

Chapter 2

Student: _____

1. The income statement is the major device for measuring the profitability of a firm over a period of time.

True False

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

True False

3. Accounting income is based on verifiably completed transactions.

True False

4. Asset accounts are listed in order of their liquidity.

True False

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

True False

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

True False

7. Book value is equal to net worth.

True False

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

True False

9. Shareholders' equity is equal to liabilities plus assets.

True False

10. Shareholders' equity is equal to assets minus liabilities.

True False

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

True False

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

True False

13. An increase in an asset represents a source of funds.

True False

14. Accumulated amortization shows up in the income statement.

True False

15. The change in accumulated amortization should always be equal to the amortization expense charged in the income statement.

True False

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

True False

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

True False

18. 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.

True False

19. Cash flow is equal to earnings before taxes minus amortization.

True False

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

True False

21. Interest expense is deductible before taxes and therefore has an aftertax cost equal to the interest paid times $(1 - \text{tax rate})$.

True False

22. Preferred stock dividends are paid out before income taxes.

True False

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

True False

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

True False

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

True False

26. An increase in a liability account represents a source of funds.

True False

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

True False

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

True False

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

True False

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

True False

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

True False

32. The investments account includes marketable securities.

True False

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

True False

34. 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 False

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

True False

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

True False

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

True False

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

True False

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

True False

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

True False

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

True False

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

True False

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

True False

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

True False

45. Balance sheet items are usually adjusted for inflation.

True False

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

True False

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

True False

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

True False

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

True False

50. The use of amortization is an attempt to allocate the past and future costs of an asset over its useful life.

True False

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

True False

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

True False

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

True False

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

True False

55. An increase in a liability represents a source of funds.

True False

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

True False

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

True False

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

True False

59. The investments account does not directly affect cash and cash equivalents.

True False

60. Amortization expense is charged in the income statement.

True False

61. An increase in inventory represents a source of funds.

True False

62. Which of the following is not one of the three basic financial statements required by Generally Accepted Accounting Principles (GAAP)?

A. Income Statement

B. Statement of Retained Earnings

C. Statement of Cash Flows

D. Balance Sheet

63. Which of the following would not be classified as a current asset?

- A. Marketable securities
- B. Investments
- C. Prepaid expenses
- D. Inventory

64. 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.

65. Which of the following is not a primary source of capital to the firm?

- A. assets
- B. common stock
- C. preferred stock
- D. bonds

66. The residual income of the firm belongs to

- A. creditors.
- B. preferred shareholders.
- C. common shareholders.
- D. bondholders.

67. 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.

68. 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

69. 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

70. 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

71. 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.

72. 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

73. "Inventory profits" are most likely to occur in an inflationary economy under which of the following inventory cost assumptions?

- A. Weighted average
- B. LIFO
- C. FIFO
- D. Lower of cost or market

74. 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

75. 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.

76. 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.

77. 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

78. 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

79. 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.

80. 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.

81. Assuming a tax rate of 30%, the aftertax cost of interest expense of \$200,000 is

- A. \$60,000.
- B. \$140,000.
- C. \$200,000.
- D. \$120,000.

82. 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).

83. The firm's price-earnings (P/E) ratio is influenced by its

- A. capital structure.
- B. earnings volatility.
- C. sales, profit margins, and earnings.
- D. all of the other answers are correct

84. 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.

85. The current cost method of inflation-adjusted accounting statements

- A. is sometimes referred to as replacement cost accounting.
- B. affects inventory and plant and equipment values the most.
- C. lowers historical profits through adjustments to amortization expense and inventory costs.
- D. all of the other answers are correct

86. An inflation-adjusted accounting statement

- A. lets management know if cash flow from internal operations is large enough to make necessary equipment replacements.
- B. provides no new information to financial managers.
- C. helps make common stock prices more predictable.
- D. eliminates the effects of inflation from decision making.

87. The Glorius VanderBuilt 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

88. 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. two of the above

89. A statement of cash flows allows a financial analyst to determine

- A. whether a cash dividend is affordable.
- B. how increases 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 other answers are correct

90. 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 other answers are correct
91. 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. zero
 - B. \$50,000
 - C. \$100,000
 - D. \$25,000
92. Assuming a tax rate of 40%, the aftertax cost of a \$200,000 dividend payment is
- A. \$200,000.
 - B. \$70,000.
 - C. \$130,000.
 - D. None of the other answers are correct

93. 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

94. 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 the above are always true.

95. 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.

96. 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

97. 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

98. 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

99. A firm's purchase of plant and equipment would be considered 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.

100.Reinvested funds from retained earnings theoretically belong to

- A. bondholders.
- B. common shareholders.
- C. employees.
- D. all of the other answers are correct

101.Asset accounts on the balance sheet are listed in the order of

- A. liquidity.
- B. profitability.
- C. size.
- D. importance.

102.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.

103.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.

104. In the last decade, free cash flow has been associated with special financial activities such as

- A. leveraged buyouts.
- B. RRSPs.
- C. stock options.
- D. golden parachutes.

105. Preferred stock dividends _____ earnings available to common shareholders.

- A. increase
- B. decrease
- C. do not effect
- D. not enough information to tell

106. Increasing interest expense will have what effect on EBIT?

- A. increase it
- B. decrease it
- C. no effect
- D. not enough information to tell

107. 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

108. Net worth is equal to shareholders' equity

- A. plus dividends.
- B. minus preferred stock.
- C. plus preferred stock.
- D. minus liabilities

109. Book value is the same as

- A. shareholders' equity.
- B. capital assets minus long-term debt.
- C. net worth.
- D. current assets minus current debt

110. 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.

111. 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

112.The P/E ratio is determined by

- A. net worth divided by earnings.
- B. market capitalization divided by earnings.
- C. net worth per share divided by earnings per share.
- D. market value per share divided by earnings per share

113.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

114.Preferred share dividends _____ earnings available to common shareholders.

- A. increase
- B. decrease
- C. due not effect
- D. not enough information to tell

115.When a firm's earnings are falling more rapidly than its share price, its P/E ratio will

- A. remain the same.
- B. go up.
- C. go down.
- D. could go either up or down.

116. Which of the following is not subtracted to arrive at operating income?

- A. interest expense.
- B. cost of goods sold.
- C. amortization.
- D. selling and administration expense.

117. 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

118. Match each key term with the most correct definition from the numbered list.

- | | |
|---|----------------------------------|
| 1. The total ownership position of preferred and common shareholders. | net worth or book value ____ |
| 2. Short-term signed obligations to banks or other creditors. | balance sheet ____ |
| 3. A financial statement that measures the profitability of the firm over a period of time. | statement of cash flows ____ |
| 4. Changes accrual-based information from income statement and balance sheet to cash based information. | liquidity ____ |
| 5. The allocation of the initial cost of an asset over its useful life. | marginal corporate tax rate ____ |
| 6. Cash flow that is generated (or reduced) from the sale or repurchase of securities or the payment of cash dividends | P/E ratio ____ |
| 7. A financial statement that indicates what the firm owns, and how these assets are financed in the form of liabilities or ownership interest. | earnings per share ____ |
| 8. The income available to common shareholders divided by the number of common shares outstanding. | income statement ____ |
| 9. Traditional method of accounting using original costs minus amortization. | marketable securities ____ |
| 10. The relative convertibility of short-term assets into cash. | cash flows from investing ____ |
| 11. The levy expressed as a percentage that applies to each new dollar of taxable income. | shareholders' equity ____ |
| 12. The multiplier applied to income per share to determine current value. | historical cost accounting ____ |

13. Represents the net cash flow that results from changes in the amount of a firm's long-term assets.

cash flows from
operations _____

14. Represents the net cash flow that results from a firm's production and sales activities.

notes payable _____

15. Cash flows from operations minus working capital minus dividend payments.

cash flow from
financing _____

16. All the assets of the firm minus the liabilities and preferred stock.

amortization _____

17. Temporary investments of excess cash.

free cash flow _____

119. The following is the December 31, 2004 balance sheet for the Epics Corporation.

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

Sales for 2005 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, 2005?

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

- A) Prepare a Statement of Cash Flows for the year ended December 31, 2005.
- 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 Sheets

ASSETS	2004	2005
Cash	\$ 45,000	\$ 50,000
Marketable Securities	175,000	60,000
Accounts Receivable	240,000	220,000
Inventories	230,000	275,000
Investments	<u>70,000</u>	<u>55,000</u>
Total current assets	760,000	760,000
Plant and Equipment	1,300,000	1,550,000
Less Accumulated Amortization	<u>450,000</u>	<u>600,000</u>
Net Plant and Equipment	<u>850,000</u>	<u>950,000</u>
Total Assets	\$1,610,000	\$1,710,000

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	<u>\$1,610,000</u>	<u>\$1,710,000</u>

A.E. Neuman Corporation

Income Statement For Year Ended December

Sales	\$5,500,000
Less: Cost of Goods Sold	4,200,000
Gross Profit	1,300,000
Less: Selling, General & Administrative Expense	<u>260,000</u>
Operating Profit	1,040,000
Less: Amortization Expense	<u>150,000</u>
Earnings Before Interest and Taxes	890,000
Less: Interest Expense	<u>90,000</u>
Earnings Before Taxes	800,000
Less: Taxes (50%)	<u>400,000</u>
Net Income	<u>\$ 400,000</u>

121. Calculate the tax bill for a corporation that earned \$250,000 in 2005 in Manitoba as a manufacturer.

122. Calculate the aftertax 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%.

123. 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).

124. 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 dividends
- _____ 5. Sale of preferred stock
- _____ 6. Increase in accrued expenses
- _____ 7. Purchase of new equipment
- _____ 8. Decrease in amortization expense
- _____ 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
- _____ 20. Sale of new common stock

125. 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. None of the other answers are correct.

126. The residual income of the firm belongs to

- A. creditors.
- B. preferred shareholders.
- C. common shareholders.
- D. Canada Revenue Agency.

127. 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

128. 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.

129. Assuming a tax rate of 30%, the aftertax cost of interest expense of \$400,000 is

- A. \$120,000.
- B. \$280,000.
- C. \$400,000.
- D. \$240,000.

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

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

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

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

134.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.

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

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

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

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

139. 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.

140.What causes the aftertax cash flow to the individuals to vary?

141.What is a tax savings?

Chapter 2 Key

1. The income statement is the major device for measuring the profitability of a firm over a period of time.

TRUE

Block - Chapter 002 #1

Difficulty: Easy

Learning Objective: 1

Type: Con

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

FALSE

Block - Chapter 002 #2

Difficulty: Easy

Learning Objective: 1

Type: Con

3. Accounting income is based on verifiably completed transactions.

TRUE

Block - Chapter 002 #3

Difficulty: Easy

Learning Objective: 1

Type: Con

4. Asset accounts are listed in order of their liquidity.

TRUE

Block - Chapter 002 #4

Difficulty: Mea

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

FALSE

Block - Chapter 002 #5

Difficulty: Easy

Learning Objective: 3

Type: Con

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

FALSE

Block - Chapter 002 #6

Difficulty: Easy

Learning Objective: 3

Type: Con

7. Book value is equal to net worth.

TRUE

Block - Chapter 002 #7

Difficulty: Easy

Learning Objective: 3

Type: Con

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

TRUE

Block - Chapter 002 #8

Difficulty: Medium

Learning Objective: 3

Type: Con

9. Shareholders' equity is equal to liabilities plus assets.

FALSE

Block - Chapter 002 #9

Difficulty: Easy

Learning Objective: 3

Type: Mem

10. Shareholders' equity is equal to assets minus liabilities.

TRUE

Block - Chapter 002 #10

Difficulty: Easy

Learning Objective: 3

Type: Mem

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

TRUE

Block - Chapter 002 #11

Difficulty: Easy

Learning Objective: 3

Type: Con

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

TRUE

Block - Chapter 002 #12

Difficulty: Easy

Learning Objective: 4

Type: Con

13. An increase in an asset represents a source of funds.

FALSE

Block - Chapter 002 #13

Difficulty: Med

Learning Objective: 3

Type: Con

14. Accumulated amortization shows up in the income statement.

FALSE

Block - Chapter 002 #14

Difficulty: Easy

Learning Objective: 3

Type: Con

15. The change in accumulated amortization should always be equal to the amortization expense charged in the income statement.

FALSE

Block - Chapter 002 #15

Difficulty: Med

Learning Objective: 3

Type: Con

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

TRUE

Block - Chapter 002 #16

Difficulty: Easy

Learning Objective: 3

Type: Mem

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

TRUE

Block - Chapter 002 #17

Difficulty: Easy

Learning Objective: 3

Type: Con

18. 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

Block - Chapter 002 #18

Difficulty: Mea

Learning Objective: 3

Type: Con

19. Cash flow is equal to earnings before taxes minus amortization.

FALSE

Block - Chapter 002 #19

Difficulty: Mea

Learning Objective: 4

Type: Con

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

FALSE

Block - Chapter 002 #20

Difficulty: Mea

Learning Objective: 3

Type: Mem

21. Interest expense is deductible before taxes and therefore has an aftertax cost equal to the interest paid times $(1 - \text{tax rate})$.

TRUE

Block - Chapter 002 #21

Difficulty: Mea

Learning Objective: 5

Type: Con

22. Preferred stock dividends are paid out before income taxes.

FALSE

Block - Chapter 002 #22

Difficulty: Mea

Learning Objective: 6

Type: Con

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

TRUE

Block - Chapter 002 #23

Difficulty: Haro

Learning Objective: 3

Type: Con

24. 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

Block - Chapter 002 #24

Difficulty: Mea

Learning Objective: 3

Type: Con

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

FALSE

Block - Chapter 002 #25

Difficulty: Easy

Learning Objective: 1

Type: Con

26. An increase in a liability account represents a source of funds.

TRUE

Block - Chapter 002 #26

Difficulty: Mea

Learning Objective: 1

Type: Con

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

TRUE

Block - Chapter 002 #27

Difficulty: Mea

Learning Objective: 4

Type: Con

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

FALSE

Block - Chapter 002 #28

Difficulty: Easy

Learning Objective: 3

Type: Con

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

FALSE

Block - Chapter 002 #29

Difficulty: Easy

Type: Mem

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

FALSE

Block - Chapter 002 #30

Difficulty: Mea

Learning Objective: 3

Type: Con

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

FALSE

Block - Chapter 002 #31

Difficulty: Easy

Learning Objective: 1

Type: Con

32. The investments account includes marketable securities.

FALSE

Block - Chapter 002 #32

Difficulty: Mea

Learning Objective: 1

Type: Con

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

TRUE

Block - Chapter 002 #33

Difficulty: Easy

Learning Objective: 1

Type: Con

34. 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

Block - Chapter 002 #34

Difficulty: Hard

Learning Objective: 1

Type: Con

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

TRUE

Block - Chapter 002 #35

Difficulty: Hard

Learning Objective: 1

Type: Con

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

FALSE

Block - Chapter 002 #36

Difficulty: Hard

Learning Objective: 1

Type: Con

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

TRUE

Block - Chapter 002 #37

Difficulty: Mea

Learning Objective: 1

Type: Con

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

TRUE

Block - Chapter 002 #38

Difficulty: Mea

Learning Objective: 1

Type: Con

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

FALSE

Block - Chapter 002 #39

Difficulty: Mea

Type: Con

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

FALSE

Block - Chapter 002 #40

Difficulty: Mea

Learning Objective: 2

Type: Con

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

TRUE

Block - Chapter 002 #41

Difficulty: Mea

Learning Objective: 2

Type: Con

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

FALSE

Block - Chapter 002 #42

Difficulty: Mea

Learning Objective: 3

Type: Con

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

FALSE

Block - Chapter 002 #43

Difficulty: Mea

Learning Objective: 3

Type: Con

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

TRUE

Block - Chapter 002 #44

Difficulty: Mea

Learning Objective: 1

Type: Con

45. Balance sheet items are usually adjusted for inflation.

FALSE

Block - Chapter 002 #45

Difficulty: Mea

Learning Objective: 3

Type: Con

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

TRUE

Block - Chapter 002 #46

Difficulty: Mea

Learning Objective: 1

Type: Con

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

TRUE

Block - Chapter 002 #47

Difficulty: Mea

Learning Objective: 1

Type: Con

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

FALSE

Block - Chapter 002 #48

Difficulty: Mea

Learning Objective: 1

Type: Con

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

TRUE

Block - Chapter 002 #49

Difficulty: Mea

Learning Objective: 4

Type: Con

50. The use of amortization is an attempt to allocate the past and future costs of an asset over its useful life.

FALSE

Block - Chapter 002 #50

Difficulty: Mea

Learning Objective: 1

Type: Con

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

FALSE

Block - Chapter 002 #51

Difficulty: Mea

Learning Objective: 4

Type: Mem

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

TRUE

Block - Chapter 002 #52

Difficulty: Mea

Learning Objective: 1

Type: Mem

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

TRUE

Block - Chapter 002 #53

Difficulty: Easy

Learning Objective: 6

Type: Con

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

FALSE

Block - Chapter 002 #54

Difficulty: Easy

Learning Objective: 1

Type: Con

55. An increase in a liability represents a source of funds.

TRUE

Block - Chapter 002 #55

Difficulty: Easy

Learning Objective: 3

Type: Con

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

FALSE

Block - Chapter 002 #56

Difficulty: Easy

Learning Objective: 2

Type: Con

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

TRUE

Block - Chapter 002 #57

Difficulty: Easy

Learning Objective: 2

Type: Con

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

TRUE

Block - Chapter 002 #58

Difficulty: Hard

Learning Objective: 3

Type: Con

59. The investments account does not directly affect cash and cash equivalents.

TRUE

Block - Chapter 002 #59

Difficulty: Hard

Learning Objective: 1

Type: Con

60. Amortization expense is charged in the income statement.

TRUE

Block - Chapter 002 #60

Difficulty: Medium

Learning Objective: 1

Type: Con

61. An increase in inventory represents a source of funds.

FALSE

Block - Chapter 002 #61

Difficulty: Medium

Learning Objective: 1

Type: Concept

62. Which of the following is not one of the three basic financial statements required by Generally Accepted Accounting Principles (GAAP)?

A. Income Statement

B. Statement of Retained Earnings

C. Statement of Cash Flows

D. Balance Sheet

Block - Chapter 002 #62

Difficulty: Easy

Learning Objective: 1

Type: Memory

63. Which of the following would not be classified as a current asset?

A. Marketable securities

B. Investments

C. Prepaid expenses

D. Inventory

Block - Chapter 002 #63

Difficulty: Easy

Learning Objective: 1

Type: Memory

64. 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.

Block - Chapter 002 #64

Difficulty: Mea

Learning Objective: 1

Type: Mem

65. Which of the following is not a primary source of capital to the firm?

- A. assets
- B. common stock
- C. preferred stock
- D. bonds

Block - Chapter 002 #65

Difficulty: Easy

Learning Objective: 1

Type: Mem

66. The residual income of the firm belongs to

- A. creditors.
- B. preferred shareholders.
- C. common shareholders.
- D. bondholders.

Block - Chapter 002 #66

Difficulty: Mea

67. 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.

Block - Chapter 002 #67

Difficulty: Mea

Learning Objective: 5

Type: Con

68. 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

Block - Chapter 002 #68

Difficulty: Easy

Learning Objective: 1

Type: Mem

69. 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

Block - Chapter 002 #69

Difficulty: Med

Learning Objective: 1

Type: Con

70. 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

Block - Chapter 002 #70

Difficulty: Med

Learning Objective: 1

Type: Con

71. 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.

Block - Chapter 002 #71

Difficulty: Mea

Learning Objective: 3

Type: Con

72. 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

Block - Chapter 002 #72

Difficulty: Haro

Learning Objective: 3

Type: Con

73. "Inventory profits" are most likely to occur in an inflationary economy under which of the following inventory cost assumptions?

- A. Weighted average
- B. LIFO
- C. FIFO
- D. Lower of cost or market

Block - Chapter 002 #73

Difficulty: Mea

74. 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

Block - Chapter 002 #74

Difficulty: Medium

Learning Objective: 3

Type: Con

75. 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.

Block - Chapter 002 #75

Difficulty: Easy

Learning Objective: 3

Type: Con

76. 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.

Block - Chapter 002 #76

Difficulty: Easy

Learning Objective: 3

Type: Mem

77. 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

Block - Chapter 002 #77

Difficulty: Easy

Learning Objective: 4

Type: Con

78. 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

Block - Chapter 002 #78

Difficulty: Easy

Learning Objective: 4

79. 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.

Block - Chapter 002 #79

Difficulty: Easy

Learning Objective: 4

Type: Con

80. 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.

Block - Chapter 002 #80

Difficulty: Easy

Learning Objective: 7

Type: Con

81. Assuming a tax rate of 30%, the aftertax cost of interest expense of \$200,000 is

- A. \$60,000.
- B. \$140,000.
- C. \$200,000.
- D. \$120,000.

Block - Chapter 002 #81

82. 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).

Block - Chapter 002 #82
Difficulty: Easy
Learning Objective: 1
Type: Mem

83. The firm's price-earnings (P/E) ratio is influenced by its

- A. capital structure.
- B. earnings volatility.
- C. sales, profit margins, and earnings.
- D. all of the other answers are correct

Block - Chapter 002 #83
Difficulty: Easy
Learning Objective: 1
Type: Con

84. 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.

Block - Chapter 002 #84

Difficulty: Mea

Learning Objective: 1

Type: Con

85. The current cost method of inflation-adjusted accounting statements

- A. is sometimes referred to as replacement cost accounting.
- B. affects inventory and plant and equipment values the most.
- C. lowers historical profits through adjustments to amortization expense and inventory costs.
- D. all of the other answers are correct

Block - Chapter 002 #85

Difficulty: Mea

Learning Objective: 1

Type: Con

86. An inflation-adjusted accounting statement

- A. lets management know if cash flow from internal operations is large enough to make necessary equipment replacements.
- B. provides no new information to financial managers.
- C. helps make common stock prices more predictable.
- D. eliminates the effects of inflation from decision making.

Block - Chapter 002 #86

Difficulty: Mea

87. The Glorius VanderBuilt 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

Block - Chapter 002 #87

Difficulty: Easy

Learning Objective: 7

Type: Con

88. 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. two of the above

Block - Chapter 002 #88

Difficulty: Easy

Learning Objective: 1

Type: Con

89. A statement of cash flows allows a financial analyst to determine

- A. whether a cash dividend is affordable.
- B. how increases 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 other answers are correct

Block - Chapter 002 #89

Difficulty: Easy

Learning Objective: 4

Type: Con

90. 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 other answers are correct

Block - Chapter 002 #90

Difficulty: Mea

Learning Objective: 3

Type: Con

91. 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. zero
- B. \$50,000
- C. \$100,000
- D. \$25,000

Block - Chapter 002 #91

Difficulty: Mea

Learning Objective: 3

Type: Con

92. Assuming a tax rate of 40%, the aftertax cost of a \$200,000 dividend payment is

- A. \$200,000.
- B. \$70,000.
- C. \$130,000.
- D. None of the other answers are correct

Block - Chapter 002 #92

Difficulty: Mea

Learning Objective: 6

Type: Con

93. 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

Block - Chapter 002 #93

Difficulty: Mea

94. 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 the above are always true.

Block - Chapter 002 #94

Difficulty: Mea

Learning Objective: 1

Type: Con

95. 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.

Block - Chapter 002 #95

Difficulty: Mea

Learning Objective: 1

Type: Con

96. 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

Block - Chapter 002 #96

Difficulty: Medium

Learning Objective: 1

Type: Conceptual

97. 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

Block - Chapter 002 #97

Difficulty: Easy

Learning Objective: 1

Type: Conceptual

98. 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

Block - Chapter 002 #98

Difficulty: Easy

Learning Objective: 1

Type: Con

99. A firm's purchase of plant and equipment would be considered 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.

Block - Chapter 002 #99

Difficulty: Easy

Learning Objective: 1

Type: Con

100. Reinvested funds from retained earnings theoretically belong to

- A. bondholders.
- B. common shareholders.
- C. employees.
- D. all of the other answers are correct

Block - Chapter 002 #100

Difficulty: Easy

101. Asset accounts on the balance sheet are listed in the order of

- A. liquidity.
- B. profitability.
- C. size.
- D. importance.

Block - Chapter 002 #101

Difficulty: Easy

Learning Objective: 1

Type: Con

102. 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.

Block - Chapter 002 #102

Difficulty: Easy

Learning Objective: 1

Type: Con

103. 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.

Block - Chapter 002 #103

Difficulty: Mea

Learning Objective: 4

Type: Con

104. In the last decade, free cash flow has been associated with special financial activities such as

- A. leveraged buyouts.
- B. RRSPs.
- C. stock options.
- D. golden parachutes.

Block - Chapter 002 #104

Difficulty: Haro

Learning Objective: 4

Type: Con

105. Preferred stock dividends _____ earnings available to common shareholders.

- A. increase
- B. decrease
- C. do not effect
- D. not enough information to tell

Block - Chapter 002 #105

Difficulty: Mea

Learning Objective: 1

106. Increasing interest expense will have what effect on EBIT?

- A. increase it
- B. decrease it
- C. no effect
- D. not enough information to tell

Block - Chapter 002 #106

Difficulty: Easy

Learning Objective: 2

Type: Con

107. 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

Block - Chapter 002 #107

Difficulty: Med

Learning Objective: 1

Type: Con

108. Net worth is equal to shareholders' equity

- A. plus dividends.
- B. minus preferred stock.
- C. plus preferred stock.
- D. minus liabilities

Block - Chapter 002 #108

109. Book value is the same as

- A. shareholders' equity.
- B. capital assets minus long-term debt.
- C. net worth.
- D. current assets minus current debt

Block - Chapter 002 #109
Difficulty: Haro
Learning Objective: 1
Type: Con

110. 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.

Block - Chapter 002 #110
Difficulty: Easy
Learning Objective: 1
Type: Con

111. 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

Block - Chapter 002 #111

Difficulty: Mea

Learning Objective: 4

Type: Con

112. The P/E ratio is determined by

- A. net worth divided by earnings.
- B. market capitalization divided by earnings.
- C. net worth per share divided by earnings per share.
- D. market value per share divided by earnings per share

Block - Chapter 002 #112

Difficulty: Mea

Learning Objective: 1

Type: Mem

113. 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

Block - Chapter 002 #113

Difficulty: Easy

Learning Objective: 3

114. Preferred share dividends _____ earnings available to common shareholders.

- A. increase
- B. decrease
- C. due not effect
- D. not enough information to tell

Block - Chapter 002 #114

Difficulty: Easy

Learning Objective: 1

Type: Con

115. When a firm's earnings are falling more rapidly than its share price, its P/E ratio will

- A. remain the same.
- B. go up.
- C. go down.
- D. could go either up or down.

Block - Chapter 002 #115

Difficulty: Mea

Learning Objective: 1

Type: Con

116. Which of the following is not subtracted to arrive at operating income?

- A. interest expense.
- B. cost of goods sold.
- C. amortization.
- D. selling and administration expense.

Block - Chapter 002 #116

117. 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

118. Match each key term with the most correct definition from the numbered list.

- | | |
|---|---------------------------------------|
| 1. The total ownership position of preferred and common shareholders. | net worth or book value <u>16</u> |
| 2. Short-term signed obligations to banks or other creditors. | balance sheet <u>7</u> |
| 3. A financial statement that measures the profitability of the firm over a period of time. | statement of cash flows <u>4</u> |
| 4. Changes accrual-based information from income statement and balance sheet to cash based information. | liquidity <u>10</u> |
| 5. The allocation of the initial cost of an asset over its useful life. | marginal corporate tax rate <u>11</u> |
| 6. Cash flow that is generated (or reduced) from the sale or repurchase of securities or the payment of cash dividends | P/E ratio <u>12</u> |
| 7. A financial statement that indicates what the firm owns, and how these assets are financed in the form of liabilities or ownership interest. | earnings per share <u>8</u> |
| 8. The income available to common shareholders divided by the number of common shares outstanding. | income statement <u>3</u> |
| 9. Traditional method of accounting using original costs minus amortization. | marketable securities <u>17</u> |
| 10. The relative convertibility of short-term assets into cash. | cash flows from investing <u>13</u> |
| 11. The levy expressed as a percentage that applies to each new dollar of taxable income. | shareholders' equity <u>1</u> |
| 12. The multiplier applied to income per share to determine current value. | historical cost accounting <u>9</u> |

13. Represents the net cash flow that results from changes in the amount of a firm's long-term assets.	cash flows from operations <u>14</u>
14. Represents the net cash flow that results from a firm's production and sales activities.	notes payable <u>2</u>
15. Cash flows from operations minus working capital minus dividend payments.	cash flow from financing <u>6</u>
16. All the assets of the firm minus the liabilities and preferred stock.	amortization <u>5</u>
17. Temporary investments of excess cash.	free cash flow <u>15</u>

Block - Chapter 002 #118

Difficulty: Med

Learning Objective: 1

Type: Con

119. The following is the December 31, 2004 balance sheet for the Epics Corporation.

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

Sales for 2005 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, 2005?

A) **Income Statement**

Sales	\$ 2,000,000
Less: Cost of Goods Sold	<u>1,100,000</u>
Gross Profit	900,000
Less: Selling, general and administrative expense	200,000
Amortization Expense	<u>125,000</u>
EBIT	575,000
Less: Interest Expense (10,800 + 33,000)	<u>43,800</u>
EBT	531,200
Less: Taxes (40%)	<u>212,480</u>
Net Earnings	\$ 318,720

B)

\$318,720	Net Income
<u>× .35</u>	Payout ratio
\$111,552	Dividends Paid
\$318,720	Net Income
<u>111,552</u>	Dividends Paid
207,168	Amount Retained
<u>+480,000</u>	Retained Earnings 04
\$687,168	Retained Earnings 05

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

A) Prepare a Statement of Cash Flows for the year ended December 31, 2005.

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 Sheets

ASSETS	2004	2005
Cash	\$ 45,000	\$ 50,000
Marketable Securities	175,000	60,000
Accounts Receivable	240,000	220,000
Inventories	230,000	275,000
Investments	<u>70,000</u>	<u>55,000</u>
Total current assets	760,000	760,000
Plant and Equipment	1,300,000	1,550,000
Less Accumulated Amortization	<u>450,000</u>	<u>600,000</u>
Net Plant and Equipment	<u>850,000</u>	<u>950,000</u>
Total Assets	\$1,610,000	\$1,710,000

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	<u>\$1,610,000</u>	<u>\$1,710,000</u>

A.E. Neuman Corporation

Income Statement For Year Ended December

Sales	\$5,500,000
Less: Cost of Goods Sold	4,200,000
Gross Profit	1,300,000
Less: Selling, General & Administrative Expense	<u>260,000</u>
Operating Profit	1,040,000
Less: Amortization Expense	<u>150,000</u>
Earnings Before Interest and Taxes	890,000
Less: Interest Expense	<u>90,000</u>
Earnings Before Taxes	800,000
Less: Taxes (50%)	<u>400,000</u>
Net Income	<u>\$ 400,000</u>

A)

Operating Activities

Net Income (earnings aftertaxes)	\$ 400,000
Add items not requiring an outlay of cash:	
Amortization	<u>150,000</u>
Cash flow from operations	550,000
Changes 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	<u>5,000</u>
Net change in non-cash working capital	<u>125,000</u>
Cash provided by operating activities	425,000

Investing Activities

Decrease in investments	15,000
Increase in plant & equipment	<u>(250,000)</u>
Cash used in investing activities	(235,000)

Financing Activities

Increase in bonds payable	100,000
Dividends paid	<u>(300,000)</u>
Cash used in financing activities	(200,000)

Net increase in cash and equivalents during year	(10,000)
Cash and equivalents, beginning of year	<u>220,000</u>
Cash and equivalents, at year end	<u>\$ 210,000</u>

B)

$$\begin{aligned}
 \text{Dividend payout ratio} &= \frac{\text{Dividends paid, 2005}}{\text{Net income, 2005}} \\
 &= \frac{\$300,000}{\$400,000} = .75 = 75\%
 \end{aligned}$$

C) The 2005 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.

121. Calculate the tax bill for a corporation that earned \$250,000 in 2005 in Manitoba as a manufacturer.

Tax rate	Incremental Income	Tax Liability
(18.1%)	\$250,000	= \$45,250

Block - Chapter 002 #121

Difficulty: Med

Learning Objective: 5

Type: Con

122. Calculate the aftertax 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	=	$10,000 \times \$1,000 \times 8\%$
	=	\$800,000
Aftertax cost	=	$\$800,000 \times (1 - \text{tax rate})$
	=	$\$800,000 \times (1 - .42)$
	=	\$464,000

Block - Chapter 002 #122

Difficulty: Med

Learning Objective: 5

Type: Con

123. 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		<u>300,000</u>
Gross Profit		1,300,000
Less: Operating Expenses		
Selling and administrative	\$80,000	
Amortization	<u>10,000</u>	<u>90,000</u>
Operating Profit (EBIT)		1,210,000
Less: Interest expense (\$100,000 @ 12%)	<u>12,000</u>	
Earnings Before Taxes		1,198,000
Less: Taxes @ 40%		<u>479,200</u>
Net Income		<u>\$ 718,800</u>
Common Shares		100,000
Earnings Per Share		\$ 7.189

Block - Chapter 002 #123

Difficulty: Med

Learning Objective: 1

Type: Con

124. 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 dividends
- _____ 5. Sale of preferred stock
- _____ 6. Increase in accrued expenses
- _____ 7. Purchase of new equipment
- _____ 8. Decrease in amortization expense
- _____ 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
- _____ 20. Sale of new common stock

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

Block - Chapter 002 #124

Difficulty: Mea

Learning Objective: 1

Type: Con

125. 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. None of the other answers are correct.

Block - Chapter 002 #125

Difficulty: Mea

Learning Objective: 1

Type: Mem

126. The residual income of the firm belongs to

- A. creditors.
- B. preferred shareholders.
- C. common shareholders.
- D. Canada Revenue Agency.

Block - Chapter 002 #126

Difficulty: Easy

Learning Objective: 1

Type: Mem

127. 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

Block - Chapter 002 #127

Difficulty: Med

Learning Objective: 1

Type: Con

128. 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.

Block - Chapter 002 #128

Difficulty: Easy

Learning Objective: 7

Type: Con

129. Assuming a tax rate of 30%, the aftertax cost of interest expense of \$400,000 is

- A. \$120,000.
- B. \$280,000.
- C. \$400,000.
- D. \$240,000.

Block - Chapter 002 #129

Difficulty: Easy

Learning Objective: 7

Type: Con

130. 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.

Block - Chapter 002 #130

131. 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

132. 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.

Block - Chapter 002 #132

Difficulty: Easy

Learning Objective: 2

Learning Objective: 3

Type: Mem

133. 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.)

Block - Chapter 002 #133

Difficulty: Easy

Learning Objective: 2

Learning Objective: 3

134. 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.

135. 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.

Block - Chapter 002 #135

Difficulty: Med

Learning Objective: 3

Type: Mem

136. 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 buildup 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.

Block - Chapter 002 #136

Difficulty: Med

Learning Objective: 4

Type: Con

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

These sections are:

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

Block - Chapter 002 #137

Difficulty: Easy

Learning Objective: 1

Type: Mem

138. 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.

Block - Chapter 002 #138

Difficulty: Hard

Learning Objective: 1

Type: Con

139. 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.

Block - Chapter 002 #139

Difficulty: Hard

Learning Objective: 4

Type: Conceptual

140. What causes the aftertax cash flow to the individuals to vary?

The aftertax 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.)

Block - Chapter 002 #140

Difficulty: Easy

Learning Objective: 6

Type: Mem

141. 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.

Block - Chapter 002 #141

Difficulty: Easy

Learning Objective: 7

Type: Mem

Chapter 2 Summary

<u>Category</u>	<u># of Questions</u>
Block - Chapter 002	141
Difficulty: Easy	60
Difficulty: Hard	11
Difficulty: Med	70
Learning Objective: 1	68
Learning Objective: 2	7
Learning Objective: 3	37
Learning Objective: 4	15
Learning Objective: 5	4
Learning Objective: 6	4
Learning Objective: 7	6
Type: Con	118
Type: Mem	23