Fundamentals of Corporate Finance 5th edition Berk Test Bank

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Fundamentals of Corporate Finance, 5e **(Berk/DeMarzo/Harford)**
Chapter 2 Introduction to Financial Statement Analysis

2.1 Firms' Disclosure of Financial Information

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

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

3) International Financial Reporting Standards are taking root throughout the world. However, it is unlikely that the U.S. will report according to IFRS before the second half of the twenty-first century.
Answer: FALSE
Diff: 1 Var: 1
Skill: Conceptual
AACSB Objective: Analytic Skills

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 ensures that the market value of assets and debt are reported accurately.
B) It ensures that information on the performance of public companies is reported on cash-basis accounting.
C) It ensures that important budgetary information is not omitted.
D) It makes it easier to compare the financial results of different firms.
Answer: D
Diff: 1 Var: 1
Skill: Conceptual
AACSB Objective: Analytic Skills

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5) Which of the following best describes why a firm produces financial statements?
A) to use as a tool when planning future investments within a firm
B) to increase the intrinsic value of a firm
C) to provide a means for interested outside parties such as creditors to obtain information about a firm, with an overview of the short- and long-term financial condition of a business
D) to show the daily activities a firm has undertaken in the previous financial year, and what activities are planned for the near future
Answer: C
Diff: 1 Var: 1
Skill: Conceptual
AACSB Objective: Analytic Skills

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

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

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

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9) Which of the following is NOT a financial statement that every public company is required to produce?
A) income statement
B) statement of sources and uses of cash
C) balance sheet
D) statement of stockholders' equity
Answer: B
Diff: 2 Var: 1
Skill: Conceptual
AACSB Objective: Analytic Skills

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

11) 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 Var: 1
Skill: Conceptual
AACSB Objective: Analytic Skills

12) 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 Var: 1
Skill: Conceptual
AACSB Objective: Analytic Skills

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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 Var: 1
Skill: Conceptual
AACSB Objective: Analytic Skills

2) Stockholders' equity is the difference between a firm's assets and liabilities, as shown on the balance sheet.
Answer: TRUE
Diff: 1 Var: 1
Skill: Conceptual
AACSB Objective: Analytic Skills

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
Answer: C
Diff: 2 Var: 1
Skill: Conceptual
AACSB Objective: Analytic Skills

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

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

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
D) prepaid rent on the offices occupied by the company
Answer: B
Diff: 1 Var: 1
Skill: Conceptual
AACSB Objective: Analytic Skills

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.
Answer: A
Diff: 1 Var: 1
Skill: Conceptual
AACSB Objective: Analytic Skills

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8) What is the main problem in using a balance sheet to provide an accurate assessment of the value of a company's equity?
A) Valuable assets such as the company's reputation, the quality of its work force, and the strength of its management are not captured on the balance sheet.
B) The balance sheet does not accurately represent the book value of assets held by the company.
C) The equity shown on the balance sheet does not reflect the market capitalization of the company.
D) Knowing at a single point in time what assets a firm possesses and the liabilities a firm owes does not give any indication of what those assets can produce in the future.
Answer: A
Diff: 2 Var: 1
Skill: Conceptual
AACSB Objective: Analytic Skills

9) The major components of stockholders' 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
Answer: C
Diff: 2 Var: 1
Skill: Conceptual
AACSB Objective: Analytic Skills

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10) **Balance Sheet**

Assets		**Liabilities**	
Current Assets		Current Liabilities	
Cash	46	Accounts payable	39
Accounts receivable	23	Notes payable/short-term debt	5
Inventories	20		
Total current assets	89	Total current liabilities	44
Long-Term Assets		Long-Term Liabilities	
Net property, plant, and equipment	121	Long-term debt	133
Total long-term assets	121	Total long-term liabilities	133
		Total Liabilities	**177**
		Stockholders' Equity	**33**
Total Assets	**210**	**Total Liabilities and Stockholders' Equity**	**210**

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) $133 million
B) $2 million
C) $89 million
D) $45 million
Answer: D
Explanation: Net working capital = total current assets - total current liabilities, which = $89 - $44 = $45 million, as all quantities are expressed in millions of dollars on the table.
Diff: 1 Var: 50+
Skill: Analytical
AACSB Objective: Analytic Skills

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11) **Balance Sheet**

Assets		**Liabilities**	
Current Assets		Current Liabilities	
Cash	49	Accounts payable	38
Accounts receivable	21	Notes payable/short-term debt	5
Inventories	18		
Total current assets	88	Total current liabilities	43
Long-Term Assets		Long-Term Liabilities	
Net property, plant, and equipment	122	Long-term debt	134
Total long-term assets	122	Total long-term liabilities	134
		Total Liabilities	**177**
		Stockholders' Equity	**33**
Total Assets	**210**	**Total Liabilities and Stockholders' Equity**	**210**

The above diagram shows a balance sheet for a certain company. If the company pays back all of its accounts payable today using cash, what will its net working capital be?
A) $131 million
B) $6 million
C) $88 million
D) $45 million
Answer: D
Explanation: Both cash and accounts payable would fall by the same amount, leaving net working capital the same: $88 - $43 = $45
Diff: 1 Var: 50+
Skill: Analytical
AACSB Objective: Analytic Skills

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12) **Balance Sheet**

Assets		**Liabilities**	
Current Assets		Current Liabilities	
Cash	54	Accounts payable	42
Accounts receivable	20	Notes payable/short-term debt	6
Inventories	16		
Total current assets	90	Total current liabilities	48
Long-Term Assets		Long-Term Liabilities	
Net property, plant, and equipment	120	Long-term debt	129
Total long-term assets	120	Total long-term liabilities	129
		Total Liabilities	**177**
		Stockholders' Equity	**33**
Total Assets	**210**	**Total Liabilities and Stockholders' Equity**	**210**

The above diagram shows a balance sheet for a certain company. If the company buys new property, plant and equipment today using its entire cash balance, what will its net working capital be?
A) -$12 million
B) $12 million
C) -$24 million
D) $24 million
Answer: A
Explanation: Current assets would fall by $54, with no change in current liabilities. $(20 + 16) - $48 = -$12.

Diff: 1 Var: 50+
Skill: Analytical
AACSB Objective: Analytic Skills

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13) **Balance Sheet**

Assets		**Liabilities**	
Current Assets		Current Liabilities	
Cash	48	Accounts payable	35
Accounts receivable	25	Notes payable/short-term debt	5
Inventories	16		
Total current assets	89	Total current liabilities	40
Long-Term Assets		Long-Term Liabilities	
Net property, plant, and equipment	121	Long-term debt	137
Total long-term assets	121	Total long-term liabilities	137
		Total Liabilities	**177**
		Stockholders' Equity	**33**
Total Assets	**210**	**Total Liabilities and Stockholders' Equity**	**210**

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 $131 million, and total liabilities and stockholders' equity would be adjusted accordingly.
D) Long-term liabilities would fall to $111 million, and total liabilities and stockholders' equity would be adjusted accordingly.
Answer: B
Diff: 1 Var: 50+
Skill: Analytical
AACSB Objective: Analytic Skills

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14) **Balance Sheet**

Assets		**Liabilities**	
Current Assets		Current Liabilities	
Cash	53	Accounts payable	40
Accounts receivable	23	Notes payable/short-term debt	5
Inventories	17		
Total current assets	93	Total current liabilities	45
Long-Term Assets		Long-Term Liabilities	
Net property, plant, and equipment	117	Long-term debt	133
Total long-term assets	117	Total long-term liabilities	133
		Total Liabilities	**178**
		Stockholders' Equity	**32**
Total Assets	**210**	**Total Liabilities and Stockholders' Equity**	**210**

The above diagram shows a balance sheet for a certain company. All quantities shown are in millions of dollars. If the company has 5 million shares outstanding, and these shares are trading at a price of $6.39 per share, what does this tell you about how investors view this firm's book value?
A) Investors consider that the firm's market value is worth very much less than its book value.
B) Investors consider that the firm's market value is worth less than its book value.
C) Investors consider that the firm's market value and its book value are roughly equivalent.
D) Investors consider that the firm's market value is worth more than its book value.
Answer: C
Diff: 1 Var: 50+
Skill: Analytical
AACSB Objective: Analytic Skills

15) Which of the following balance sheet equations is INCORRECT?
A) Assets - Liabilities = Shareholders' equity
B) Assets = Liabilities + Shareholders' equity
C) Assets - Current liabilities = Long-term liabilities
D) Assets - Current liabilities = Long-term liabilities + Shareholders' equity
Answer: C
Diff: 2 Var: 1
Skill: Conceptual
AACSB Objective: Analytic Skills

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16) Cash is a _____.
A) long-term asset
B) current asset
C) current liability
D) long-term liability
Answer: B
Diff: 1 Var: 1
Skill: Definition
AACSB Objective: Analytic Skills

17) Accounts payable is a _____.
A) long-term liability
B) current asset
C) long-term asset
D) current liability
Answer: D
Diff: 1 Var: 1
Skill: Definition
AACSB Objective: Analytic Skills

18) A 30-year mortgage loan is a _____.
A) long-term liability
B) current liability
C) current asset
D) long-term asset
Answer: A
Diff: 1 Var: 1
Skill: Definition
AACSB Objective: Analytic Skills

19) Which of the following statements regarding the balance sheet is INCORRECT?
A) The balance sheet provides a snapshot of a firm's financial position at a given point in time.
B) The balance sheet lists a firm's assets and liabilities.
C) The balance sheet reports stockholders' equity on the right-hand side.
D) The balance sheet reports liabilities on the left-hand side.
Answer: D
Diff: 2 Var: 1
Skill: Conceptual
AACSB Objective: Analytic Skills

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20)

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

Assets	**2006**	**2005**	**Liabilities and Stockholders' Equity**	**2006**	**2005**
Current Assets			*Current Liabilities*		
Cash	50.7	58.5	Accounts payable	84.4	73.5
Accounts receivable	54.9	39.6	Notes payable / short-term debt	9.4	9.6
Inventories	44.7	42.9	Current maturities of long-term debt	39.8	36.9
Other current assets	6.1	3.0	Other current liabilities	6.0	12.0
Total current assets	156.4	144.0	Total current liabilities	139.6	132.0
Long-Term Assets			*Long-Term Liabilities*		
Land	66.8	62.1	Long-term debt	222.3	168.9
Buildings	106.2	91.5	Capital lease obligations		
Equipment	115.7	99.6			
Less accumulated depreciation	(56.5)	(52.5)	Deferred taxes	22.8	22.2
Net property, plant, and equipment	232.2	200.7	Other long-term liabilities	---	---
Goodwill	60.0	--	Total long-term liabilities	245.1	191.1
Other long-term assets	63.0	42.0	Total liabilities	384.7	323.1
Total long-term assets	355.2	242.7	Stockholders' Equity	126.9	63.6
Total Assets	**511.6**	**386.7**	**Total liabilities and Stockholders' Equity**	**511.6**	**386.7**

Refer to the balance sheet above. What is Luther's net working capital in 2006?
A) $16.8 million
B) $296.0 million
C) $33.6 million
D) $8.4 million
Answer: A
Explanation: NWC = Current assets - Current liabilities = $156.4 - $139.6 = $16.8 million
Diff: 2 Var: 50+
Skill: Analytical
AACSB Objective: Analytic Skills

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2.3 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 Var: 1
Skill: Conceptual
AACSB Objective: Analytic Skills

2) What is a firm's net income?
A) the difference between the sales and other income generated by a firm, and all costs, taxes, and expenses incurred by the firm in a given period
B) the last or "bottom" line of the income statement
C) a measure of the firm's profitability over a given period
D) all of the above
Answer: D
Diff: 3 Var: 1
Skill: Conceptual
AACSB Objective: Analytic Skills

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 a firm in a given period
B) the difference between sales revenues and the costs
C) the difference between sales revenues and cash expenditures associated with those sales
D) all of the above
Answer: B
Diff: 3 Var: 1
Skill: Conceptual
AACSB Objective: Analytic Skills

4) Which of the following is NOT considered to be an operating expense on the income statement?
A) administrative expenses and overhead
B) corporate taxes
C) salaries
D) depreciation and amortization
Answer: B
Diff: 2 Var: 1
Skill: Conceptual
AACSB Objective: Analytic Skills

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5) **Income Statement for Xenon Manufacturing:**

	2008	**2009**
Total sales	202	212
Cost of sales	-148	-172
Gross Profit	54	40
Selling, general, and administrative expenses	-22	-20
Research and development	-8	-7
Depreciation and amortization	-4	-3
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

Consider the above Income Statement for Xenon Manufacturing. All values are in millions of dollars. If Xenon Manufacturing has 20 million shares outstanding, what is its EPS in 2008?
A) $0.50
B) $0.25
C) $0.40
D) $0.60
Answer: A
Explanation: EPS = Net income / Shares outstanding = $ 10 million / 20 million shares = $0.50 per share
Diff: 2 Var: 22
Skill: Analytical
AACSB Objective: Analytic Skills

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6) **Income Statement for CharmCorp:**

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

Consider the above Income Statement for CharmCorp. All values are in millions of dollars. If CharmCorp. has 4 million shares outstanding, and its managers and employees have stock options for 2 million shares, what is its diluted EPS in 2008?
A) $0.83
B) $1.33
C) $1.67
D) $2.00
Answer: C
Diff: 3 Var: 30
Skill: Analytical
AACSB Objective: Analytic Skills

7) Which of the following statements regarding the income statement is INCORRECT?
A) The income statement shows the cash flows and expenses at a given point in time.
B) The income statement shows the flow of revenues and expenses generated by a firm between two dates.
C) The last or "bottom" line of the income statement shows a firm's net income.
D) The first line of an income statement lists the revenues from the sales of products or services.
Answer: A
Diff: 2 Var: 1
Skill: Conceptual
AACSB Objective: Analytic Skills

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8) Gross profit is calculated as _____.
A) total sales - cost of sales - selling, general, and administrative expenses - depreciation and amortization
B) total sales - cost of sales - selling, general, and administrative expenses
C) total sales - cost of sales
D) none of the above
Answer: C
Diff: 2 Var: 1
Skill: Conceptual
AACSB Objective: Analytic Skills

9) Which of the following is NOT an operating expense?
A) interest expense
B) depreciation and amortization
C) selling, general, and administrative expenses
D) research and development
Answer: A
Diff: 2 Var: 1
Skill: Conceptual
AACSB Objective: Analytic Skills

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

	2006	2005
Total sales	610.1	578.3
Cost of sales	-500.2	-481.9
Gross profit	109.9	96.4
Selling, general, and administrative expenses	-40.5	-39.0
Research and development	-24.6	-22.8
Depreciation and amortization	-3.6	-3.3
Operating income	41.2	31.3
Other income	--	--
Earnings before interest and taxes (EBIT)	41.2	31.3
Interest income (expense)	-25.1	-15.8
Pretax income	16.1	15.5
Taxes	-5.5	-5.3
Net income	10.6	10.2
Price per share	$16	$15
Sharing outstanding (millions)	10.3	8.0
Stock options outstanding (millions)	0.4	0.1
Stockholders' Equity	126.6	63.6
Total Liabilities and Stockholders' Equity	533.1	386.7

Refer to the income statement above. For the year ending December 31, 2006 Luther's earnings per share is closest to _____.
A) $0.51
B) $1.03
C) $0.82
D) $1.23
Answer: B
Explanation: EPS = Net income / Shares outstanding = $10.6 / 10.3 = $1.03
Diff: 1 Var: 50+
Skill: Analytical
AACSB Objective: Analytic Skills

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

	2006	2005
Total sales	610.1	578.3
Cost of sales	-500.2	-481.9
Gross profit	109.9	96.4
Selling, general, and administrative expenses	-40.5	-39.0
Research and development	-24.6	-22.8
Depreciation and amortization	-3.6	-3.3
Operating income	41.2	31.3
Other income	--	--
Earnings before interest and taxes (EBIT)	41.2	31.3
Interest income (expense)	-25.1	-15.8
Pretax income	16.1	15.5
Taxes	-5.5	-5.3
Net income	10.6	10.2
Price per share	$16	$15
Sharing outstanding (millions)	10.0	8.1
Stock options outstanding (millions)	0.3	0.2
Stockholders' Equity	126.6	63.6
Total Liabilities and Stockholders' Equity	533.1	386.7

Refer to the income statement above. Assuming that Luther has no convertible bonds outstanding, then for the year ending December 31, 2006 Luther's diluted earnings per share are closest to _____.
A) $1.03
B) $0.51
C) $0.82
D) $1.23
Answer: A
Explanation: Diluted EPS = Net income / (Shares outstanding + Options contracts outstanding + Shares possible from convertible bonds outstanding) = $10.6 / (10.0 + 0.3 + 0.0) = $1.03
Diff: 2 Var: 50+
Skill: Analytical
AACSB Objective: Analytic Skills

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12) 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 Var: 1
Skill: Analytical
AACSB Objective: Analytic Skills

13) 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 Var: 1
Skill: Conceptual
AACSB Objective: Analytic Skills

2.4 The Statement of Cash Flows

1) A 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 Var: 1
Skill: Conceptual
AACSB Objective: Analytic Skills

2) Which of the following is NOT a reason that the income statement does not accurately indicate how much cash a firm has earned?
A) It includes entries for the depreciation of assets.
B) It does not include entries for expenditures on inventory.
C) It does not include entries for collection of money from account receivables.
D) It includes cash inflows from services rendered.
Answer: D
Diff: 1 Var: 1
Skill: Conceptual
AACSB Objective: Analytic Skills

3) Which of the following is a way that the operating activity section of the statement of cash flows adjusts Net Income from the balance sheet?
A) It subtracts all expenses and costs related to a firm's operating activities.
B) It adds all non-cash entries related to a firm's operating activities.
C) It adds the cash that flows from investors to a firm.
D) It removes the cash used for investment purposes.
Answer: B
Diff: 1 Var: 1
Skill: Conceptual
AACSB Objective: Reflective Thinking Skills

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4) 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 it would be reflected in the change in cash.
D) None of the above answers is correct.
Answer: B
Diff: 1 Var: 1
Skill: Conceptual
AACSB Objective: Analytic Skills

5) A printing company prints a brochure for a client and then bills them for this service. At the time the printing company's financial disclosure statements are prepared, the client has not yet paid the bill for this service. How will this transaction be recorded?
A) The sale will be added to Net Income on the income statement and retained in Net Income on the statement of cash flows.
B) The sale will be added to Net Income on the income statement but deducted from Net Income on the statement of cash flows.
C) The sale will not be added to Net Income on the income statement but added to Net Income on the statement of cash flows.
D) The sale will neither be added to Net Income on the income statement nor used to adjust Net Income on the statement of cash flows.
Answer: B
Diff: 1 Var: 1
Skill: Conceptual
AACSB Objective: Analytic Skills

6) A manufacturer of plastic bottles for the medical trade purchases a new compression blow molder for its bottle production plant. How will the cost to the company of this piece of equipment be recorded?
A) It will be depreciated over time on the income statement and subtracted as a capital expenditure on the statement of cash flows.
B) It will be depreciated over time on the income statement and subtracted as Inventory on the statement of cash flows.
C) It will be depreciated over time on the income statement and therefore not be recorded separately on the statement of cash flows.
D) It will be subtracted from Gross Profit on the income statement and therefore, not be recorded separately on the statement of cash flows.
Answer: A
Diff: 1 Var: 1
Skill: Conceptual
AACSB Objective: Analytic Skills

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7) 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) not recorded on the statement of cash flows
Answer: B
Diff: 1 Var: 1
Skill: Conceptual
AACSB Objective: Analytic Skills

8) **AOS Industries Statement of Cash Flows for 2008**

Operating activities	
Net Income	3.2
Depreciation and amortization	1.4
Cash effect of changes in	
Accounts receivable	- 1.9
Accounts payable	1.0
Inventory	- 0.6
Cash from operating activities	3.1
Investment activities	
Capital expenditures	-2.2
Acquisitions and other investing activity	-0.4
Cash from investing activities	**-2.6**
Financing activities	
Dividends paid	-1.0
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	**5.7**
Change in Cash and Cash Equivalents	**6.2**

Consider the above statement of cash flows. If all amounts shown above are in millions of dollars, what were AOS Industries' retained earnings for 2008?
A) $5.2 million
B) $2.2 million
C) $4.4 million
D) $3.1 million
Answer: B
Explanation: $ 3.2 - $1 = $ 2.2 million
Diff: 2 Var: 50+
Skill: Analytical
AACSB Objective: Analytic Skills

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Use the table for the question(s) below.

AOS Industries Statement of Cash Flows for 2008

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

9) Consider the above statement of cash flows. What were AOS Industries' major means of raising money in 2008?
A) from investment activities
B) by sale of stock
C) from its operations
D) by issuing debt
Answer: D
Diff: 1 Var: 1
Skill: Analytical
AACSB Objective: Analytic Skills

10) 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 it charged.
B) It sold more inventory than it bought.
C) It charged more on its accounts payable back than it paid back.
D) All of the above are true.
Answer: D
Diff: 1 Var: 1
Skill: Analytical
AACSB Objective: Analytic Skills

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11) **AOS Industries Statement of Cash Flows for 2008**

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

Consider the above statement of cash flows. In 2008, AOS Industries had contemplated buying a new warehouse for $3 million, the cost of which would be depreciated over 10 years. If AOS Industries has a tax rate of 25%, what would be the impact for the amount of cash held by AOS at the end of the 2008?
A) It would have $3,000,000 less cash at the end of 2008.
B) It would have $2,925,000 less cash at the end of 2008.
C) It would have $1,500,000 less cash at the end of 2008.
D) It would have an additional $7,500,000 in cash at the end of 2008.
Answer: B
Explanation: - $3,000,000 + 300,000 × 25% = - $2,925,000
Diff: 3 Var: 8
Skill: Analytical
AACSB Objective: Analytic Skills

12) 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 Var: 1
Skill: Conceptual
AACSB Objective: Analytic Skills

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13) What will be the effect on the statement of cash flows if a firm buys a new processing plant through a new loan?
Answer: The new loan entry should show as a cash inflow for the firm, while the payment for the new processing plant will be entered as a cash outflow.
Diff: 3 Var: 1
Skill: Conceptual
AACSB Objective: Analytic Skills

2.5 Other Financial Statement Information

1) The management of public companies is not legally required to disclose any off-balance sheet transactions.
Answer: FALSE
Diff: 1 Var: 1
Skill: Conceptual
AACSB Objective: Analytic Skills

2) A firm whose primary business is in a line of regional grocery stores would be most likely to have to include which of the following facts, if true, in the firm's management discussion and analysis (MD&A)?
A) that a large number of funds were allocated to advertising to increase awareness of the firm's brand in new areas it had expanded into this year
B) that some senior members of the management team have retired in this financial year
C) that the company has lost a class action suit brought against the firm by its employees and is expected to have to pay a large amount of damages
D) that the firm has plans to expand into the organic food business in the next financial year by purchasing several small organic food retailers
Answer: C
Diff: 2 Var: 1
Skill: Conceptual
AACSB Objective: Ethical Understanding and Reasoning Abilities

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

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

2.6 Financial Statement Analysis

1) In general, a successful firm will have a market-to-book ratio that is substantially greater than 1.
Answer: TRUE
Diff: 1 Var: 1
Skill: Conceptual
AACSB Objective: Analytic Skills

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2)

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

Assets	**2006**	**2005**	**Liabilities and Stockholders' Equity**	**2006**	**2005**
Current Assets			*Current Liabilities*		
Cash	59.5	58.5	Accounts payable	88.9	73.5
Accounts receivable	55.1	39.6	Notes payable / short-term debt	10.4	9.6
Inventories	45.9	42.9	Current maturities of long-term debt	37.3	36.9
Other current assets	5.5	3.0	Other current liabilities	6.0	12.0
Total current assets	166.0	144.0	Total current liabilities	142.6	132.0
Long-Term Assets			*Long-Term Liabilities*		
Land	66.1	62.1	Long-term debt	236	168.9
Buildings	109.4	91.5	Capital lease obligations		
Equipment	118.5	99.6			
Less accumulated depreciation	(54.9)	(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	258.8	191.1
Other long-term assets	63.0	42.0	Total liabilities	401.4	323.1
Total long-term assets	362.1	242.7	Stockholders' Equity	126.7	63.6
Total Assets	**528.1**	**386.7**	**Total liabilities and Stockholders' Equity**	**528.1**	**386.7**

Refer to the balance sheet above. If in 2006 Luther has 10.2 million shares outstanding and these shares are trading at $16 per share, then Luther's market-to-book ratio would be closest to _____.

A) 2.58
B) 0.64
C) 1.29
D) 1.80
Answer: C
Explanation: MTB = Market Value of Equity / Book Value of Equity
= (10.2 million × 16) / 126.7 = 163.2 / 126.7 = 1.288
Diff: 2 Var: 50+
Skill: Analytical
AACSB Objective: Analytic Skills

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3)

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

Assets	**2006**	**2005**	**Liabilities and Stockholders' Equity**	**2006**	**2005**
Current Assets			*Current Liabilities*		
Cash	65.6	58.5	Accounts payable	88.8	73.5
Accounts receivable	54.3	39.6	Notes payable / short-term debt	10.7	9.6
Inventories	45.8	42.9	Current maturities of long-term debt	38.7	36.9
Other current assets	5.5	3.0	Other current liabilities	6.0	12.0
Total current assets	171.2	144.0	Total current liabilities	144.2	132.0
Long-Term Assets			*Long-Term Liabilities*		
Land	65.3	62.1	Long-term debt	234.4	168.9
Buildings	109.4	91.5	Capital lease obligations		
Equipment	116.3	99.6			
Less accumulated depreciation	(57.9)	(52.5)	Deferred taxes	22.8	22.2
Net property, plant, and equipment	233.1	200.7	Other long-term liabilities	---	---
Goodwill	60.0	--	Total long-term liabilities	257.2	191.1
Other long-term assets	63.0	42.0	Total liabilities	401.4	323.1
Total long-term assets	356.1	242.7	Stockholders' Equity	125.9	63.6
Total Assets	**527.3**	**386.7**	**Total liabilities and Stockholders' Equity**	**527.3**	**386.7**

Refer to the balance sheet above. When using the book value of equity, the debt-equity ratio for Luther in 2006 is closest to _____.
A) 4.51
B) 2.25
C) 1.13
D) 3.16
Answer: B

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Explanation: D / E = Total debt / Total equity
Total debt = Notes payable (10.7) + Current maturities of long-term debt (38.7) + Long-term debt (234.4) = 283.8 million
Total equity = 125.9, so D / E = 283.8 /125.9 = 2.25

Diff: 2 Var: 50+
Skill: Analytical
AACSB Objective: Analytic Skills

4)

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

Assets	**2006**	**2005**	**Liabilities and Stockholders' Equity**	**2006**	**2005**
Current Assets			*Current Liabilities*		
Cash	57.6	58.5	Accounts payable	86.0	73.5
Accounts receivable	55.2	39.6	Notes payable / short-term debt	10.5	9.6
Inventories	45.6	42.9	Current maturities of long-term debt	39.6	36.9
Other current assets	5.6	3.0	Other current liabilities	6.0	12.0
Total current assets	164.0	144.0	Total current liabilities	142.1	132.0
Long-Term Assets			*Long-Term Liabilities*		
Land	66.4	62.1	Long-term debt	231.3	168.9
Buildings	108.3	91.5	Capital lease obligations		
Equipment	114.3	99.6			
Less accumulated depreciation	(54.4)	(52.5)	Deferred taxes	22.8	22.2
Net property, plant, and equipment	234.6	200.7	Other long-term liabilities	---	---
Goodwill	60.0	--	Total long-term liabilities	254.1	191.1
Other long-term assets	63.0	42.0	Total liabilities	396.2	323.1
Total long-term assets	357.6	242.7	Stockholders' Equity	125.4	63.6
Total Assets	**521.6**	**386.7**	**Total liabilities and Stockholders' Equity**	**521.6**	**386.7**

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Refer to the balance sheet above. If in 2006 Luther has 10.2 million shares outstanding and these shares are trading at $16 per share, then using the market value of equity, the debt-equity ratio for Luther in 2006 is closest to _____.
A) 3.45
B) 1.72
C) 0.86
D) 2.41
Answer: B
Explanation: D / E = Total debt / Total equity
Total Debt = Notes payable (10.5) + Current maturities of long-term debt (39.6) + Long-term debt (231.3) = 281.4 million
Total equity = 10.2 × $16 = $163.2, so D / E = $281.4 / $163.2 = 1.72
Diff: 2 Var: 50+
Skill: Analytical
AACSB Objective: Analytic Skills

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5)

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

Assets	**2006**	**2005**	**Liabilities and Stockholders' Equity**	**2006**	**2005**
Current Assets			*Current Liabilities*		
Cash	56.1	58.5	Accounts payable	88.1	73.5
Accounts receivable	54.5	39.6	Notes payable / short-term debt	10.9	9.6
Inventories	44.8	42.9	Current maturities of long-term debt	40.7	36.9
Other current assets	5.0	3.0	Other current liabilities	6.0	12.0
Total current assets	160.4	144.0	Total current liabilities	145.7	132.0
Long-Term Assets			*Long-Term Liabilities*		
Land	66.8	62.1	Long-term debt	227	168.9
Buildings	108.5	91.5	Capital lease obligations		
Equipment	117.1	99.6			
Less accumulated depreciation	(54.4)	(52.5)	Deferred taxes	22.8	22.2
Net property, plant, and equipment	238	200.7	Other long-term liabilities	---	---
Goodwill	60.0	--	Total long-term liabilities	249.8	191.1
Other long-term assets	63.0	42.0	Total liabilities	395.5	323.1
Total long-term assets	361	242.7	Stockholders' Equity	125.9	63.6
Total Assets	**521.4**	**386.7**	**Total liabilities and Stockholders' Equity**	**521.4**	**386.7**

Refer to the balance sheet above. If in 2006 Luther has 10.2 million shares outstanding and these shares are trading at $16 per share, then what is Luther's enterprise value?
A) - $540.0 million
B) $771.4 million
C) $385.7 million
D) $521.4 million
Answer: C
Explanation: Enterprise value = Market Value of Equity + Debt - Cash = (10.2 × $16) + $ 278.6 - $ 56.1 = $ 385.7
Diff: 2 Var: 50+
Skill: Analytical
AACSB Objective: Analytic Skills

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6)

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

Assets	**2006**	**2005**	**Liabilities and Stockholders' Equity**	**2006**	**2005**
Current Assets			*Current Liabilities*		
Cash	53.6	58.5	Accounts payable	89.2	73.5
Accounts receivable	55.8	39.6	Notes payable / short-term debt	10.3	9.6
Inventories	45.5	42.9	Current maturities of long-term debt	38.6	36.9
Other current assets	5.4	3.0	Other current liabilities	6.0	12.0
Total current assets	160.3	144.0	Total current liabilities	144.1	132.0
Long-Term Assets			*Long-Term Liabilities*		
Land	66.2	62.1	Long-term debt	228.7	168.9
Buildings	107.7	91.5	Capital lease obligations		
Equipment	120.6	99.6			
Less accumulated depreciation	(57.1)	(52.5)	Deferred taxes	22.8	22.2
Net property, plant, and equipment	237.4	200.7	Other long-term liabilities	---	---
Goodwill	60.0	--	Total long-term liabilities	251.5	191.1
Other long-term assets	63.0	42.0	Total liabilities	395.6	323.1
Total long-term assets	360.4	242.7	Stockholders' Equity	125.1	63.6
Total Assets	**520.7**	**386.7**	**Total liabilities and Stockholders' Equity**	**520.7**	**386.7**

Refer to the balance sheet above. Luther's current ratio for 2006 is closest to _____.
A) 1.67
B) 2.22
C) 0.56
D) 1.11
Answer: D
Explanation: Current ratio = Current assets / Current liabilities = $160.3 / $144.1 = 1.11
Diff: 2 Var: 50+
Skill: Analytical
AACSB Objective: Analytic Skills

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7)

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

Assets	**2006**	**2005**	**Liabilities and Stockholders' Equity**	**2006**	**2005**
Current Assets			*Current Liabilities*		
Cash	65.7	58.5	Accounts payable	87.7	73.5
Accounts receivable	54.4	39.6	Notes payable / short-term debt	9.6	9.6
Inventories	46.1	42.9	Current maturities of long-term debt	39.9	36.9
Other current assets	5.1	3.0	Other current liabilities	6.0	12.0
Total current assets	171.3	144.0	Total current liabilities	143.2	132.0
Long-Term Assets			*Long-Term Liabilities*		
Land	66.6	62.1	Long-term debt	237.7	168.9
Buildings	106.2	91.5	Capital lease obligations		
Equipment	119.3	99.6			
Less accumulated depreciation	(56.6)	(52.5)	Deferred taxes	22.8	22.2
Net property, plant, and equipment	235.5	200.7	Other long-term liabilities	---	---
Goodwill	60.0	--	Total long-term liabilities	260.5	191.1
Other long-term assets	63.0	42.0	Total liabilities	403.7	323.1
Total long-term assets	358.5	242.7	Stockholders' Equity	126.1	63.6
Total Assets	**529.8**	**386.7**	**Total liabilities and Stockholders' Equity**	**529.8**	**386.7**

Refer to the balance sheet above. Luther's quick ratio for 2006 is closest to _____.
A) 0.87
B) 1.75
C) 0.88
D) 1.31
Answer: A
Explanation: Quick ratio = (Current assets - Inventory) / Current liabilities
Quick ratio = ($171.3 - $46.1) / $143.2 = 0.87
Diff: 2 Var: 50+
Skill: Analytical
AACSB Objective: Analytic Skills

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8)

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

Assets	**2006**	**2005**	**Liabilities and Stockholders' Equity**	**2006**	**2005**
Current Assets			*Current Liabilities*		
Cash	52.4	58.5	Accounts payable	88.9	73.5
Accounts receivable	54.6	39.6	Notes payable / short-term debt	9.3	9.6
Inventories	46.5	42.9	Current maturities of long-term debt	39.9	36.9
Other current assets	5.4	3.0	Other current liabilities	6.0	12.0
Total current assets	158.9	144.0	Total current liabilities	144.1	132.0
Long-Term Assets			*Long-Term Liabilities*		
Land	65.8	62.1	Long-term debt	224.8	168.9
Buildings	107.6	91.5	Capital lease obligations		
Equipment	118.3	99.6			
Less accumulated depreciation	(56.4)	(52.5)	Deferred taxes	22.8	22.2
Net property, plant, and equipment	235.3	200.7	Other long-term liabilities	---	---
Goodwill	60.0	--	Total long-term liabilities	247.6	191.1
Other long-term assets	63.0	42.0	Total liabilities	391.7	323.1
Total long-term assets	358.3	242.7	Stockholders' Equity	125.5	63.6
Total Assets	**517.2**	**386.7**	**Total liabilities and Stockholders' Equity**	**517.2**	**386.7**

Refer to the balance sheet above. The change in Luther's quick ratio from 2005 to 2006 is closest to _____.
A) a decrease of 0.01
B) an increase of 0.01
C) a decrease of 0.02
D) an increase of 0.02
Answer: B
Explanation: Quick ratio in 2006 = ($ 158.9 - $ 46.5) / $ 144.1 = 0.78
Quick ratio in 2005 = ($144.0 - $42.9) / 132 = 0.77
So, the quick ratio increased by 0.78 - 0.77 = 0.01.
Diff: 3 Var: 50+
Skill: Analytical
AACSB Objective: Analytic Skills

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9) 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 is greater than their liquidation value.
Answer: B
Diff: 1 Var: 1
Skill: Analytical
AACSB Objective: Analytic Skills

10) GenCorp. has a total debt of $140 million and stockholders' equity of $50 million. It also has 26 million shares outstanding, with a market price of $4.00 per share. What is GenCorp's market debt-equity ratio?
A) 0.67
B) 1.08
C) 2.80
D) 1.35
Answer: D
Explanation: 140 / ($ 4.00 × 26) = 1.35
Diff: 2 Var: 50+
Skill: Analytical
AACSB Objective: Analytic Skills

11) A company has a share price of $22.15 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) $1.9 billion
B) $3.044 billion
C) $4.566 billion
D) $3.8 billion
Answer: D
Explanation: Market cap = $ 22.15 × 118 = $2.614 billion;
Book value of equity = $2.614 / 4.2 = 0.622 billion; Debt = $0.622 × 3.2 = 1.991;
Enterprise value = $2.614 + $1.991 - $0.800 = $3.805 billion
Diff: 3 Var: 50+
Skill: Analytical
AACSB Objective: Analytic Skills

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12) Convex Industries has inventories of $218 million, current assets of $1.4 billion, and current liabilities of $504 million. What is its quick ratio?
A) 1.17
B) 0.94
C) 2.81
D) 2.35
Answer: D
Explanation: ($ 1400 - $ 218) / $ 504 = 2.35
Diff: 2 Var: 50+
Skill: Analytical
AACSB Objective: Analytic Skills

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

14) Company A has current assets of $42 billion and current liabilities of $41 billion. Company B has current assets of $2.7 billion and current liabilities of $1.8 billion. Which of the following statements is correct, based on this information?
A) Company A is less likely than Company B to have sufficient working capital to meet its short-term needs.
B) Company A has greater leverage than Company B.
C) Company A has less leverage than Company B.
D) Company A and Company B have roughly equivalent enterprise values.
Answer: A
Diff: 3 Var: 1
Skill: Analytical
AACSB Objective: Analytic Skills

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Use the table for the question(s) below.

Balance Sheet

Assets	**2007**	**2008**	**Liabilities**	**2007**	**2008**
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**
			Stockholders' Equity	**33**	**23**
Total Assets	**210**	**212**	**Total Liabilities and Stockholders' Equity**	**210**	**212**

15) If the above balance sheet is for a retail company, what indications about this company would best be drawn from the changes in the balance sheet between 2007 and 2008?
A) The company is having difficulties selling its product.
B) The company has reduced its debt.
C) The company has added a major new asset in terms of plant and equipment.
D) The company has experienced a significant rise in its market value.
Answer: A
Diff: 2 Var: 1
Skill: Analytical
AACSB Objective: Analytic Skills

16) If the above balance sheet is for a retail company, what indications about this company would best be drawn from the changes in stockholders' equity between 2007 and 2008?
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) No conclusions can be drawn regarding stockholders' equity without additional information.
Answer: C
Diff: 2 Var: 1
Skill: Analytical
AACSB Objective: Analytic Skills

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17) If the above balance sheet is for a retail company, what indications about this company would best be drawn from the changes in quick ratio between 2007 and 2008?
A) The company has eliminated the risk that it will experience a cash shortfall in the near future.
B) The company has reduced the risk that it will experience a cash shortfall in the near future.
C) The risk that the company will experience a cash shortfall in the near future is unchanged.
D) The company has increased the risk that it will experience a cash shortfall in the near future.
Answer: D
Diff: 2 Var: 1
Skill: Analytical
AACSB Objective: Analytic Skills

18) If the above balance sheet is for a retail company, how has the company's leverage changed between 2007 and 2008?
A) The company has experienced a very significant decrease in its leverage.
B) The company has experienced a significant decrease in its leverage.
C) The company has experienced no significant change in its leverage.
D) The company has experienced a significant increase in its leverage.
Answer: D
Diff: 3 Var: 1
Skill: Analytical
AACSB Objective: Analytic Skills

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Use the table for the question(s) below.

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

	2006	2005
Total sales	610.1	578.3
Cost of sales	(500.2)	(481.9)
Gross profit	109.9	96.4
Selling, general, and administrative expenses	(40.5)	(39.0)
Research and development	(24.6)	(22.8)
Depreciation and amortization	(3.6)	(3.3)
Operating income	41.2	31.3
Other income	---	---
Earnings before interest and taxes (EBIT)	41.2	31.3
Interest income (expense)	(25.1)	(15.8)
Pretax income	16.1	15.5
Taxes	(5.5)	(5.3)
Net income	10.6	10.2
Price per share	$16	$15
Shares outstanding (millions)	10.2	8.0
Stock options outstanding (millions)	0.3	0.2
Stockholders' Equity	126.6	63.6
Total Liabilities and Stockholders' Equity	533.1	386.7

19) Refer to the partial balance sheet above. If on December 31, 2005 Luther has 8 million shares outstanding trading at $15 per share, then what is Luther's market-to-book ratio?
Answer: Market-to-book = Market value of equity / Book value of equity
Market-to-book = 8 million × $15 / $63.6 = 1.89
Diff: 2 Var: 1
Skill: Analytical
AACSB Objective: Analytic Skills

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Use the table for the question(s) below.

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

Assets	**2006**	**2005**	**Liabilities and Stockholders' Equity**	**2006**	**2005**
Current Assets			*Current Liabilities*		
Cash	63.6	58.5	Accounts payable	87.6	73.5
Accounts receivable	55.5	39.6	Notes payable / short-term debt	10.5	9.6
Inventories	45.9	42.9	Current maturities of long-term debt	39.9	36.9
Other current assets	6.0	3.0	Other current liabilities	6.0	12.0
Total current assets	171.0	144.0	Total current liabilities	144.0	132.0
Long-Term Assets			*Long-Term Liabilities*		
Land	66.6	62.1	Long-term debt	239.7	168.9
Buildings	109.5	91.5	Capital lease obligations	---	---
Equipment	119.1	99.6	Total Debt	239.7	168.9
Less accumulated depreciation	(56.1)	(52.5)	Deferred taxes	22.8	22.2
Net property, plant, and equipment	239.1	200.7	Other long-term liabilities	---	---
Goodwill	60.0	--	Total long-term liabilities	262.5	191.1
Other long-term assets	63.0	42.0	Total liabilities	406.5	323.1
Total long-term assets	362.1	242.7	Stockholders' Equity	126.6	63.6
Total Assets	**533.1**	**386.7**	**Total liabilities and Stockholders' Equity**	**533.1**	**386.7**

20) Refer to the balance sheet above. If on December 31, 2005 Luther has 8 million shares outstanding trading at $15 per share, then what is Luther's enterprise value?
Answer: Enterprise value = Market value of equity + Debt - Cash
Market value of equity = 8 million × $15 = $120 million
Debt = Notes payable + Current maturities of long-term debt + Long-term debt
Debt = $9.6 + $36.9 + $168.9 = $215.4
Cash = $58.5
So, enterprise value = $120 + 215.4 - 58.5 = $276.90.
Diff: 2 Var: 1
Skill: Analytical
AACSB Objective: Analytic Skills

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21) How does a firm select the date for preparation of its balance sheet?
Answer: The balance sheet is prepared on the fiscal closing date for the accounts of a firm that may or may not coincide with the calendar year-end of December 31st.
Diff: 3 Var: 1
Skill: Analytical
AACSB Objective: Analytic Skills

22) What will be the effect on the balance sheet if a firm buys a new processing plant through a new loan?
Answer: The Assets side will increase under Net property, plant, and equipment with the net effect of the new processing plant, while the Liabilities side will correspondingly show the new debt that was incurred in paying for the plant.
Diff: 3 Var: 1
Skill: Conceptual
AACSB Objective: Reflective Thinking Skills

23) Price-earnings ratios tend to be high for fast-growing firms.
Answer: TRUE
Diff: 1 Var: 1
Skill: Conceptual
AACSB Objective: Analytic Skills

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

	2006	**2005**
Total sales	610.1	562.8
Cost of sales	-500.2	- 380.8
Gross profit	109.9	182
Selling, general, and administrative expenses	-40.5	- 40.7
Research and development	-24.6	- 23.4
Depreciation and amortization	-3.6	- 3.3
Operating income	41.2	114.6
Other income	--	--
Earnings before interest and taxes (EBIT)	41.2	114.6
Interest income (expense)	-25.1	- 14.1
Pretax income	16.1	100.5
Taxes	-5.5	- 35.175
Net income	10.6	65.325
Price per share	$16	$15
Sharing outstanding (millions)	10.2	8.0
Stock options outstanding (millions)	0.3	0.2
Stockholders' Equity	126.6	63.6
Total Liabilities and Stockholders' Equity	533.1	386.7

Refer to the income statement above. Luther's operating margin for the year ending December 31, 2005 is closest to _____.
A) 10.18%
B) 16.29%
C) 20.36%
D) 24.43%
Answer: C
Explanation: Operating margin = Operating income / Sales = $ 114.6 / $ 562.8 = 0.2036 or 20.36%
Diff: 1 Var: 50+
Skill: Analytical
AACSB Objective: Analytic Skills

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

	2006	2005
Total sales	610.1	569.6
Cost of sales	-500.2	- 389.2
Gross profit	109.9	180.4
Selling, general, and administrative expenses	-40.5	- 39.6
Research and development	-24.6	- 21.6
Depreciation and amortization	-3.6	- 3.3
Operating income	41.2	115.9
Other income	--	--
Earnings before interest and taxes (EBIT)	41.2	115.9
Interest income (expense)	-25.1	- 14.2
Pretax income	16.1	101.7
Taxes	-5.5	- 35.595
Net income	10.6	66.105
Price per share	$16	$15
Sharing outstanding (millions)	10.2	8.0
Stock options outstanding (millions)	0.3	0.2
Stockholders' Equity	126.6	63.6
Total Liabilities and Stockholders' Equity	533.1	386.7

Refer to the income statement above. Luther's net profit margin for the year ending December 31, 2005 is closest to _____.
A) 11.61%
B) 5.80%
C) 9.28%
D) 13.93%
Answer: A
Explanation: Net profit margin = Net income / Sales = $66.105 / $569.6 = 0.1161 or 11.61%
Diff: 1 Var: 50+
Skill: Analytical
AACSB Objective: Analytic Skills

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

	2006	2005
Total sales	610.1	553.6
Cost of sales	-500.2	- 357.1
Gross profit	109.9	196.5
Selling, general, and administrative expenses	-40.5	- 38.8
Research and development	-24.6	- 21.8
Depreciation and amortization	-3.6	- 3.4
Operating income	41.2	132.5
Other income	--	--
Earnings before interest and taxes (EBIT)	41.2	132.5
Interest income (expense)	-25.1	- 15.9
Pretax income	16.1	116.6
Taxes	-5.5	- 40.81
Net income	10.6	75.79
Price per share	$16	$15
Sharing outstanding (millions)	10.2	8.0
Stock options outstanding (millions)	0.3	0.2
Stockholders' Equity	126.6	63.6
Total Liabilities and Stockholders' Equity	533.1	386.7

Refer to the income statement above. Luther's earnings before interest, taxes, depreciation, and amortization (EBITDA) for the year ending December 31, 2005 is closest to _____.
A) $271.8 million
B) $108.7 million
C) $163.1 million
D) $135.9 million
Answer: D
Explanation: EBITDA = EBIT + Depreciation and amortization = $132.5 + $3.4 = $135.9 million
Diff: 1 Var: 50+
Skill: Analytical
AACSB Objective: Analytic Skills

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

	2006	**2005**
Total sales	610.1	579.1
Cost of sales	-500.2	- 378.8
Gross profit	109.9	200.3
Selling, general, and administrative expenses	-40.5	- 39.6
Research and development	-24.6	- 20.9
Depreciation and amortization	-3.6	- 3.7
Operating income	41.2	136.1
Other income	--	--
Earnings before interest and taxes (EBIT)	41.2	136.1
Interest income (expense)	-25.1	- 15.2
Pretax income	16.1	120.9
Taxes	-5.5	- 42.315
Net income	10.6	78.585
Price per share	$16	$15
Sharing outstanding (millions)	10.2	8.0
Stock options outstanding (millions)	0.3	0.2
Stockholders' Equity	126.6	63.6
Total Liabilities and Stockholders' Equity	533.1	386.7

Refer to the income statement above. Luther's return on equity (ROE) for the year ending December 31, 2005 is closest to _____.
A) 247.12%
B) 98.85%
C) 123.56%
D) 148.27%
Answer: C
Explanation: ROE = Net income / Shareholders' equity = $78.585 / $63.6 = 1.2356 or 123.56%
Diff: 2 Var: 50+
Skill: Analytical
AACSB Objective: Analytic Skills

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

	2006	2005
Total sales	610.1	564.9
Cost of sales	-500.2	- 360.5
Gross profit	109.9	204.4
Selling, general, and administrative expenses	-40.5	- 40.5
Research and development	-24.6	- 23.5
Depreciation and amortization	-3.6	- 3.4
Operating income	41.2	137
Other income	--	--
Earnings before interest and taxes (EBIT)	41.2	137
Interest income (expense)	-25.1	- 14.3
Pretax income	16.1	122.7
Taxes	-5.5	- 42.945
Net income	10.6	79.755
Price per share	$16	$15
Sharing outstanding (millions)	10.2	8.0
Stock options outstanding (millions)	0.3	0.2
Stockholders' Equity	126.6	63.6
Total Liabilities and Stockholders' Equity	533.1	386.7

Refer to the income statement above. Luther's return on assets (ROA) for the year ending December 31, 2005 is closest to _____.
A) 24.32%
B) 48.64%
C) 19.46%
D) 1.99%
Answer: A
Explanation: ROA = (Net income + Interest Expense) / 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 = ($79.755 + $14.3) / $386.7 = 0.2432 or 24.32%.
Diff: 3 Var: 50+
Skill: Analytical
AACSB Objective: Analytic Skills

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Use the table for the question(s) below.

Income Statement for Xenon Manufacturing:

	2008	**2009**
Total sales	202	212
Cost of sales	-148	-172
Gross Profit	54	40
Selling, general, and administrative expenses	-22	-20
Research and development	-8	-7
Depreciation and amortization	-4	-3
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

29) Consider the above Income Statement for Xenon Manufacturing. All values are in millions of dollars. Calculate the operating margin for 2008 and 2009. What does the change in the operating margin between these two years imply about the company?
A) The efficiency of Xenon Manufacturing has significantly risen between 2008 and 2009.
B) The ability of Xenon Manufacturing to sell its goods and services for more than the costs of producing them rose between 2008 and 2009.
C) The efficiency of Xenon Manufacturing has significantly fallen between 2008 and 2009.
D) The leverage of Xenon Manufacturing fell slightly between 2008 and 2009.
Answer: C
Explanation: 24 / 202 = 0.12; 16 / 212 = 0.08
Diff: 3 Var: 1
Skill: Analytical
AACSB Objective: Analytic Skills

30) Consider the above Income Statement for Xenon Manufacturing. All values are in millions of dollars. Calculate the gross margin for 2008 and 2009. 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 2008 and 2009.
B) The ability of Xenon Manufacturing to sell its goods and services for more than the costs of producing them rose between 2008 and 2009.
C) The ability of Xenon Manufacturing to sell its goods and services for more than the costs of producing them fell between 2008 and 2009.
D) The leverage of Xenon Manufacturing fell slightly between 2008 and 2009.
Answer: C
Diff: 3 Var: 1
Skill: Analytical
AACSB Objective: Analytic Skills

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31) In 2009, an agricultural company introduced a new cropping process which reduced the cost of growing some of its crops. If sales in 2008 and 2009 were steady at $30 million, but the gross margin increased from 2.8% to 3.9% between those years, by what amount was the cost of sales reduced?
A) $330,000
B) $660,000
C) $264,000
D) $462,000
Answer: A
Explanation: [($ 30 × 3.9%) - ($20 × 2.8%)] × 1,000,000 = $330,000
Diff: 2 Var: 27
Skill: Analytical
AACSB Objective: Analytic Skills

32)

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

Firm B:	
Assets	
Current assets	7
Fixed assets	7
Total assets	**14**

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

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

Above are portions of the balance sheet and income statement for two companies in 2008. Based upon this information, which of the following statements is most likely to be true?
A) Asset turnover ratios indicate that firm A is generating greater revenue per dollar of assets than firm B.
B) Fixed asset turnover ratios indicate that firm A generating fewer sales for the assets it employs 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 it employs than firm B.
Answer: B
Diff: 3 Var: 1
Skill: Analytical
AACSB Objective: Analytic Skills

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33) **Balance Sheet**

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

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

The balance sheet and income statement of a particular firm are shown above. What does the account receivable days ratio tell you about this company?
A) It takes on average about 4 weeks to collect payment from its customers.
B) It takes on average about 6 weeks to collect payment from its customers.
C) It takes on average about 7 weeks to collect payment from its customers.
D) It takes on average about 11 weeks to collect payment from its customers.
Answer: A
Diff: 2 Var: 1
Skill: Analytical
AACSB Objective: Analytic Skills

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34) Which of the following is the LEAST likely explanation for a firm's high ROE?
A) The firm is growing.
B) The firm is able to find investment opportunities that are very profitable.
C) The firm has very efficient use of its assets.
D) The firm enjoys high sales margins.
Answer: A
Diff: 2 Var: 1
Skill: Analytical
AACSB Objective: Analytic Skills

35) Which of the following firms would be expected to have a high ROE?
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
Answer: D
Diff: 1 Var: 1
Skill: Conceptual
AACSB Objective: Reflective Thinking Skills

36) 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
Answer: A
Diff: 1 Var: 1
Skill: Conceptual
AACSB Objective: Reflective Thinking Skills

37) Manufacturer A has a profit margin of 2.2%, an asset turnover of 1.7 and an equity multiplier of 5.0.
Manufacturer B has a profit margin of 2.5%, an asset turnover of 1.2 and an equity multiplier of 4.7.
How much asset turnover should manufacturer B have to match manufacturer A's ROE?
A) 1.59%
B) 3.18%
C) 2.23%
D) 1.27%
Answer: A
Explanation: $ROE_A = 2.2 \times 1.7 \times 5.0 = 18.7$; $18.7 / (2.5 \times 4.7) = 1.59$
Diff: 3 Var: 50+
Skill: Analytical
AACSB Objective: Analytic Skills

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

The above data is for four regional trucking firms. Based on price-earnings ratios, which firm's stock is the best value?
A) Firm A
B) Firm B
C) Firm C
D) Firm D
Answer: B
Diff: 2 Var: 1
Skill: Analytical
AACSB Objective: Analytic Skills

39) Why must care be taken when comparing a firm's share price to its operating income?
A) Both share price and operating income are related to the whole firm.
B) Share price is a quantity related to the entire firm, while operating income is an amount that is related solely to equity holders.
C) Both share price and operating income are related solely to equity holders.
D) Share price is a quantity related to equity holders, while operating income is an amount that is related to the whole firm.
Answer: D
Diff: 1 Var: 1
Skill: Conceptual
AACSB Objective: Analytic Skills

2.7 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 Var: 1
Skill: Conceptual
AACSB Objective: Ethical Understanding and Reasoning Abilities

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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 off-balance sheet promises to repurchase assets should have been disclosed in management discussion and analysis (MD&A) or notes to the financial statement.
D) Both B and C are deceptive.
Answer: D
Diff: 2 Var: 1
Skill: Conceptual
AACSB Objective: Ethical Understanding and Reasoning Abilities

3) WorldCom classified $3.85 billion in operating expenses as long-term investments. How would this make WorldCom's financial statements more attractive to investors?
A) by decreasing depreciation
B) by reducing capital expenditures
C) by raising its reported earnings
D) by boosting its cash flows
Answer: C
Diff: 2 Var: 1
Skill: Conceptual
AACSB Objective: Ethical Understanding and Reasoning Abilities

4) Which of the following is NOT one of the ways that the Sarbanes-Oxley Act sought to improve the accuracy of information given to both boards and shareholders?
A) by increasing the penalties to firms for providing false information
B) by increasing the independence of auditors and clients
C) by decreasing the non-audit fees that an auditor can receive from a client
D) by forcing companies to audit financial statements they release
Answer: D
Diff: 1 Var: 1
Skill: Conceptual
AACSB Objective: Ethical Understanding and Reasoning Abilities

5) What are the requirements of section 404 of SOX?
A) It requires that senior management return any profits or bonuses resulting from stock sales during any period covered by financial statements that must later be restated.
B) It requires that auditors do not perform any non-auditing tasks for the companies they audit.
C) It requires that audit partners rotate every five years.
D) It requires that senior management and the boards of public companies attest to the effectiveness and validity of their financial control process.
Answer: D
Diff: 1 Var: 1
Skill: Conceptual
AACSB Objective: Ethical Understanding and Reasoning Abilities

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6) 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.
Answer: D
Diff: 1 Var: 1
Skill: Conceptual
AACSB Objective: Ethical Understanding and Reasoning Abilities

7) What role do external auditors play in a firm's financial reporting process?
Answer: As the name implies, external auditors act as third party monitors to a firm's financial reporting process.
Diff: 1 Var: 1
Skill: Conceptual
AACSB Objective: Ethical Understanding and Reasoning Abilities

8) What role does Generally Accepted Accounting Principles (GAAP) play in the accounting process?
Answer: All firms quoted on a U.S. exchange are required to use GAAP in their financial reporting process. This standardization process makes it easier to adjust and/or compare the financial figures across different firms.
Diff: 1 Var: 1
Skill: Conceptual
AACSB Objective: Ethical Understanding and Reasoning Abilities

9) State the names of some of the firms discussed in the chapter that had inaccurate reporting in their financial statements.
Answer: Examples of some firms that had practiced inaccurate reporting are Enron and WorldCom.
Diff: 1 Var: 1
Skill: Conceptual
AACSB Objective: Ethical Understanding and Reasoning Abilities

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10) According to the text, did Enron and WorldCom follow Generally Accepted Accounting Principles (GAAP) in their financial reporting process?
Answer: Many of the problems of Enron and WorldCom were kept hidden from boards and shareholders, until it was too late. People felt that the accounting statements of these companies, while often remaining true to the letter of GAAP, did not present an accurate picture of the financial health of the company.
Diff: 2 Var: 1
Skill: Conceptual
AACSB Objective: Ethical Understanding and Reasoning Abilities

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