. The low inventory turnover may be caused by overstocking and/or obsolete inventories. The high average collection period may have resulted from poor collections procedures. Further investigation is necessary to determine the cause of the variances.
DEBT: 3P has less debt than the industry average. The trend since 2003 has been toward reducing the debt ratio. The firm, therefore, is subject to less financial risk than the average firm in the industry.
PROFITABILITY: Although the gross profit margin is inferior to the industry average, the operating and net profit margin far exceed the standards, boosting return on total assets and return on equity. The trend in the gross profit margin is unfavorable and may either be caused by a slide in product prices or an escalation in cost of sales. The cause of the poor gross profit margin should be investigated.
Overall, the firm needs to focus attention on inventory and accounts receivable management and the cause of the poor gross profit margin. In general, the firm is in good financial condition.

Topic: Complete Ratio Analysis
Question Status: Revised

37) Complete the balance sheet for General Aviation, Inc. based on the following financial data.

Balance Sheet
General Aviation, Inc.
December 31, 2005

Assets	
Cash	$ 8,005
Marketable securities	—
Accounts receivable	—
Inventories	—
Total current assets	—
Gross fixed assets	—
Less: Accumulated depreciation	$50,000
Net fixed assets	—
Total assets	—

Liabilities and Stockholders' Equity	
Accounts payable	$28,800
Notes payable	—
Accruals	$18,800
Total current liabilities	—
Long-term debts	—
Total liabilities	—
Stockholders' equity	
Preferred stock	2,451
Common stock at par	30,000
Paid-in capital in excess of par	6,400
Retained earnings	90,800
Total stockholders' equity	—
Total liabilities and stockholders' equity	—

Key Financial Data (2005)
1. Sales totaled $720,000.
2. The gross profit margin was 38.7 percent.
3. Inventory turned 6 times.
4. There are 360 days in a year.
5. The average collection period was 31 days.
6. The current ratio was 2.35.
7. The total asset turnover was 2.81.
8. The debt ratio was 49.4 percent.
9. Total current assets equal $159,565.

Answer:

Balance Sheet
General Aviation, Inc.
December 31, 2005

Assets		
Cash		$ 8,005
Marketable securities		16,000
Accounts receivable		62,000
Inventories		73,560
Total current assets		$159,565
Gross fixed assets	146,663	
Less: Accumulated depreciation	$50,000	
Net fixed assets		$ 96,663
Total assets		$256,228

Liabilities and Stockholders' Equity	
Current liabilities	
Accounts payable	$28,800
Notes payable	20,300
Accruals	$18,800
Total current liabilities	$67,900
Long-term debts	58,677
Total liabilities	$126,577
Stockholders' equity	
Preferred stock	2,451
Common stock at par	30,000
Paid-in capital in excess of par	6,400
Retained earnings	90,800
Total stockholders' equity	$129,651
Total liabilities and stockholders' equity	$256,228

Topic: Ratio and Financial Statement Analysis
Question Status: Previous Edition