Foundations of Financial Management (Canadian) 11th edition Block Test Bank

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Chapter 02
Review of Accounting

Multiple Choice Questions

1. Which of the following is not one of the four basic financial statements required by Accounting Standards for Private Enterprises (ASPE)?
A. Income Statement
B. Statement of Financial Position
C. Statement of Cash Flows
D. Balance Sheet

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-01 Accounting for Information

2. Which of the following would not be classified as a current asset?
A. Marketable securities
B. Long term Investments
C. Prepaid expenses
D. Inventory

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

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3. An item that may be converted to cash within one year or one operating cycle of the firm is classified as a:
A. current liability.
B. long-term asset.
C. current asset.
D. long-term liability.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-08 Statement of Cash Flows

4. Which of the following is not a primary source of capital to the firm?
A. Assets
B. Common stock
C. Preferred stock
D. Bonds

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-03 Return on Capital

5. The residual income of the firm belongs to:
A. creditors.
B. preferred shareholders.
C. common shareholders.
D. bondholders.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

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6. The best indication of the operational efficiency of management is:
A. net income.
B. earnings per share.
C. earnings before interest and taxes (EBIT).
D. gross profit.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-02 Income Statement

7. Which account represents the cumulative earnings of the firm since its formation, minus dividends paid?
A. Share price
B. Common stock
C. Retained earnings
D. Accumulated amortization

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

8. A firm has $3,500,000 in its common stock account and $2,500,000 in its retained earnings account. The firm issued 100,000 shares of common stock. What was the original issue price if only one stock issue has ever been sold?
A. $35 per share
B. $25 per share
C. $60 per share
D. Not enough information to tell

Accessibility: Keyboard Navigation
Blooms: Apply
Difficulty: Medium
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

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9. A firm has $2,000,000 in its common stock account and $20,000,000 in its retained earnings account. The firm issued 500,000 shares of common stock. What are accumulated earnings per share?
A. $4 per share
B. $44 per share
C. $40 per share
D. $5 per share

Accessibility: Keyboard Navigation
Blooms: Apply
Difficulty: Medium
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

10. The major limitation of financial statements is:
A. in their complexity.
B. in their lack of comparability.
C. in their use of historical cost accounting.
D. in their lack of detail.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-03 Examine the limitations of the balance sheet as a measure of a firm's financial position.
Topic: 02-10 Determining Cash Flows from Operating Activities

11. Inflation has its major impact on balance sheets in which of the following areas?
A. Inventory and accounts payable
B. Plant and equipment and long-term debt
C. Plant and equipment and inventory
D. Interest expense and earnings per share

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Hard
Learning Objective: 02-03 Examine the limitations of the balance sheet as a measure of a firm's financial position.
Topic: 02-10 Determining Cash Flows from Operating Activities

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12. "Inventory profits" are most likely to occur in an inflationary economy under which of the following inventory cost assumptions?
A. Weighted average
B. Specific item
C. FIFO
D. Lower of cost or market

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-03 Examine the limitations of the balance sheet as a measure of a firm's financial position.
Topic: 02-10 Determining Cash Flows from Operating Activities

13. The orientation of book value per share is _____, while the orientation of market value per share is _____.
A. short term; long term
B. future; historical
C. historical; future
D. long term; short term

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

14. A firm with earnings per share of $5 and a price-earnings ratio of 15 will have a share price of?
A. $20.00
B. $75.00
C. $3.00
D. The market assigns a stock price independent of EPS and the P/E ratio

Accessibility: Keyboard Navigation
Blooms: Apply
Difficulty: Easy
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-04 Valuation Basics from the Income Statement

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15. Earnings per share is:
A. operating profit divided by number of shares outstanding.
B. net income divided by number of shares outstanding.
C. net income divided by shareholders' equity.
D. net income minus preferred dividends divided by number of shares outstanding.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-04 Valuation Basics from the Income Statement

16. Which of the following is an outflow of cash?
A. Profitable operations
B. The sale of equipment
C. The sale of the company's common stock
D. The payment of cash dividends

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-13 Combining the Three Sections of the Statement

17. Which of the following is an inflow of cash?
A. Funds spent in normal business operations
B. The purchase of a new factory
C. The sale of the firm's bonds
D. The retirement of the firm's bonds

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-13 Combining the Three Sections of the Statement

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18. Amortization is a source of cash inflow because:
A. it is a tax-deductible noncash expense.
B. it supplies cash for future asset purchases.
C. it is a tax-deductible cash expense.
D. it is a taxable expense.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-13 Combining the Three Sections of the Statement

19. Assuming a tax rate of 35%, amortization expenses of $400,000 will:
A. reduce income by $140,000.
B. reduce taxes by $140,000.
C. reduce taxes by $400,000.
D. have no effect on income or taxes, since amortization is not a cash expense.

Accessibility: Keyboard Navigation
Blooms: Apply
Difficulty: Easy
Learning Objective: 02-08 Explain the concept of tax savings for companies.
Topic: 02-24 Amortization (Capital Cost Allowance) as a Tax Shield

20. Assuming a tax rate of 30%, the after tax cost of interest expense of $200,000 is:
A. $60,000.
B. $140,000.
C. $200,000.
D. $120,000.

Accessibility: Keyboard Navigation
Blooms: Apply
Difficulty: Easy
Learning Objective: 02-08 Explain the concept of tax savings for companies.
Topic: 02-23 Cost of a Tax-deductible Expense

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21. Gross profit is equal to:
A. sales minus cost of goods sold.
B. sales minus (selling and administrative expenses).
C. sales minus (cost of goods sold and selling and administrative expenses).
D. sales minus (cost of goods sold and amortization expense).

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-02 Income Statement

22. The firm's price-earnings (P/E) ratio is not influenced by its:
A. capital structure.
B. earnings volatility.
C. sales, profit margins, and earnings.
D. Purchase of machinery.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-04 Valuation Basics from the Income Statement

23. Total shareholders' equity consists of:
A. preferred stock and common stock.
B. common stock and retained earnings.
C. common stock and contributed surplus.
D. preferred stock, common stock, contributed surplus, and retained earnings.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-03 Return on Capital

Foundations of Financial Management (Canadian) 11th edition Block Test Bank

24. The Balance Sheet cannot show:
A. the current ratio.
B. the value of common stock outstanding.
C. the change in retained earnings.
D. the price earnings relationship.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-03 Examine the limitations of the balance sheet as a measure of a firm's financial position.
Topic: 02-10 Determining Cash Flows from Operating Activities

25. Well prepared accounting statements:
A. let management know if cash flow from internal operations is large enough to make necessary equipment replacements.
B. provide no new information to financial managers.
C. determine the market price of common stock.
D. eliminate the effects of inflation from decision making.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-03 Examine the limitations of the balance sheet as a measure of a firm's financial position.
Topic: 02-10 Determining Cash Flows from Operating Activities

26. The Glorious Vander Built Denim Slacks Company has taxable income of $100,000. Assuming a 34% tax rate, what is the tax payable?
A. $34,000
B. $66,000
C. $100,000
D. $12,250

Accessibility: Keyboard Navigation
Blooms: Apply
Difficulty: Easy
Learning Objective: 02-06 Outline the effect of corporate tax considerations on aftertax cash flow.
Topic: 02-20 Corporate Tax Rates

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27. Book value of a firm:
A. is usually the same as the firm's market value.
B. is based on current asset costs.
C. is the same as net worth.
D. none of the choices are correct.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

28. A statement of cash flows allows a financial analyst to determine:
A. whether a cash dividend is affordable.
B. how increase in asset accounts have been financed.
C. whether long-term assets are being financed with long-term or short-term financing.
D. all of the choices are correct.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-11 Determining Cash Flows from Investing Activities

29. A firm has $200,000 in current assets, $400,000 in long-term assets, $80,000 in current liabilities, and $200,000 in long-term liabilities. What is its net working capital?
A. $120,000
B. $320,000
C. $520,000
D. None of the choices are correct

Accessibility: Keyboard Navigation
Blooms: Apply
Difficulty: Medium
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

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30. A firm has current assets of $25,000, long term assets of $100,000, long term liabilities of $50,000, and $50,000 in shareholders' equity. What is its net working capital?
A. $0
B. $50,000
C. $100,000
D. $25,000

Accessibility: Keyboard Navigation
Blooms: Apply
Difficulty: Medium
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

31. Assuming a tax rate of 40%, the after tax cost of a $200,000 dividend payment is:
A. $200,000.
B. $70,000.
C. $130,000.
D. None of the choices are correct

Accessibility: Keyboard Navigation
Blooms: Apply
Difficulty: Medium
Learning Objective: 02-07 Identify the different forms of investment income and the effects on investors' taxes payable.
Topic: 02-22 Personal Taxes

32. Which of the following would not be included in the balance sheet investment account?
A. Shares of other corporations
B. Long term government bonds
C. Marketable securities
D. Investments in other corporations

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

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33. Which of the following is not true of current cost accounting?
A. The book value of equipment is near replacement value
B. The book value of the common stock equals market value
C. Dividends and income are adjusted for inflation
D. All of the choices are correct

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-03 Examine the limitations of the balance sheet as a measure of a firm's financial position.
Topic: 02-10 Determining Cash Flows from Operating Activities

34. The primary disadvantage of accrual accounting is that:
A. it does not match revenues and expenses in the period in which they are incurred.
B. it does not appropriately measure accounting profit.
C. it does not recognize the actual exchange of cash.
D. it does not adequately show the actual cash flow position of the firm.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-02 Income Statement

35. The statement of cash flows does not include which of the following sections?
A. Cash flows from operating activities
B. Cash flows from sales activities
C. Cash flows from investing activities
D. Cash flows from financing activities

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-12 Determining Cash Flows from Financing Activities

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36. Which of the following would represent a use of funds and, indirectly, a reduction in cash balances?
A. An increase in inventories.
B. A decrease in marketable securities.
C. An increase in accounts payable.
D. The sale of new bonds by the firm.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-13 Combining the Three Sections of the Statement

37. Which of the following would represent a source of funds and, indirectly, an increase in cash balances?
A. A reduction in accounts receivable.
B. The repurchase of shares of the firm's stock.
C. A decrease in net income.
D. A reduction in notes payable.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-13 Combining the Three Sections of the Statement

38. A firm's purchase of plant and equipment would be considered as a:
A. use of cash for financing activities.
B. use of cash for operating activities.
C. source of cash for investment activities.
D. use of cash for investment activities.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-13 Combining the Three Sections of the Statement

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39. Reinvested funds from retained earnings theoretically belong to:
A. bondholders.
B. common shareholders.
C. employees.
D. all of the choices are correct.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-03 Return on Capital

40. For private companies, asset accounts on the balance sheet are listed in the order of:
A. liquidity.
B. profitability.
C. size.
D. importance.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

41. An increase in investments in long-term securities will:
A. increase cash flow from investing activities.
B. decrease cash flow from investing activities.
C. increase cash flow from financing activities.
D. decrease cash flow from financing activities.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-13 Combining the Three Sections of the Statement

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42. Free cash flow is equal to cash flow from operating activities:
A. plus capital expenditures, minus dividends.
B. plus capital expenditures, plus dividends.
C. plus dividends, minus capital expenditures.
D. minus capital expenditures, minus dividends.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-18 Interpretation of Balance Sheet Items

43. In the last decade, free cash flow has been associated with special financial activities such as:
A. leveraged buyouts.
B. Registered Retirement Savings Plan (RRSPs).
C. stock options.
D. golden parachutes.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Hard
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-18 Interpretation of Balance Sheet Items

44. Common stock dividends are _____ by preferred stock dividends.
A. increased
B. decreased
C. not effected
D. Not enough information to tell

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-02 Income Statement

Foundations of Financial Management (Canadian) 11th edition Block Test Bank

45. Increasing interest expense will have what effect on EBIT?
A. Increase it
B. Decrease it
C. No effect
D. Not enough information to tell

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-02 Income Statement

46. When a firm's earnings are falling more rapidly than its stock price, its P/E ratio will:
A. remain the same.
B. go up.
C. go down.
D. could go either up or down.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-04 Valuation Basics from the Income Statement

47. Net worth is equal to shareholders' equity:
A. plus dividends.
B. minus preferred stock.
C. plus preferred stock.
D. minus liabilities.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

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48. Net worth for an individual is the same as _____ for a corporation.
A. shareholders' equity
B. capital assets minus long-term debt
C. book value
D. current assets minus current debt

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

49. Amortization tends to:
A. increase cash flow and decrease income.
B. decrease cash flow and increase income.
C. affect only cash flow.
D. affect only income.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-17 Effects of IFRS on Financial Analysis

50. Accrual based accounting results in income and cash flow being:
A. the same.
B. different.
C. equal except for amortization.
D. equal except for dividends.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-17 Effects of IFRS on Financial Analysis

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51. The P/E ratio is determined by:
A. net worth divided by earnings.
B. market capitalization divided by dividend.
C. net worth per share divided by earnings per share.
D. market value per share divided by earnings per share.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-04 Valuation Basics from the Income Statement

52. A balance sheet valuation measure is:
A. earnings per share.
B. the P/E ratio.
C. the dividend yield.
D. market value to book value.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

53. Preferred share dividends _____ earnings available to common shareholders.
A. increase
B. decrease
C. due not effect
D. not enough information to tell

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-02 Income Statement

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54. Which of the following is not subtracted to arrive at operating profit?
A. Interest expense
B. Cost of goods sold
C. Amortization
D. Selling and administration expense

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-02 Income Statement

55. Given the following what is free cash flow?

Cash flow from operations	$175,000
Capital expenditures	35,000
dividends	25,000

A. $115,000
B. $235,000
C. $150,000
D. $140,000

Accessibility: Keyboard Navigation
Blooms: Apply
Difficulty: Medium
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-18 Interpretation of Balance Sheet Items

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56. All of the following would be included in Cash Flows from Investing, except:
A. investments in Plant.
B. merchandise Purchases.
C. purchases of Investments.
D. sale of Long-Term Investments.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-14 Amortization and Cash Flow

57. An item that must be paid within one year or one operating cycle of the firm is classified as a:
A. current liability.
B. long-term asset.
C. current asset.
D. None of the choices are correct.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

58. Assuming no conversion rights of bond holders or preferred shareholders, the retained earnings of the firm belongs to:
A. creditors.
B. preferred shareholders.
C. common shareholders.
D. Canada Revenue Agency.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

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59. A firm has $7,500,000 in its common stock account and $2,500,000 in its retained earnings account. The firm issued 100,000 shares of common stock. What was the original issue price if only one stock issue has ever been sold?
A. $75 per share
B. $25 per share
C. $100 per share
D. Not enough information to tell

Accessibility: Keyboard Navigation
Blooms: Apply
Difficulty: Medium
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

60. Assuming a tax rate of 35%, amortization expenses of $800,000 will:
A. reduce income by $280,000.
B. reduce taxes by $280,000.
C. reduce taxes by $800,000.
D. have no effect on income or taxes, since amortization is not a cash expense.

Accessibility: Keyboard Navigation
Blooms: Apply
Difficulty: Easy
Learning Objective: 02-08 Explain the concept of tax savings for companies.
Topic: 02-24 Amortization (Capital Cost Allowance) as a Tax Shield

61. Assuming a tax rate of 30%, the after tax cost of interest expense of $400,000 is:
A. $120,000.
B. $280,000.
C. $400,000.
D. $240,000.

Accessibility: Keyboard Navigation
Blooms: Apply
Difficulty: Easy
Learning Objective: 02-08 Explain the concept of tax savings for companies.
Topic: 02-23 Cost of a Tax-deductible Expense

True / False Questions

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62. The income statement is the primary financial statement for measuring the profitability of a firm over a period of time.
TRUE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-02 Income Statement

63. The income statement measures the increase in the assets of a firm over a period of time.
FALSE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-02 Income Statement

64. Accounting income is based on verifiably completed transactions.
TRUE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-02 Income Statement

65. For private companies, asset accounts are listed in order of their liquidity.
TRUE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

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66. Book value per share and market value per share are usually the same dollar amount.
FALSE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

67. Book value per share is of greater concern to the financial manager than market value per share.
FALSE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

68. Book value is equal to net worth.
TRUE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

69. Equity is a measure of the monetary contributions that have been made directly or indirectly on behalf of the shareholders of the company.
TRUE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

Foundations of Financial Management (Canadian) 11th edition Block Test Bank

70. Shareholders' equity is equal to liabilities plus assets.
FALSE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

71. Shareholders' equity is equal to assets minus liabilities.
TRUE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

72. Shareholders' equity minus preferred stock is the same thing as what is sometimes called net worth or book value.
TRUE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

73. The statement of cash flows helps measure how the changes in a balance sheet are financed between two time periods.
TRUE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-11 Determining Cash Flows from Investing Activities

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74. An increase in an asset represents a source of funds.
FALSE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-13 Combining the Three Sections of the Statement

75. Accumulated amortization shows up in the income statement.
FALSE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-17 Effects of IFRS on Financial Analysis

76. The change in accumulated amortization is usually equal to the amortization expense charged in the income statement.
TRUE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-17 Effects of IFRS on Financial Analysis

77. Net working capital is the difference between current assets and current liabilities.
TRUE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

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78. Amortization is an accounting entry and does not involve a cash expense.
TRUE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-17 Effects of IFRS on Financial Analysis

79. An advantage of the net working capital approach over the cash approach is that it looks at the changes of every account of the statement of cash flows.
FALSE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-11 Determining Cash Flows from Investing Activities

80. Cash flow is equal to earnings before taxes minus amortization.
FALSE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-11 Determining Cash Flows from Investing Activities

81. The corporate tax rate is 25% on the first $200,000 of income and 50% on any amount over $200,000.
FALSE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-06 Outline the effect of corporate tax considerations on aftertax cash flow.
Topic: 02-20 Corporate Tax Rates

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82. Interest expense is deductible before taxes and therefore has an after tax cost equal to the interest paid times (1-tax rate).
TRUE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-08 Explain the concept of tax savings for companies.
Topic: 02-24 Amortization (Capital Cost Allowance) as a Tax Shield

83. Preferred stock dividends are paid out before income taxes.
FALSE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-02 Income Statement

84. Total assets of a firm are financed with liabilities and shareholders' equity.
TRUE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

85. Retained earnings shown on the balance sheet represents available cash on hand generated from prior year's earnings but not paid out in dividends.
FALSE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

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86. Current cost accounting adjusts financial statements by using the consumer price index.
FALSE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-07 Limitations of the Balance Sheet

87. An increase in a liability account represents a source of funds.
TRUE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-13 Combining the Three Sections of the Statement

88. The statement of cash flows includes the effects of dividends paid and amortization expense.
TRUE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-11 Determining Cash Flows from Investing Activities

89. The net working capital approach to funds flow analysis looks at the difference between total assets and total liabilities.
FALSE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-11 Determining Cash Flows from Investing Activities

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90. The marginal corporate tax rate for incomes over $1,000,000 is 50%.
FALSE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-06 Outline the effect of corporate tax considerations on aftertax cash flow.
Topic: 02-20 Corporate Tax Rates

91. Preferred stock is always excluded from shareholders' equity because it is a hybrid security and does not have full voting rights.
FALSE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-03 Return on Capital

92. Current cost accounting undervalues plant and equipment because it does not adjust for inflation.
FALSE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-11 Determining Cash Flows from Investing Activities

93. The investments account includes marketable securities.
FALSE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

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94. The investments account represents a commitment of funds of at least one year.
TRUE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

95. A $125,000 credit sale could be a part of a firm's cash flow from operations if paid off within a firm's fiscal year.
TRUE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Hard
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-11 Determining Cash Flows from Investing Activities

96. An increase in accounts receivable represents a reduction in cash flows from operations.
TRUE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Hard
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-13 Combining the Three Sections of the Statement

97. An increase in accounts payable represents a reduction in cash flows from operations.
FALSE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Hard
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-13 Combining the Three Sections of the Statement

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98. The purchase of a new factory would reduce the cash flows from investing activities.
TRUE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-14 Amortization and Cash Flow

99. The sale of corporate bonds held by the firm as a long-term investment would increase cash flows from investing activities.
TRUE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-15 Free Cash Flow

100. Paying dividends to common shareholders will not affect cash flows from financing activities.
FALSE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-14 Amortization and Cash Flow

101. It is not possible for a company with a high profit margin to have a low operating profit.
FALSE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-02 Income Statement

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102. Operating profit is essentially a measure of how efficient management is in generating revenues and controlling expenses.
TRUE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-03 Return on Capital

103. The P/E ratio provides no indication of investors' expectations about the future of a company.
FALSE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-04 Valuation Basics from the Income Statement

104. The real value of a firm is the same in an economic and accounting sense.
FALSE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

105. A balance sheet represents the assets, liabilities, and shareholders' equity of a company at a given point in time.
TRUE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-02 Examine the limitations of the income statement as a measure of a firm's profitability.
Topic: 02-06 Balance Sheet

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106. Balance sheet items are usually adjusted for inflation.
FALSE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-02 Examine the limitations of the income statement as a measure of a firm's profitability.
Topic: 02-06 Balance Sheet

107. Marketable securities are temporary investments of excess cash and are carried at the lower of cost or market.
TRUE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

108. Retained earnings represent the firm's cumulative earnings since inception, minus dividends and other adjustments.
TRUE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

109. Cash flow consists of illiquid cash equivalents which are difficult to convert to cash within 90 days.
FALSE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-14 Amortization and Cash Flow

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110. The sale of a firm's securities is a source of funds, whereas the payment of dividends is a use of funds.
TRUE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-15 Free Cash Flow

111. The use of amortization is an attempt to allocate the past and future cost of an asset over its useful life.
FALSE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-17 Effects of IFRS on Financial Analysis

112. Free cash flow is equal to cash flow from operating activities plus amortization.
FALSE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-18 Interpretation of Balance Sheet Items

113. Free cash flow is equal to cash flow from operating activities minus necessary capital expenditures and normal dividend payments.
TRUE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-18 Interpretation of Balance Sheet Items

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114. Taxes on individuals have traditionally been progressive, meaning that the more taxable income you have, the higher your marginal tax rate.
TRUE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-07 Identify the different forms of investment income and the effects on investors' taxes payable.
Topic: 02-22 Personal Taxes

115. The P/E ratio is strongly related to the past performance of the firm.
FALSE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-04 Valuation Basics from the Income Statement

116. An increase in assets represents a source of funds.
FALSE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-13 Combining the Three Sections of the Statement

117. Sales less cost of goods sold is equal to earnings before taxes.
FALSE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-02 Income Statement

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118. Sales less cost of goods sold is equal to gross profit.
TRUE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-02 Income Statement

119. When a firm has a sharp drop off in earnings, its P/E ratio may be artificially high.
TRUE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Hard
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-04 Valuation Basics from the Income Statement

120. The investments account does not directly affect cash and cash equivalents.
TRUE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Hard
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

121. Amortization expense is charged in the income statement.
TRUE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-02 Income Statement

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122. An increase in inventory represents a source of funds.
FALSE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-13 Combining the Three Sections of the Statement

123. The income statement allows analysts and investors to measure a firm's profitability of over a period of a month, quarter or year.
TRUE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-02 Income Statement

124. Earnings available to common shareholders includes potential dividends to be paid to preferred shareholders.
FALSE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-03 Return on Capital

125. The effective tax rate on dividend income is lower than interest income because of the dividend tax credit (DTC). Canadians are allowed to claim the DTC because the government wants to reduce the effects of double taxation.
TRUE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-07 Identify the different forms of investment income and the effects on investors' taxes payable.
Topic: 02-22 Personal Taxes

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126. Prior Adjustments may be added or subtracted from a firm's Retained Earnings. These "adjustments" are usually for accounting errors or substantive changes to historical cost of assets or liabilities.
TRUE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-03 Return on Capital

127. Preferred and/or Common Share dividends are added to Cash Flow from Operations in determining Free Cash Flow.
FALSE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-18 Interpretation of Balance Sheet Items

128. The sale of a firm's preferred shares is a source of funds, whereas the payment of preferred dividends is a use of funds.
TRUE

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-15 Free Cash Flow

Short Answer Questions

Foundations of Financial Management (Canadian) 11th edition Block Test Bank

129. What is an income statement and what is its purpose as it relates to financial management?

The income statement

• Measures the profitability of a firm over a time period (month, year)
• Assists financial decision making and analysis, utilizing past patterns for predicting the timing, uncertainty, and amount of future earnings and cash flows.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-02 Income Statement

130. What is the P/E ratio? Why is it an important ratio? List 3 factors that influence the P/E ratio.

The P/E ratio is Market share price/Earnings per share. This ratio allows comparison of the relative market value of many companies on the basis of $1 of earnings per share. Firms expected to provide greater than average future returns often have P/E ratios higher than the market average P/E ratio. As investors' expectations for future returns change, a company's P/E ratio can shift substantially.
The price/earnings ratio (P/E ratio) of a firm is influenced by

• Earnings and sales growth
• Risk (business performance and debt-equity structure)
• Dividend payment policy
• Quality of management
• Many other factors

Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: Easy
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-04 Valuation Basics from the Income Statement

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131. In the text, the author said that "Earnings are flexible." What was meant by this?

In efforts to meet earnings targets, accountants and managers had resorted to stretching accounting standards beyond their reasonable limits. Earnings can be managed or "manipulated" because professional accounting bodies allow latitude. Accruals, such as allowance for doubtful accounts or warranty expenses, and write-downs of assets (inventories and capital) are by their nature discretionary. Margins can also be managed, by classification of "overhead" as a cost of goods rather than administrative expenses. Management has this discretion due to its experience and the need to make estimates of many of the revenues and expenses that will flow through the firm.

Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: Easy
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-02 Income Statement
Topic: 02-03 Return on Capital
Topic: 02-04 Valuation Basics from the Income Statement

132. Several theories have been suggested about the factors contributing to the management or "manipulation" of reported earnings. List and explain them.

• Bonuses (Compensation is tied to reported earnings.)
• Political considerations (High reported earnings attract societal attention.)
• Smoothing (Less volatile earnings are viewed favourably by the market.)
• Debt covenants (Debt contracts are often based on book value calculations.)
• Big bath (New CEOs will look better in the future if assets are written down as they take over, avoiding future amortization charges.)

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-02 Examine the limitations of the income statement as a measure of a firm's profitability.
Topic: 02-04 Valuation Basics from the Income Statement

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133. Explain these terms found on a typical balance sheet. Provide examples of each if applicable.

Marketable securities, Accounts receivable, Inventory, Prepaid expenses, Investments, Plant and equipment, Accumulated amortization, Accounts payable, Notes payable, Accrued expense, Shareholders' equity.

Marketable securities are temporary investments of excess cash (lower of cost or current market value).
Accounts receivable include an allowance for bad debts (based on historical evidence) to suggest their anticipated collection value.
Inventory may be in the form of raw material, goods in process, or finished goods.
Prepaid expenses represent future expenses that have already been paid (insurance premiums, rent).
Investments, unlike marketable securities, are a longer-term commitment of funds, including stocks, bonds, or investments in other corporations (often for acquisition).
Plant and equipment is identified as original cost minus accumulated amortization.
Accumulated amortization is the sum of all past and present amortization charges on currently owned assets, whereas amortization expense is the current year's charge.
Accounts payable represent amounts owed on open account to suppliers.
Notes payable are generally short-term signed obligations to the banker or other creditors.
Accrued expense is an obligation incurred but payment has not yet occurred (additional wages for services provided and owed workers).
Shareholders' equity represents the total contribution and ownership interest of preferred and common shareholders.

Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: Medium
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

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134. List and describe the limitations of the balance sheet.

The values on the balance sheet are often subject to interpretation or revaluation.

• Values are stated on a historical or original cost basis, not market values (some assets may be worth considerably more than their original cost or may require many times the original cost for replacement).
• Accounting policy choice, which should be disclosed in the financial notes, will influence the recorded values.
• Contingent liabilities omitted from the balance sheet, or items such as intangibles that are included, may have a hard-to-determine influence on economic value. Contingent liabilities should be disclosed in footnotes on the balance sheet, alerting us to their possible impact.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 02-03 Examine the limitations of the balance sheet as a measure of a firm's financial position.
Topic: 02-10 Determining Cash Flows from Operating Activities

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135. What is a cash flow statement? What information can it provide? Why is a cash flow statement important to small business?

The cash flow statement reports changes in cash and cash equivalents (rather than working capital) resulting from the activities of the firm during a given period.
For many internal and external users of a firm's financial information, cash flow information is critical.

The cash flow statement allows an analyst to identify

• Cash flow generated from the firm's assets
• Financial obligations (interest and dividends)
• Commitment to new assets

The statement of cash flows can highlight

• The relative build up in short-term and long-term assets
• The means of financing used to support any growth in the firm's asset base
• The appropriateness and the future implications of the financing used

The cash flow statements for the small business are particularly important, as cash flow is more relevant to the firm's short-term survival than its reported income. One is likely to be concerned about the quality, timing, and amount of earnings, and hence the firm's ability to acquire assets and meet its obligations. In the very competitive corporate environment of today exacting cash flow analysis is essential for a firm's survival.

Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: Medium
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-11 Determining Cash Flows from Investing Activities

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136. List the 3 primary sections on the cash flow statement.

These sections are:

1. Operating activities
2. Investing activities
3. Financing activities

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-11 Determining Cash Flows from Investing Activities

137. Describe and briefly explain the steps used in the indirect method to compute cash flows from typical operating activities of a company.

We follow these procedures to **compute cash flows from operating activities** using the indirect method.

• Start with net income.
• Recognize that noncash deductions in computing net income should be added back to net income to *increase* the cash balance. These include such items as amortization, deferred income taxes, restructuring charges, and foreign exchange losses. **This produces cash flow from operations**.
• Next identify changes in noncash working capital.
• Recognize that increases in current assets are a use of funds and *reduce* the cash balance (indirectly)—as an example, the firm spends more funds on inventory.
• Recognize that decreases in current assets are a source of funds and *increase* the cash balance (indirectly)—that is, the firm reduces funds tied up in inventory.
• Recognize that increases in current liabilities are a source of funds and *increase* the cash balance (indirectly)—that is, the firm gets more funds from creditors.
• Recognize that decreases in current liabilities are a use of funds and *decrease* the cash balance (indirectly)—that is, the firm pays off creditors.

Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: Hard
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-13 Combining the Three Sections of the Statement

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138. Define free cash flow. Explain what it is equal to and why it is important a finance manager needs to know the value of free cash flow.

Free cash flow is equal to:

Cash flow from operating activities

Minus: Capital expenditures (required to maintain the productive capacity of the firm)
Minus: Dividends (needed to maintain the necessary payout on common stock and to cover any preferred stock obligation)

The concept of free cash flow forces the stock analyst or banker not only to consider how much cash is generated from operating activities, but also to subtract out the necessary capital expenditures on plant and equipment to maintain normal activities. Similarly, dividend payments to shareholders must be subtracted out, as these dividends must generally be paid to keep shareholders satisfied. The balance, free cash flow, is then available for *special financial activities*. In the last decade, special financing activities have often been synonymous with leveraged buyouts, in which a firm borrows money to buy its stock and take itself private with the hope of restructuring its balance sheet and perhaps going public again in a few years at a higher price than it paid. The analyst or banker normally looks at *free cash flow* to determine whether there are sufficient excess funds to pay back loans associated with special financial activities.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Hard
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-18 Interpretation of Balance Sheet Items

139. What causes the after tax cash flow to the individuals to vary?

The after tax cash flow to the individual varies depending on whether investment income is in the form of interest, dividends, or capital gain. (Highest to lowest marginal tax rate.)

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-07 Identify the different forms of investment income and the effects on investors' taxes payable.
Topic: 02-22 Personal Taxes

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140. What is a tax savings?

A tax savings is the reduction of taxes otherwise payable as a result of an allowable deduction of an expense from taxable income.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 02-07 Identify the different forms of investment income and the effects on investors' taxes payable.
Topic: 02-22 Personal Taxes

141. Valley Home Improvements (VHI) earned $350,000 after taxes in its most recent fiscal year. If VHI's Board of Directors declared a total of $45,000 in preferred dividends what would be the total amount available to pay common shareholders?

Earnings Available to Common Shareholders (EAT) = Earnings After Taxes - Preferred Dividends

EAT = $350,000 - $45,000 = $305,000

Accessibility: Keyboard Navigation
Blooms: Apply
Difficulty: Easy
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-02 Income Statement

142. Two-by-Four Wood Products (TBF) report net income of $2 per share in its most recent financial statements. If TBF has no preferred shares outstanding and the market price of its stock is $4 what is TBF's P/E ratio?

$$\frac{P = \$4}{E\ \$2}$$

P/E = 2 times
For every $1 earned by TBF you would be paying $2 in price.

Accessibility: Keyboard Navigation
Blooms: Apply
Difficulty: Easy
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-04 Valuation Basics from the Income Statement

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143. Jane is considering an investment in Fauna Flowers (FF). FF is trading at $33 a share. It the company's current dividend is $1.50 a share, what is FF's dividend yield?

Dividend Yeild	=	Divided
		Price

Dividend Yield = ($1.50/$33) × 100 = 4.55%

Accessibility: Keyboard Navigation
Blooms: Apply
Difficulty: Easy
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Topic: 02-04 Valuation Basics from the Income Statement

144. Blink and Wink (BW) manufactures contact lens. In its most recent fiscal year BW reported after-tax interest expense on a new bond issue of $550,000. If BW's effective tax rate is 35%, what was the firm's before tax interest expense?

Before Tax Interest Expense	=	$550,000
		1 – Tax Rate

Before Tax Interest Expense	=	$550,000
		1 – .35

Before Tax Interest Expense = $846,154

Accessibility: Keyboard Navigation
Blooms: Apply
Difficulty: Medium
Learning Objective: 02-08 Explain the concept of tax savings for companies.
Topic: 02-23 Cost of a Tax-deductible Expense

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145. Cool Ties and Things (CTT) has Total Shareholder's Equity of $350,000. CTT issued $85,000 in preferred stock two years ago. If CTT has 37,000 shares issued and outstanding what is CTT's book value per share?

BV per Share	=	Shareholder's Equity – Value of Preferred Shares O/S
		Common Share O/S

BV per Share	=	$350,000 - $85,000
		37,000

BV per Share = $265,000/37,000 = $7.16

Accessibility: Keyboard Navigation
Blooms: Apply
Difficulty: Easy
Learning Objective: 02-05 Identify the effects of IFRS (International Financial Reporting Standards) on financial analysis.
Topic: 02-08 Statement of Cash Flows

146. The following is the December 31, 20X4 balance sheet for Epics Corporation.

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Assets		**Liabilities**	
Cash	$70,000	Accounts payable	$100,000
Accounts receivable	150,000	Notes payable	120,000
Inventory	280,000	Bonds payable	300,000
Total current assets	500,000	Total liabilities	520,000
Plant and equipment	1,250,000	Equity	
Less: acc. amortization	250,000	Common stock	500,000
Net plant and Equipment	1,000,000	Retained earnings	480,000
		Total equity	980,000
Total assets	1,500,000	Total liab. & equity	$1,500,000

Sales for 20X5 were $2,000,000, with the cost of goods sold being 55% of sales. Amortization expense was 10% of the gross plant and equipment at the beginning of the year. Interest expense was 9% on the notes payable and 11% on the bonds payable. Selling, general, and administrative expenses were $200,000 and the firm's tax rate is 40%.

A) Prepare an income statement.
B) If the dividend payout ratio for Epics is 35%, what is the value of the retained earnings account on December 31, 20X5?

A) Income Statement		**B)**	
Sales	$2,000,000	$318,720	Net Income
Less: Cost of Goods Sold	1,100,000	x .35	Payout ratio
Gross Profit	900,000	$111.552	Dividends Paid
Less: Selling, general and administrative expense	200,000		
Amortization Expense	125,000		
EBIT	575,000	$318,720	Net Income
Less: Interest Expense (10,800 + 33,000)	43,800	111,552	Dividends Paid
EBT	531,200	207,168	Amount Retained
Less: Taxes (40%)	212,480	+480,000	Retained Earnings 04
Net Earnings	$318,720	$687,168	Retained Earnings 05

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Accessibility: Keyboard Navigation
Blooms: Apply
Difficulty: Medium
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Learning Objective: 02-08 Explain the concept of tax savings for companies.
Topic: 02-02 Income Statement
Topic: 02-03 Return on Capital
Topic: 02-04 Valuation Basics from the Income Statement
Topic: 02-23 Cost of a Tax-deductible Expense

147. Given the financial information for the A.E. Neuman Corporation,

A) Prepare a Statement of Cash Flows for the year ended December 31, 20X5.
B) What is the dividend payout ratio?
C) If we increased the dividend payout ratio to 100%, what would happen to retained earnings?

A.E Neuman Corporation	**Balance Sheet**	
Assets	**20X4**	**20X5**
Cash	$45,000	$50,000
Marketable Securities	175,000	160,000
Accounts Receivable	240,000	220,000
Inventories	230,000	275,000
Investments	70,000	55,000
Total current assets	$760,000	$760,000
Plant and Equipment	1,300,000	1,550,000
Less Accumulated Amortization	450,000	600,000
Net plant and Equipment	$850,000	$950,000
Total Assets	1,610,000	1,710,000

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LIABILITIES AND SHAREHOLDERS' EQUITY		
Accounts payable	$110,000	$85,000
Notes payable	65,000	10,000
Accrued Expenses	30,000	5,000
Income Taxes Payable	5,000	10,000
Bonds Payable (2016)	800,000	900,000
Common Stock (100,000 shares)	200,000	200,000
Retained Earnings	400,000	500,000
Total Liabilities' and Shareholders' Equity	$1,610,000	$1,710,000

A.E. Neuman Corporation Income Statement For the Year Ended December 31, 20X5	
Sales	$ 5,500,000
Less: Cost of Goods Sold	4,200,000
Gross Profit	1,300,000
Less: Selling, General & Administrative Expenses	260,000
Operating profit	1,040,000
Less: Amortization Expense	150,000
Earnings Before Interest and Taxes	890,000
Less: Interest Expense	90,000
Earnings Before Taxes	800,000
Less: Taxes (50%)	400,000
Net Income	$ 400,000

A)

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Operating Activities	
Net Income (earnings after taxes)	$400,000
Add items not requiring on outlay of cash:	
Amortization	150,000
Cash flow from operations	550,000
Change in non-cash working capital:	
Decrease in accounts receivable	20,000
Increase in inventories	(45,000)
Decrease in accounts payable	(25,000)
Decrease in notes payable	(55,000)
Decrease in accrued expenses	(25,000)
Increase in income taxes payable	5,000
Net Change in non-cash working capital	125,000
Cash provided by operating activities	425,000
Investing Activities	
Decrease in investments	15,000
Increase in plant & equipment	(250,000)
Cash used in investing activities	(235,000)
Financing Activities	
Increase in bonds payable	100,000
Dividends paid	(300,000)
Cash used in financing activities	(200,000)
Net increase in cash and equivalents during year	(10,000)
Cash and equivalents, beginning of year	220,000
Cash and equivalents, at year end	$210,000

B)

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Dividend payout ratio	=	Dividends paid, 20X5
		Net income, 20X5
	= $\frac{\$300,000}{\$400,000}$	= 0.75=75%

C) The 20X5 value for retained earnings would decrease by $100,000. In addition, assets would have to decrease by $100,000 or other liabilities would have to increase by the same amount.

Accessibility: Keyboard Navigation
Blooms: Apply
Difficulty: Medium
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-02 Income Statement
Topic: 02-03 Return on Capital
Topic: 02-04 Valuation Basics from the Income Statement
Topic: 02-12 Determining Cash Flows from Financing Activities
Topic: 02-13 Combining the Three Sections of the Statement
Topic: 02-14 Amortization and Cash Flow
Topic: 02-15 Free Cash Flow
Topic: 02-16 Income Tax Considerations

148. Calculate the tax bill for a corporation that earned $250,000 in 20X5 in Manitoba as a manufacturer.

Tax Rate	Incremental Income	Tax Liability
13%	$250,000	= $32,500

Accessibility: Keyboard Navigation
Blooms: Apply
Difficulty: Medium
Learning Objective: 02-06 Outline the effect of corporate tax considerations on aftertax cash flow.
Topic: 02-20 Corporate Tax Rates

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149. Calculate the after tax cost of the interest. Assume the company has issued 10,000 bonds with a coupon rate of 8% and a face value of $1,000 per bond, and the company has a marginal tax rate of 42%.

Annual interest	=	10,000 × $1,000 × 8%
	=	$800,000
After tax cost		$800,000 × (1 – tax rate)
	=	$800,000 × (1 – 42)
	=	$464,000

Accessibility: Keyboard Navigation
Blooms: Apply
Difficulty: Medium
Learning Objective: 02-06 Outline the effect of corporate tax considerations on aftertax cash flow.
Topic: 02-21 Effective Tax Rate Examples

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150. ElectroWizard Company produces a popular video game called Destructo, which sells for $32. Last year ElectroWizard sold 50,000 Destructo games, each of which costs $6 to produce. ElectroWizard incurred selling and administrative expenses of $80,000 and amortization expense of $10,000. In addition, ElectroWizard has a $100,000 loan outstanding at 12%. Its tax rate is 40%. There are 100,000 common shares outstanding.
Prepare an income statement for ElectroWizard in good form (include EPS).

ElectroWizard Company Income Statement for the year ended 12/31/_		
Sales (50,000 @ $32)		$1,600,000
Less: Cost of Goods Sold		300,000
Gross Profit		1,300,000
Less: Operating Expenses		
Selling and administrative	$80,000	
Amortization	10,000	90,000
Operating Profit (EBIT)		1,210,000
Less: Interest expense ($100,000 @ 12%)	12,000	
Earnings Before Taxes		1,198,000
Less: Taxes @ 40%		479,200
Net Income		$718,800
Common Shares		100,000
Earnings Per Share		$7.189

Accessibility: Keyboard Navigation
Blooms: Apply
Difficulty: Medium
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.
Learning Objective: 02-06 Outline the effect of corporate tax considerations on aftertax cash flow.
Topic: 02-02 Income Statement
Topic: 02-03 Return on Capital
Topic: 02-04 Valuation Basics from the Income Statement
Topic: 02-21 Effective Tax Rate Examples

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151. Identify each of the following as increasing (+) or decreasing (-) cash flows from operating activities (O), investment activities (I), or financing activities (F). (EXAMPLE: the sale of plant and equipment would increase cash flows from investing activities, and the correct answer would be + I).
1. Increase in accounts payable
2. Decrease in inventory
3. Net income from operations
4. Payment of common share dividends using ASPE
5. Sale of preferred stock
6. Increase in accrued expenses
7. Purchase of new equipment
8. Decrease in current portion of long term debt
9. Increase in accounts receivable
10. Decrease in notes payable
11. Increase in net worth
12. Increase in long-term liabilities
13. Increase in investments
14. Decrease in marketable securities
15. Reduction in retained earnings
16. Repurchase of common shares outstanding
17. Increase in prepaid expense
18. Decrease in income taxes payable
19. Retirement of long term bonds payable

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20. Sale of new common stock

+O 1. Increase in accounts payable
+O 2. Decrease in inventory
+O 3. Net income from operations
-F 4. Payment of common share dividends using ASPE
+F 5. Sale of preferred stock
-O 6. Increase in accrued expenses
-I 7. Purchase of new equipment
-O 8. Decrease in current portion of long term debt
-O 9. Increase in accounts receivable
-O 10. Decrease in notes payable
+F 11. Increase in net worth
+F 12. Increase in long-term liabilities
-I 13. Increase in investments
+O 14. Decrease in marketable securities
-F 15. Reduction in retained earnings
-F 16. Repurchase of common shares outstanding
-O 17. Increase in prepaid expense
-O 18. Decrease in income taxes payable
-F 19. Retirement of long term bonds payable
+F 20. Sale of new common stock

Accessibility: Keyboard Navigation
Blooms: Apply
Difficulty: Medium
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.
Topic: 02-12 Determining Cash Flows from Financing Activities
Topic: 02-13 Combining the Three Sections of the Statement
Topic: 02-14 Amortization and Cash Flow
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