

Test Bank for Corporate Finance 4th Edition by Berk

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Corporate Finance

BERK DEMARZO STANGELAND FOURTH CANADIAN EDITION



Test Bank

Corporate Finance, Cdn. Ed., 4e (Berk)

Chapter 2 Introduction to Financial Statement Analysis

2.1 The Disclosure of Financial Information

1) Canadian public companies are required to file their interim financial statements and annual financial statements with which one of the following authorities?

- A) Provincial Security Commissions
- B) Federal Security Commissions
- C) Provincial Finance Ministry
- D) Federal Finance Ministry

Answer: A

Diff: 1 Type: MC

Topic: 2.1 The Disclosure of Financial Information

2) As of January 1, 2011, Canadian publicly accountable companies must follow IFRS in their financial statements. IFRS rules are expected to be adopted in the US for fiscal years beginning:

- A) January 1st, 2014
- B) January 1st, 2017
- C) January 1st, 2015
- D) January 1st, 2016

Answer: D

Diff: 2 Type: MC

Topic: 2.1 The Disclosure of Financial Information

3) Under IFRS, every public company is required to produce _____ financial statements.

- A) four
- B) five
- C) six
- D) seven

Answer: B

Diff: 2 Type: MC

Topic: 2.1 The Disclosure of Financial Information

4) The third party who checks annual financial statements to ensure that they are prepared according to Canadian GAAP and verifies that the information reported is reliable is the:

- A) Toronto Stock Exchange Board
- B) Accounting Standards Board
- C) Provincial Securities Commission
- D) Auditor

Answer: D

Diff: 2 Type: MC

Topic: 2.1 The Disclosure of Financial Information

5) Which of the following is NOT a financial statement that every public company is required by IFRS to produce?

- A) Income Statement
- B) Statement of Comprehensive Income
- C) Balance Sheet
- D) Statement of Changes in Equity

Answer: B

Diff: 3 Type: MC

Topic: 2.1 The Disclosure of Financial Information

6) 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 the Canadian GAAP.
3. To verify that the information used in preparing the annual financial statements is reliable.

Diff: 2 Type: ES

Topic: 2.1 The Disclosure of Financial Information

7) What are the five financial statements that all public companies are required to produce by IFRS?

Answer:

1. The Balance Sheet
2. The Income Statement
3. The Statement of Cash Flows
4. The Statement of Shareholders' Equity
5. The Statement of Changes in Equity

Diff: 3 Type: ES

Topic: 2.1 The Disclosure of Financial Information

2.2 The Balance Sheet

1) Cash is a:

- A) long-term asset
- B) current asset
- C) current liability
- D) long-term liability

Answer: B

Diff: 1 Type: MC

Topic: 2.2 The Balance Sheet

2) Accounts payable is a:

- A) long-term liability
- B) current asset
- C) long-term asset
- D) current liability

Answer: D

Diff: 1 Type: MC

Topic: 2.2 The Balance Sheet

3) 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 Type: MC

Topic: 2.2 The Balance Sheet

4) Shareholders' equity, the difference between the firm's _____, is an accounting measure of the firm's _____.

- A) assets and liabilities; net value
- B) assets and liabilities; book value
- C) short-term liabilities and long-term liabilities; net value
- D) short-term liabilities and long-term liabilities; book value

Answer: A

Diff: 1 Type: MC

Topic: 2.2 The Balance Sheet

5) Depreciation is _____ that the firm _____.

- A) an actual cash expense; pays
- B) not an actual cash expense; receives
- C) not an actual cash expense; pays
- D) an actual cash expense; receives

Answer: C

Diff: 2 Type: MC

Topic: 2.2 The Balance Sheet

6) Goodwill captures the value of other _____ that the firm acquired through acquisition. If the value of these _____ assets declines over time, the amount of goodwill listed on the balance sheet will be _____ by a write-down that captures the change in value of the acquired assets.

- A) "tangibles"; tangible; reduced
- B) "tangibles"; tangible; raised
- C) "intangibles"; intangible; raised
- D) "intangibles"; intangible; reduced

Answer: D

Diff: 2 Type: MC

Topic: 2.2 The Balance Sheet

7) Which of the following balance sheet equations is incorrect?

- A) $\text{Assets} - \text{Liabilities} = \text{Shareholders' Equity}$
- B) $\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity}$
- C) $\text{Assets} - \text{Current Liabilities} = \text{Long Term Liabilities}$
- D) $\text{Assets} - \text{Current Liabilities} = \text{Long Term Liabilities} + \text{Shareholders' Equity}$

Answer: C

Diff: 2 Type: MC

Topic: 2.2 The Balance Sheet

8) Which of the following statements regarding the balance sheet is incorrect?

- A) The balance sheet provides a snapshot of the firm's financial position at a given point in time.
- B) The balance sheet lists the firm's assets and liabilities.
- C) The balance sheet reports stockholders' equity on the right hand side.
- D) The balance sheet reports liabilities on the left hand side.

Answer: D

Diff: 2 Type: MC

Topic: 2.2 The Balance Sheet

Use the table for the question(s) below.

Consider the following balance sheet:

| Luther Corporation Consolidated Balance Sheet December 31, 2006 and 2005 (in \$ millions) | | | | | |
|--|--------------|--------------|---|--------------|--------------|
| Assets | | | Liabilities and Stockholders' Equity | | |
| | 2006 | 2005 | | 2006 | 2005 |
| <i>Current Assets</i> | | | <i>Current Liabilities</i> | | |
| 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 |
| <i>Long-Term Assets</i> | | | <i>Long-Term Liabilities</i> | | |
| 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 | | | Total liabilities and Stockholders' Equity | | |
| | 533.1 | 386.7 | | 533.1 | 386.7 |

9) What is Luther's net working capital in 2005?

- A) \$12 million
- B) \$27 million
- C) \$39 million
- D) \$63.6 million

Answer: A

Explanation: $NWC = \text{current assets} - \text{current liabilities} = 144 - 132 = \12 million

Diff: 2 Type: MC

Topic: 2.2 The Balance Sheet

10) A market-to-book value less than one:

- A) indicates that investors perceive the market value of the firm's assets is less than the depreciated value of the assets
- B) indicates that the market value of firm's assets are probably undervalued
- C) indicates that the market value of the firm's assets are probably overvalued
- D) indicates that the book value of the firm's assets are based on an incorrect calculation of accumulated depreciation

Answer: A

Diff: 2 Type: MC

Topic: 2.2 The Balance Sheet

2.3 The Income Statement

1) Firms disclose the potential for the dilution from options they have awarded by reporting:

- A) diluted total earnings before interest and taxes
- B) diluted earnings per share
- C) diluted dividend payment
- D) diluted total earnings

Answer: B

Diff: 1 Type: MC

Topic: 2.3 The Income Statement

2) Which of the following statements regarding the income statement is incorrect?

- A) The income statement shows the earnings and expenses at a given point in time.
- B) The income statement shows the flow of earnings and expenses generated by the firm between two dates.
- C) The last or "bottom" line of the income statement shows the firm's net income.
- D) The first line of an income statement lists the revenues from the sales of products or services.

Answer: A

Diff: 2 Type: MC

Topic: 2.3 The Income Statement

3) 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 Type: MC

Topic: 2.3 The Income Statement

4) 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 Type: MC

Topic: 2.3 The Income Statement

Use the table for the question(s) below.

Consider the following income statement and other information:

| 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 |

5) For the year ending December 31, 2006 Luther's earnings per share are closest to:

- A) \$1.01
- B) \$1.04
- C) \$1.58
- D) \$4.04

Answer: B

Explanation: $EPS = \text{Net Income} / \text{Shares Outstanding} = \$10.6 / 10.2 = \$1.04$

Diff: 1 Type: MC

Topic: 2.3 The Income Statement

6) Assuming that Luther has no convertible bonds outstanding, then for the year ending December 31, 2006 Luther's diluted earnings per share are closest to:

- A) \$1.01
- B) \$1.04
- C) \$1.53
- D) \$3.92

Answer: A

Explanation: Diluted EPS = Net Income / (shares outstanding + options contracts outstanding + shares possible from convertible bonds outstanding) = 10.6 / (10.2 + 0.3 + 0.0) = \$1.01

Diff: 2 Type: MC

Topic: 2.3 The Income Statement

7) The income statement lists the firm's:

- A) assets and equities over a period of time
- B) assets and liabilities over a period of time
- C) variable costs and fixed costs at the end of the fiscal year
- D) revenues and expenses over a period of time

Answer: D

Diff: 1 Type: MC

Topic: 2.3 The Income Statement

8) The balance sheet shows the _____ of a firm _____. The income statement shows the flow of _____ generated by them _____.

- A) assets and liabilities; between two dates; revenues and expenses; at a given point in time
- B) revenues and expenses; between two dates; assets and liabilities; at a given point in time
- C) assets and liabilities; at a given point in time; revenues and expenses; between two dates
- D) revenues and expenses; at a given point in time; assets and liabilities; between two dates

Answer: C

Diff: 2 Type: MC

Topic: 2.3 The Income Statement

2.4 The Statement of Cash Flows

1) The statement of cash flows is divided into three sections:

- A) operating leverage, investment leverage, and financing leverage
- B) cash inflows, cash outflows, and cash flow cycle
- C) cash-in-use, cash-in-resource, and cash conversion cycle
- D) operating activity, investment activity, and financing activity

Answer: D

Diff: 1 Type: MC

Topic: 2.4 The Statement of Cash Flows

2) Which of the following is NOT a section on the cash flow statement?

- A) Income generating activities
- B) Investing activities
- C) Operating activities
- D) Financing activities

Answer: A

Diff: 1 Type: MC

Topic: 2.4 The Statement of Cash Flows

3) Which of the following statements regarding net income transferred to retained earnings is correct?

- A) $\text{Net income} = \text{net income transferred to retained earnings} - \text{dividends}$
- B) $\text{Net income transferred to retained earnings} = \text{net income} + \text{dividends}$
- C) $\text{Net income} = \text{net income transferred to retained earnings} + \text{dividends}$
- D) $\text{Net income transferred to retained earnings} - \text{net income} = \text{dividends}$

Answer: C

Diff: 2 Type: MC

Topic: 2.4 The Statement of Cash Flows

4) Which of the following is NOT a reason why cash flow may not equal net income?

- A) Amortization is added in when calculating net income.
- B) Changes in inventory will change cash flows but not income.
- C) Capital expenditures are not recorded on the income statement.
- D) Depreciation is deducted when calculating net income.

Answer: A

Diff: 1 Type: MC

Topic: 2.4 The Statement of Cash Flows

5) Which of the following adjustments to net income is NOT correct if you are trying to calculate cash flow from operating activities?

- A) Add increases in accounts payable.
- B) Add back depreciation.
- C) Add increases in accounts receivable.
- D) Deduct increases in inventory.

Answer: C

Diff: 2 Type: MC

Topic: 2.4 The Statement of Cash Flows

6) Which of the following adjustments is NOT correct if you are trying to calculate cash flow from financing activities?

- A) Add dividends paid.
- B) Add any increase in long-term borrowing.
- C) Add any increase in short-term borrowing.
- D) Add proceeds from the sale of stock.

Answer: A

Diff: 2 Type: MC

Topic: 2.4 The Statement of Cash Flows

7) How many reasons are there that net income does not correspond to cash earned?

Answer: There are two reasons that net income does not correspond to cash earned. First, there are non-cash entries on the income statement, such as depreciation and amortization. Second, certain uses of cash, such as the purchase of a building or expenditures on inventory, are not reported on the income statement.

Diff: 2 Type: ES

Topic: 2.4 The Statement of Cash Flows

8) Why is the firm's statement of cash flows very important?

Answer: The firm's statement of cash flows utilizes the information from the income statement and balance sheet to determine how much cash the firm has generated, and how that cash has been allocated, during a set period. As we will see, from the perspective of an investor attempting to value the firm, the statement of cash flows provides what may be the most important information of the five financial statements.

Diff: 2 Type: ES

Topic: 2.4 The Statement of Cash Flows

Use the tables for the question(s) below.

Consider the following financial information:

| Luther Corporation Consolidated Balance Sheet December 31, 2006 and 2005 (in \$ millions) | | | | | |
|--|--------------|--------------|---|--------------|--------------|
| Assets | 2006 | 2005 | Liabilities and Stockholders' Equity | 2006 | 2005 |
| <i>Current Assets</i> | | | <i>Current Liabilities</i> | | |
| 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 |
| <i>Long-Term Assets</i> | | | <i>Long-Term Liabilities</i> | | |
| 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 | |
| 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 |

| 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 |
| | | |
| Dividends Paid | 5.1 | 5.0 |
| 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 |

9) Calculate Luther's cash flow from operating activities for the year ending December 31, 2006.

Answer: Operating cash flow = NI + Depreciation - chg in AR + chg in AP - chg in INV

Operating cash flow = 10.6 + 3.6 - (55.5 - 39.6) + (87.6 - 73.5) - (45.9 - 42.9) = 9.4

Diff: 3 Type: ES

Topic: 2.4 The Statement of Cash Flows

10) Calculate Luther's cash flow from financing activities for the year ending December 31, 2006.

Answer: Cash flow from financing:

| | |
|-------------------------------|-------|
| - dividends paid | (5.1) |
| + sale or (purchase) of stock | 57.5* |
| + increase in ST borrowing | 3.9 |
| + increase in LT borrowing | 70.8 |

| | |
|--------------------------|-------|
| Cash flow from financing | 127.1 |
|--------------------------|-------|

NI transferred to RE(2006) = NI - Dividends paid = 10.6 - 5.1 = 5.6

sale of stock = Equity(2006) - NI transferred to RE(2006) - Equity(2005)
 = 126.6 - 5.5 - 63.6 = 57.5

increase in ST borrowing = chg in notes payable + chg in current portion of LT debt
 = (10.5 - 9.6) + (39.9 - 36.9) = 3.9

increase in LT borrowing = 239.7 - 168.9 = 70.8

Diff: 3 Type: ES

Topic: 2.4 The Statement of Cash Flows

11) Why does a firm's net income not correspond to cash generated?

Answer:

1. There are non-cash entries on the income statement, such as depreciation and amortization.
2. Certain uses of cash, such as the purchase of a building or expenditures on inventory, are not reported on the income statement.

Diff: 3 Type: ES

Topic: 2.4 The Statement of Cash Flows

2.5 Other Financial Statement Information

1) According to the IFRS, in addition to the balance sheet, income statement, and the statement of cash flows, a firm's complete financial statements will include all of the following EXCEPT:

- A) Management discussion and analysis
- B) Notes to the financial statements
- C) Securities Commission's commentary
- D) A statement of shareholders' equity

Answer: C

Diff: 1 Type: MC

Topic: 2.5 Other Financial Statement Information

2) In the IFRS, in addition to the five financial statements, companies provide _____ with further details on the information provided in the statements.

- A) pro forma statements
- B) statements of cash used and sources
- C) extensive notes
- D) ratio analysis

Answer: C

Diff: 2 Type: MC

Topic: 2.5 Other Financial Statement Information

3) Off-balance sheet transactions are required to be disclosed:

- A) in the management discussion and analysis
- B) in the auditor's report
- C) in the Provincial Securities Commission's commentary
- D) in the statement of stockholders' equity

Answer: A

Diff: 2 Type: MC

Topic: 2.5 Other Financial Statement Information

4) Details of acquisitions, spin-offs, leases, taxes, and risk management activities are given:

- A) in the management discussion and analysis
- B) in the Provincial Securities Commission's commentary
- C) in the auditor's report
- D) in the notes to the financial statements

Answer: D

Diff: 2 Type: MC

Topic: 2.5 Other Financial Statement Information

5) Management is also required to disclose any _____, which are transactions or arrangements that can have a material impact on the firm's future performance yet do not appear on the _____.

- A) earnings per share; income statement
- B) investment decision; statement of cash flows
- C) financing decision; statement of cash flows
- D) off-balance sheet transactions; balance sheet

Answer: D

Diff: 3 Type: MC

Topic: 2.5 Other Financial Statement Information

6) The Change in Stockholder's Equity equals:

- A) Net Income - Dividends + Sale of Stock - Repurchase of Stock
- B) Net Income + Dividends + Sale of Stock - Repurchase of Stock
- C) Net Income - Dividends - Sale of Stock - Repurchase of Stock
- D) Net Income + Dividends - Sale of Stock - Repurchase of Stock

Answer: A

Diff: 1 Type: MC

Topic: 2.5 Other Financial Statement Information

7) What information do the notes to financial statements provide?

Answer: In addition to the financial statements, companies provide extensive notes with further details on the information provided in the statements. For example, the notes document important accounting assumptions that were used in preparing the statements. They often provide information specific to a firm's subsidiaries or its separate product lines. They show the details of the firm's stock-based compensation plans for employees and the different types of debt the firm has outstanding. Details of acquisitions, spin-offs, leases, taxes, and risk management activities are also given. The information provided in the notes is often very important to interpret fully the firm's financial statements.

Diff: 3 Type: ES

Topic: 2.5 Other Financial Statement Information

2.6 Financial Statement Analysis

1) Market-to-book-ratio is also called the:

- A) price-to-debt ratio
- B) price-to-book ratio
- C) price-to-asset ratio
- D) price-to-equity ratio

Answer: B

Diff: 1 Type: MC

Topic: 2.6 Financial Statement Analysis

2) Market-to-Book-Ratio is a ratio between:

- A) market value of asset and book value of asset
- B) market value of inventory and book value of inventory
- C) market value of liabilities and book value of liabilities
- D) market value of equity and book value of equity

Answer: D

Diff: 1 Type: MC

Topic: 2.6 Financial Statement Analysis

3) A higher _____ implies less risk of the firm experiencing a cash shortfall in the near future.

- A) return on asset ratio
- B) market-to-book ratio
- C) current ratio
- D) return on equity ratio

Answer: C

Diff: 1 Type: MC

Topic: 2.6 Financial Statement Analysis

4) _____ is the difference between total asset value and total liability value.

- A) Market value
- B) Residual value
- C) Liquidity value
- D) Liquidation value

Answer: C

Diff: 2 Type: MC

Topic: 2.6 Financial Statement Analysis

5) The debt-to-equity ratio is calculated by dividing the _____ by _____.

- A) total debt; total shareholders' equity
- B) short-term debt; retained earnings
- C) long-term debt; total equity
- D) long-term debt; preferred equity

Answer: A

Diff: 2 Type: MC

Topic: 2.6 Financial Statement Analysis

6) Enterprise Value is equal to:

- A) market value of equity plus debt minus current assets
- B) market value of current assets plus current liabilities minus inventory
- C) market value of assets plus debt minus equity
- D) market value of equity plus debt minus cash

Answer: D

Diff: 2 Type: MC

Topic: 2.6 Financial Statement Analysis

7) Creditors often compare a firm's _____ and _____ to assess whether the firm has sufficient working capital to meet its short-term needs.

- A) total assets; total liabilities
- B) current assets; current liabilities
- C) total assets; current liabilities
- D) current assets; total liabilities

Answer: B

Diff: 2 Type: MC

Topic: 2.6 Financial Statement Analysis

Use the table for the question(s) below.

Consider the following balance sheet:

| Luther Corporation Consolidated Balance Sheet December 31, 2006 and 2005 (in \$ millions) | | | | | |
|--|--------------|--------------|---|--------------|--------------|
| Assets | 2006 | 2005 | Liabilities and Stockholders' Equity | 2006 | 2005 |
| <i>Current Assets</i> | | | <i>Current Liabilities</i> | | |
| 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 |
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| Less accumulated depreciation | (56.1) | (52.5) | Deferred taxes | 22.8 | 22.2 |
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| 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 |

8) If in 2006 Luther has 10.2 million shares outstanding and these shares are trading at \$16 per share, then Luther's market-to-book ratio would be closest to:

- A) 0.39
- B) 0.76
- C) 1.29
- D) 2.57

Answer: C

Explanation: MTB = market cap / book value of equity = $(10.2 \text{ million} \times 16) / 126.6 = 163.2 / 126.6 = 1.289$

Diff: 2 Type: MC

Topic: 2.6 Financial Statement Analysis

9) When using the book value of equity, the debt to equity ratio for Luther in 2006 is closest to:

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

Answer: B

Explanation: $D/E = \text{Total Debt} / \text{Total Equity}$

Total Debt = (notes payable (10.5) + current maturities of long-term debt (39.9) + long-term debt (239.7) = 290.1 million

Total Equity = 126.6, so $D/E = 290.1 / 126.6 = 2.29$

Diff: 2 Type: MC

Topic: 2.6 Financial Statement Analysis

10) Luther's current ratio for 2006 is closest to:

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

Answer: D

Explanation: $\text{current ratio} = \text{current assets} / \text{current liabilities} = 171 / 144 = 1.19$

Diff: 2 Type: MC

Topic: 2.6 Financial Statement Analysis

11) Luther's quick ratio for 2005 is closest to:

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

Answer: A

Explanation: $\text{quick ratio} = (\text{current assets} - \text{inventory}) / \text{current liabilities}$

$\text{quick ratio} = (144.0 - 42.9) / 132 = 0.77$

Diff: 2 Type: MC

Topic: 2.6 Financial Statement Analysis

12) 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 to equity ratio for Luther in 2006 is closest to:

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

Answer: B

Explanation: $D/E = \text{Total Debt} / \text{Total Equity}$

Total Debt = (notes payable (10.5) + current maturities of long-term debt (39.9) + long-term debt (239.7) = 290.1 million

Total Equity = $10.2 \times \$16 = 163.2$, so $D/E = 290.1 / 163.2 = 1.78$

Diff: 3 Type: MC

Topic: 2.6 Financial Statement Analysis

13) If in 2006 Luther has 10.2 million shares outstanding and these shares are trading at \$16 per share, then what is Luther's Enterprise Value?

- A) -\$63.3 million
- B) \$353.1 million
- C) \$389.7 million
- D) \$516.9 million

Answer: C

Explanation: Enterprise value = MVE + Debt - Cash = $10.2 \times \$16 + 290.1 - 63.6 = 389.7$

Diff: 3 Type: MC

Topic: 2.6 Financial Statement Analysis

14) The change in Luther's quick ratio from 2005 to 2006 is closest to:

- A) a decrease of .10
- B) an increase of .10
- C) a decrease of .15
- D) an increase of .15

Answer: B

Explanation: quick ratio in 2006 = $(171.0 - 45.9)/144 = .87$

quick ratio 2005 = $(144.0 - 42.9) / 132 = .77$

so the quick ratio increased by $.87 - .77 = .10$

Diff: 3 Type: MC

Topic: 2.6 Financial Statement Analysis

15) P/B ratio is:

- A) price-to-book ratio
- B) profit-to-book ratio
- C) property-to-book ratio
- D) price-to-benefit ratio

Answer: A

Diff: 3 Type: MC

Topic: 2.6 Financial Statement Analysis

16) The debt-equity ratio is a common ratio used to assess a firm's:

- A) liquidity
- B) return on equity
- C) leverage
- D) retained earnings

Answer: C

Diff: 3 Type: MC

Topic: 2.6 Financial Statement Analysis

17) By comparing a firm's current assets and current liabilities, one can assess whether the firm has sufficient _____ to meet its _____ needs.

- A) long-term capital; short-term
- B) working capital; short-term
- C) working capital; long-term
- D) marketable securities; long-term

Answer: B

Diff: 3 Type: MC

Topic: 2.6 Financial Statement Analysis

Use the table for the question(s) below.

Consider the following balance sheet:

| Luther Corporation Consolidated Balance Sheet December 31, 2006 and 2005 (in \$ millions) | | | | | |
|--|--------------|--------------|---|--------------|--------------|
| Assets | | | Liabilities and Stockholders' Equity | | |
| | 2006 | 2005 | | 2006 | 2005 |
| <i>Current Assets</i> | | | <i>Current Liabilities</i> | | |
| 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 |
| <i>Long-Term Assets</i> | | | <i>Long-Term Liabilities</i> | | |
| 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 liabilities and Stockholders' Equity | | |
| Total Assets | 533.1 | 386.7 | | 533.1 | 386.7 |

18) 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: 3 Type: ES

Topic: 2.6 Financial Statement Analysis

19) 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 \times \$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: 3 Type: ES

Topic: 2.6 Financial Statement Analysis

20) DuPont Identity expresses the ROE in terms of the firm's:

A) profitability, asset efficiency, and leverage

B) current assets, current liabilities, long-term debts

C) profitability, interest expense, and net income

D) total assets, total liabilities, and total equity

Answer: A

Diff: 1 Type: MC

Topic: 2.6 Financial Statement Analysis

21) The P/E ratio is not useful when the firm's _____ are negative. In this case, it is common to look at the firm's _____ relative to sales.

A) operating earnings; enterprise value

B) net earnings; enterprise value

C) operating earnings; market value

D) net earnings; market value

Answer: B

Diff: 2 Type: MC

Topic: 2.6 Financial Statement Analysis

Use the table for the question(s) below.

Consider the following income statement and other information:

| 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 |

22) Luther's Operating Margin for the year ending December 31, 2005 is closest to:

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

Answer: C

Explanation: Operating Margin = Operating Income / Sales

OM = $31.3 / 578.3 = .054$ or 5.4%

Diff: 2 Type: MC

Topic: 2.6 Financial Statement Analysis

23) Luther's Net Profit Margin for the year ending December 31, 2005 is closest to:

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

Answer: A

Explanation: Net Profit Margin = Net Income / Total Sales = $10.2 / 578.3 = .018$ or 1.8%

Diff: 1 Type: MC

Topic: 2.6 Financial Statement Analysis

24) Luther's earnings before interest, taxes, depreciation, and amortization (EBITDA) for the year ending December 31, 2006 are closest to:

- A) \$19.7 million
- B) \$37.6 million
- C) \$41.2 million
- D) \$44.8 million

Answer: D

Explanation: EBITDA = EBIT + Depreciation & Amortization = $41.2 + 3.6 = \$44.8$ million

Diff: 3 Type: MC

Topic: 2.6 Financial Statement Analysis

25) Luther's return on equity (ROE) for the year ending December 31, 2006 is closest to:

- A) 2.0%
- B) 6.5%
- C) 8.4%
- D) 12.7%

Answer: C

Explanation: ROE = Net income / shareholders' equity = $10.6 / 126.6 = .084$ or 8.4%

Diff: 3 Type: MC

Topic: 2.6 Financial Statement Analysis

26) Luther's return on assets (ROA) for the year ending December 31, 2006 is closest to:

- A) 2.0%
- B) 6.5%
- C) 8.4%
- D) 12.7%

Answer: A

Explanation: ROA = Net income / total assets.

This is a little tricky in that total assets aren't given in the problem. The student must remember the basic balance sheet equation $A = L + SE$. Total Liabilities and Shareholders' Equity is given and this is the same as total assets. So $ROA = 10.6 / 533.1 = .020$ or 2.0%

Diff: 3 Type: MC

Topic: 2.6 Financial Statement Analysis

27) Luther's price - earnings ratio (P/E) for the year ending December 31, 2006 is closest to:

- A) 7.9
- B) 10.1
- C) 15.4
- D) 16.0

Answer: C

Explanation: $P/E = \text{Price} / \text{EPS or Market Cap} / \text{Earnings} = (10.2 \times \$16) / \$10.6 = 15.4$

Diff: 3 Type: MC

Topic: 2.6 Financial Statement Analysis

28) Calculate Luther's return of equity (ROE), return of assets (ROA), and price-to-earnings ratio (P/E) for the year ending December 31, 2005.

Answer: $ROE = NI / \text{shareholder equity} = 10.2 / 63.6 = .160$ or 16.0%

$ROA = NI / \text{total assets}$

Here total assets are not given, but we know that $\text{Total Assets} = \text{Total Liabilities} + \text{Shareholder Equity}$, so

$ROA = 10.2 / 386.7 = .026$ or 2.6%

$P/E = \text{price} / \text{EPS or Market Cap} / NI = (8.0 \times \$15) / \$10.2 = 11.8$

Diff: 3 Type: ES

Topic: 2.6 Financial Statement Analysis

29) If Luther's accounts receivable were \$55.5 million in 2006, then calculate Luther's accounts receivable days for 2006.

Answer: $\text{Accounts receivable days} = \frac{\text{accounts receivable}}{\text{sales} / 365} = \frac{55.5}{610.1/365} = 33.2 \text{ days}$

Diff: 2 Type: ES

Topic: 2.6 Financial Statement Analysis

2.7 Financial Reporting in Practice

1) Following the Sarbanes-Oxley Act in United States, Canadian regulators adopted similar measures that came into effect in:

- A) 2001
- B) 2003
- C) 2005
- D) 2007

Answer: C

Diff: 1 Type: MC

Topic: 2.7 Financial Reporting in Practice

2) In 2002, the United States Congress passed _____ that requires, among other things, that CEO's and CFOs certify the accuracy and appropriateness of their firm's financial statements and increase the penalties against them if the financial statements later prove to be fraudulent.

- A) the Sarbanes-Oxley Act
- B) new American GAAP
- C) the IFRS
- D) revised GAAP

Answer: A

Diff: 2 Type: MC

Topic: 2.7 Financial Reporting in Practice

3) As the Bernard Madoff's Ponzi Scheme makes clear, when making an investment decision, it is important not only to review the firm's _____, but also to consider _____ who prepare the statement in the first place.

- A) balance sheet; the reliability and reputation of the auditors
- B) Financial Statements; the reliability and reputation of the government offices
- C) Financial Statements; the reliability and reputation of the auditors
- D) Financial Statements; the reliability and reputation of the bookkeepers

Answer: C

Diff: 2 Type: MC

Topic: 2.7 Financial Reporting in Practice

4) In WorldCom's case, the fraud was to reclassify \$3.85 billion in _____ as _____.

- A) capital budgeting; short-term investment
- B) operating expenses; long-term investment
- C) operating expenses; short-term investment
- D) capital budgeting; long-term investment

Answer: B

Diff: 3 Type: MC

Topic: 2.7 Financial Reporting in Practice