**1.1 Quick Check: What is Finance?**

1. Economics is a subfield of Finance. False

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| 1. Which of the following is not an example of firm capital? Financial Markets 2. Capital is defined as a financial asset. True 3. Corporate finance is devoted to understanding various types of financial instruments. False 4. Which of the following is an example of firm capital? Cash 5. Corporate finance focuses on the decision making by the management of the firm. True 6. What are the three important areas of finance discussed in this section?   Corporate finance, investments, banking/financial institutions   1. Banks make money when the interest rates they charge to borrowers are   less than interest rates they pay depositors. False   1. Stocks and bonds are two types of financial instruments. True  1.2 Quick Check: Financial Securities 1. Stocks and bonds are two types of financial instruments. True  2. Stock represents ownership in a particular company. True  3. Companies can raise capital by issuing bonds or stocks. True  4. A stock is a debt instrument issued by corporations. False  5. A treasury bond is a debt instrument issued by corporations. False  6. A bond is a debt instrument issued by corporations or governments. True  7. A stock is a share of\_\_\_\_\_\_\_\_\_\_\_ in a particular company. Ownership  8. A bond is similar to a loan. True 1.3 Quick Check: Primary Financial Markets 1. Primary financial markets are markets where issuers place new securities with investors. True  2. What are the two ways a syndicate can place a bond? Competitive sale or negotiated sale  3. An IPO is a seasonal equity offering. False  4. an IPO occurs on the primary market. True  5. Syndicates are generally made up of investment banks and other institutional investors. True  6. While competitive sales allow underwriters to submit bids to purchase bonds,  negotiated sales do not. False 1.4 Quick Check: Secondary Financial Markets 1. NASDAQ is the world’s largest secondary financial market. False  2. Auction markets have a physical location. True  3. Dealer markets have a physical location. False  4. Nasdaq is an example of an auction market. False  5. Stocks that are listed on dealer markets generally have a single dealer for each stock. False  6. When dealers have to compete with one another, transaction costs will generally  \_\_\_\_\_\_\_\_\_\_\_. Decrease  7. Markets are where prices are determined. True 1.5 Quick Check: The Role of Financial Markets 1. The NYSE specialist has an objective to provide liquidity to the market. True  2. The NYSE specialist will charge a higher price to sellers of the stock and a lower  price to the buyer of the stock. False  3. The ask price of stock A is $56.75 while the bid price for stock A is $56.71.  What is the bid ask spread? **56.75-56.71 = 0.04**  **4.** The ask price of stock A is $215.54 while the bid price for stock A is $215.14.  What is the bid ask spread? **215.54-215.14 = 0.40**  **5.** The bid-ask spread is compensation to the specialist for providing liquidity to the market. True 1.6 Quick Check: Trading in Financial Markets 1. What are the two types of orders that are used by investors? Market orders and Limit orders.  2. Market orders are\_\_\_\_\_ sensitive while limit orders are \_\_\_\_\_ sensitive. Time, price  3. A market order to buy a stock would execute at the current ask price. True  4. A market order to sell a stock would execute at the current ask price. False  5. A limit order to buy a stock at $101.55 would execute at the current ask price. False  6. A limit order to buy a stock at $101.55 would execute when the ask price is at or below $101.55. True 1.7 Quick Check: Efficiency in Market Prices  * 1. Which of the following best explains the role of prices? ***Prices convey information*** * ***Prices affect the distribution of income*** * ***Prices affect incentives***   2. Efficient markets are those in which prices are volatile. False  3. Efficient markets will often mispriced securities. False  4. Inefficient markets are those in which prices will respond quickly to new information. False  5. Inefficient markets will often have mispriced securities. True  6. Because in an efficient market all available information is built into the price of a stock –  investment patterns and trends to “get rich quickly” are not easily discernable and  it is difficult to predict the price. True  7. In an inefficient market, prices will slowly respond to new information. True  8. In an efficient market, new information will move prices almost immediately. True 1.8 Quick Check: Calculating Security Returns 1. Suppose you bought a stock for $45 one year ago.  Today the stock is currently priced  at $47.42. If the stock does not pay a dividend, what is the dollar return for this stock?  **47.42-45 = 2.42**  2. Suppose you bought a stock for $45 one year ago.  Today the stock is currently priced at  $47.42. If the stock does not pay a dividend, what is the percentage return for this stock?  **(47.42-45)/45 = 0.0538 or 5.38%**  3. Suppose you bought a stock for $22.10 one year ago.  Today the stock is currently priced  at $22.08. The stock recently paid a $4 dividend, what is the dollar return for this stock?  **22.08-22.10 + 4 = 3.98**  4. Suppose you bought a stock for $22.10 one year ago.  Today the stock is currently  priced at $22.08. The stock recently paid a $4 dividend, what is the percentage return for this  stock? **(22.08-22.10 + 4)/22.10 = 0.1801 or 18.01%**  5. Suppose you bought a stock for $101.44 one year ago.  Today the stock is currently  priced at $109.54. If the stock does not pay a dividend, what is the dollar return for this stock?  **109.54-101.44 = 8.10**  6. Suppose you bought a stock for $101.44 one year ago. Today the stock is currently priced  at $109.54. If the stock does not pay a dividend, what is the percentage return for this stock?  **(109.54-101.44)/101.44 = 0.0799 or 7.99%**  7. Suppose you bought a stock for $19.84 one year ago.  Today the stock is currently priced  at $18.45. The stock recently paid a $3.50 dividend, what is the percentage return for this stock?  **(18.45-19.84+3.50)/19.84 = 0.1064 or 10.64%**  8. Firms with high unexpected earnings usually exhibit large positive returns on the  earnings announcement day. True   |  |  |  |  | | --- | --- | --- | --- | | 9. Firms with low unexpected earnings usually exhibit large positive returns on the earnings announcement day. False 1.9 Quick Check: The Goal of the Firm 1. The goal of the firm is to \_\_\_\_\_\_\_\_\_\_\_ shareholder value. Maximize  2. Firms that are maximizing shareholder value will generally see increases in the firm’s stock price. True  3. What is a way firms can maximize shareholder value? **Invest in new machinery that will be profitable.**  4. Privately-held companies and publicly traded companies will always maximize shareholder value in the same way. False  5. The goal of the firm is to maximize  \_\_\_\_\_\_\_\_\_\_\_  value. Shareholder  6. What are ways firms can maximize shareholder value?   |  |  |  | | --- | --- | --- | | * Hire new employees to improve production and the profitability. * Invest in new research and development that will be profitable. * Invest capital into projects that will improve the profitability of the firm. * All of these choices   7. Companies should always maximize shareholder value. True  8. Firms that are maximizing shareholder value will generally see stability in the firm’s stock price. False  9. The goal of the firm is to maximize shareholder value. True   |  |  | | --- | --- | | 1.10 Quick Check: Issues Relating to the Maximization of Shareholder Value 1. Agency costs are costs that are incurred when management does not act in the best interest of shareholders. True  2. Firms try to mitigate agency costs by aligning managers' interests with shareholders' interests. True   |  | | --- | |  | | | |   3. Agency costs are commonly mitigated by increasing management compensation. False  4. Agency costs are commonly mitigated by compensating management with company stock. True  5. What issue(s) are associated with the firm goal to maximize shareholder value?  *Agency costs and potential unethical behavior*  6. Maximizing shareholder value ethically can improve society generally by:   |  | | --- | | * Employing additional workers * Creating growth and leading to increased production by other firms * Increasing the profitability of other firms because of increased consumption * All of these choices |   7. An example of agency costs is a firm's decision to invest in a project because  management enjoys working on the project. True  8. An example of agency costs is management spending company money on  unprofitable goods and services. True  9. An example of agency costs is increased costs incurred because of higher levels  of production. False 2.3 Quick Check: What is 'Accrual Accounting' and Why Do We Use It Anyway? 1. Cash accounting offers a superior method of analyzing a company. False 2.4 Quick Check: The Income Statement - The Basic Layout 1. The income statement is the most easily interpreted of the basic financial statements. False  2. The basic equation of an income statement is; Revenues – expenses = net income.  3. Revenues minus cost of goods sold is: Gross Profit 2.5 Quick Check: The Income Statement – A Closer Look 1. On the income statement, Cost of Good Sold includes: Direct material and direct labor associated  with production.  2.Which of the following best describes the guiding principle for revenue recognition within accrual  accounting system. Revenue is reported when the earnings process is complete.  3. A high-quality customer just purchased $500,000 worth of product from your company.  The contract calls for immediate delivery of the product with a cash payment of $300,000 today  and $200,000 to be paid 60 days.  The expense associated with the product is $300,000, of  which $100,000 has not been paid to your supplier. Under accrual based accounting system,  you will most likely report: Revenues of $500,000 and expenses of $300,000. 2.6 Quick Check: The Balance Sheet – The Basic Layout 1. The basic equation for the balance sheet is: Equity = Assets – Liabilities  2. Thirty years ago, your firm purchased a parcel of land for $100,000.  You still own the land.  The current market price of the land is $1,000,000. Under accrual accounting, which  of the following adjustment should be made to recognize the current value of the land?  There is no adjustment to be made. 2.7 Quick Check: The Balance Sheet – Asset Side . 1, A firm purchased equipment three years ago for $500,000. The equipment is the only  fixed asset the firm has ever owned. If the firm claimed depreciation of $20,000 the first year,  $35,000 the second year and $32,500 the  third year, the Gross Fixed Assets should be equal to: $500,000  2. Inventory is the most liquid component of current assets. False  3. On the balance sheet, Gross Fixed Assets represent:  The original cost of the fixed assets currently owned by the firm. 2.8 Quick Check: The Balance Sheet – Financing Side 1. Current liabilities are reported in order of: Maturity(shortest first)  2. (True/False) Retained earnings represent the accumulated net income of the firm less  dividends paid. True  3. (True/False) Current liabilities represent money owed by a firm that requires  payment within one year. True 2.9 Quick Check: Linking the Income Statement and the Balance She1. TellAll reports retained earnings of $1122 and $1402 for 20x1 and 20x2, respectively.Additionally, the firm paid dividends of $200 and $225 in 20x1 and 20x2, respectively.What was TellAll’s net income for 20x2?Solution:  New RE = Old RE + NI – Div; 1402 = 1122 + NI – 225; NI = 5052. Which of the following represent potential uses of net income under theaccrual accounting system: Retain within the firm and dividends3. BackJack reports retained earnings of $15,225 for 20x2.  The firm paid dividendsof $4000 and $2,025 in 20x1 and 20x2, respectively.  Additionally, the firm reportednet income of $8,000 and$5,000 in 20x1 and 20x2, respectively.  What were BackJack’s reported retainedearnings for 20x1?Solution:  New RE = Old RE + NI – Div; 15225 = Old RE + 5000 – 2025; Old RE = 12,2503.2 Quick Check: The Statement of Cash Flows (SCF) – Overview and "The Myth"1. Cash flow from operations cannot be managed. False2. The Statement of Cash Flows categorizes cash flow into cash flow from operations,cash flow from production, and cash flow from financing. False3. (True/False) Unlike net income, CFO is not subject to managerial discretionor manipulation. False3.3 Quick Check: Cash Flow from Operations (CFO) vs. Net Income1. Which of the following is not a reason for the difference between CFO andnet income? Net income doesn’t account for the change in cash **2.** Suppose a firm shows an increase in accounts receivable of $100 during a period.  Considered in isolation, which of the follow best describes the impact of this change on  the Statement of Cash Flows?  The change will decrease CFO by $100 3.4 Quick Check: Calculating CFO – A Simplified Approach1. Which of the following best describes the simplified calculation of CFO:**Correct Answer:**CFO = NI + Depreciation expense + changes in operating accounts2. A change in notes payable will impact CFO. False3.5 Quick Check: CFO – Impounding Changes in Balance Sheet Operating Accounts **1.** Which of the following represent operating asset accounts considered in the calculation  of CFO? ***Accounts receivable and inventory***  2. Brighton and DarkTec are identical companies: both companies sell computers to identical  clients, recognize the same amount of revenue, and purchased the same capital equipment  at the same cost at the beginning of this year. However, Brighton’s sales are 1/3 on credit  while 2/3 of DarkTec’s sales are on credit. In addition, while both companies use straight-line  depreciation, Brighton calculates depreciation of the new equipment based on an 8-year useful  life while DarkTec calculates depreciation based on 10-year life (i.e. Depreciation Expense = Cost  of Machine/Life of the Machine). Assume both companies had exactly the same balance sheets  at the beginning of the year. Which of the following statements is most likely correct?  **DarkTec has a higher net income than Brighton.**  3. An increase in inventory will decrease CFO. True 3.6 Quick Check: Cash Flow from Investing (CFI) 1.   | **Logan Enterprises Cash Flow** | **20x2** | **20x1** | | --- | --- | --- | | Gross PP&E | $22,500 | $20,600 | | Less: Acc. Depr | $????? | $5,400 | | Net PP&E | $????? | $15,200 |     What is the firm's CFI?  **Correct Answer: *$1,900***    With the assumption of no asset disposals, CFI will be equal to 1) change in Gross PP&E, or 2)  change in Net PP&E plus depreciation expense.  The change in Gross PP&E is $1,900.  2. Last year a firm recorded Net PP&E of $4,600 while this year the same firm recorded Net  PP&E of $4,500. If the depreciation expense for last year and this year are $500 and $800  respectively, what is the CFI of the company? (assume no asset disposals) **Correct Answer: *$700***  Solution: CFI = (Change in Net PP&E + Depreciation Exp) = (4500 – 4600 + 800) = $700  3. A firm recorded Gross PP&E of $5,000 in 20x1 and $6,300 in 20x2. Further, accumulated  depreciation was $2,000 and $2,400 in 20x1 and 20x2, respectively.  Assuming no asset  disposals, CFI is closest to which of the following? **Correct Answer: *$1,300***    Solution: CFI = Change in Gross PP&E = 6300 – 5000 = $1,300.  4.   | **Logan Enterprises Cash Flow** | **20x2** | **20x1** | | --- | --- | --- | | Gross PP&E | $22,500 | $????? | | Less: Acc. Depr | $7,100 | $????? | | Net PP&E | $15,400 | $15,200 |     Using the data above and assuming no asset disposals, what is the firm's CFI for the year  20x2?  Assume that the firm claims $1,600 in depreciation expense during the period.  **Correct Answer: *$1,800***    With the assumption of no asset disposals, CFI will be equal to 1) change in Gross PP& E, or 2)  Change in Net PP&E plus depreciation expense.  The change in Net PP&E of $200 plus  $1,600 in depreciation expense equals CFI of $1800. 3.7 Quick Check: Cash Flow from Financing (CFF) 1. Balken Inc. reports the following on their most recent financial statements:   -  Change in accounts payable: $50   -  Change in notes payable: $100   -  Change in long-term debt: $200   -  Change in retained earnings: -$120   -  Dividends declared: $160  What is Balken’s net income for the period?  **Correct Answer: *$40***    Change in RE = net income – dividends; -120 = net income – 160.  2. U&I Inc. recorded retained earnings of $2,000 last year and $2,500 this year. Net income  of U&I Inc. is $500 and $650 for last year and this year, respectively. This year, U&I Inc.  must have paid dividends of:  **Correct Answer: *$150***    Solution: Change in RE = NI –dividends.  Rearranging: Dividends = NI – Change in RE.  Therefore: Dividends = 650 – (2500 – 2000) = $150.  3. Balken Inc. reports the following on their most recent financial statements:   -  Change in accounts payable: $50   -  Change in notes payable: $100   -  Change in long-term debt: $200   -  Change in retained earnings: -$120   -  Net income: $170  What is Balken’s CFF for the period?  **Correct Answer: *$10***    CFF = change in notes payable + change in long-term debt – dividends (assuming no other  relevant changes); hence, CFF = 100 + 200 -Dividends. The change in RE = net income –  dividends; so, -120 = 170 – dividends; thus, dividends = 290. Finally, CFF = 100 +200 – 290 = 10. 3.8 Quick Check: Visualizing Interaction Between the SCF and the Balance Sheet 1. Generally speaking, the operating accounts relevant to the calculation of CFO are located at  the top of both the asset and financing side of the balance sheet……………True  2. When calculating CFF, most of the data can be located at the bottom of the asset side  of the balance sheet……………………….false  3. Which of the following are current asset or current liability accounts that are not included  in the calculation of CFO?   |  | | --- | | * Cash and notes payable  3.9 Quick Check: What can we learn from the SCF? 1. A firm with positive CFO should be considered healthy…………..false  2. The firm in an industry with the largest CFO is the industry’s top performer…false 3.10 Quick Check: CFO vs. Free Cash Flow (FCF) 1. Dividing CFO among the owners of a firm is a sustainable policy……..false  2. Which of the following accurately describes the calculation of Free Cash Flow to the Firm?  **Correct Answer: *FCFF = EBIT\*(1-tax rate) + Depreciation – CAPEX – Increases in NWC***  3. Depreciation expense is added back when calculating Free Cash Flow (FCF) because depreciation expense:  **Correct Answer: Is a non-cash expense** |  4.2 Quick Check: Why Ratios? 1. The ratios used in financial analysis are defined by GAAP………..false  2. Which of the following statements is NOT correct with respect to using ratios to analyze a  firm or firms?...... **Correct Answer: A change in a ratios reveals the economic character**  **of the firm.**  3. Which one of the following is NOT part of the common ratio categories?   |  | | --- | | * Financing * Profitability * Operating * Liquidity |   **Correct Answer: Operating**  **4.** Ratios help identify the areas of a firm that need investigation…..true   |  | | --- | | True 4.3 Quick Check: Liquidity Ratios Use the following balance sheet and income statement to answer the next three questions:      1. What is the current ratio of Eastern Family?  **Correct Answer: *2.49***  Current Ratio = 9700 / 3900 = 2.49  2. Accounts receivable turnover for the industry is 4.50. Assume a 365 day year **and all sales**  **were made on credit**. This tells you that:  **Correct Answer: In this industry, the companies take about 81.1 days to collect their**  **accounts receivable.**  3. If the current ratio of a company is higher than the industry, then:  **Correct Answer: You cannot tell without looking at other liquidity ratios.**  **4.** Suppose the inventory turnover of a company is higher than the industry.  Based on  this one ratio, which of the following is most likely to be correct?  **Correct Answer: The firm has too little inventory resulting in lost sales or stock-outs.** 4.4 Quick Check: Efficiency Ratios Use the following balance sheet and income statement to answer the next two questions:     1. What is the fixed asset turnover of Eastern Family?   **Correct Answer: *1.53***  FAT = Sales / Fixed Assets = 10000 / 6500 = 1.53   1. If a competitor of Eastern Family has a Total Asset Turnover (TAT) of 1.10, then:   **Correct Answer: Eastern Family’s asset utilization success cannot be assessed by the**  **TAT alone.**   1. Consider two companies, Hoogle and Mapple. They are economically identical.   However, for reporting purposes Hoogle uses the managerial discretion that is  required with accrual accounting to increase net income relative to Mapple  (assume any balance sheet effects are inconsequential). Which of the following is correct:  **Correct Answer: Hoogle’s OIROI is higher than Mapple’s but Hoogle is NOT more efficient.**  4. Suppose that Macrosoft decides to increase the estimated life over which fixed assets  are depreciated.  Which of the following is most likely?  **Correct Answer: *Macrosoft’s OIROI will increase.***  Macrosoft’s depreciation expense will be lower as a result of extending the estimated life  of its assets (recall depreciation expense = (cost-salvage value)/estimated life).  Lower  depreciation expense leads to higher EBIT. Higher EBIT results in higher OIROI.   (Note:  the change in depreciation expense will increase EBIT and increase total assets; however,  the change in EBIT will likely dominate). 4.5 Quick Check: Financing Ratios Use the following balance sheet and income statement to answer next two questions:    1. What is the Times Interest Earned for Eastern Family?  **Correct Answer: *2.41x***  TIE = 1350 / 560 = 2.41x  2. If the industry average debt ratio is 60%, then:  **Correct Answer: *Eastern Family is more aggressively financed by debt than the industry.***  Eastern Family’s debt ratio is 67.28% (= total liabilities/total assets = 10,900 / 16200; remember,  total liabilities equals current liabilities [$3,900] + long-term liabilities [$7,000]). Since the  industry average is only 60%, Eastern Family finances a higher portion of its assets with  debt than the industry norm. Thus, Eastern is more *aggressively* financed than the industry.  Having a higher debt ratio does not necessarily mean that the company’s debt is lower quality.   1. Suppose a firm has a financial leverage ratio of 2.50.  What percentage of the firm’s assets   are financed by equity?  **Correct Answer: *40%***  The correct answer is 40%. We know that Assets (100%) = Liabilities (X%) + Equity (Y%).  So Financial leverage ratio = 2.5 = 100% / Y% = Assets/Equity; thus Y = 100 / 2.5 = 40%.   1. If a firm’s financial leverage ratio is 2.50, what percentage of assets are financed by debt?   **Correct Answer: *60%***  Solution: We know that Assets (100%) = Liabilities (X%) + Equity (Y%). So, Financial leverage  ratio = 2.5 = 100%/Y% = Assets/Equity; thus Y = 40%, so X = 60% = percent financed by debt. 4.6 Quick Check: Profitability Ratios Use the following balance sheet and income statement to answer the next three questions: |  1. What is the ROE for Eastern Family?   **Correct Answer: *8.94%***  ROE = 474 / 5300 = 8.94%   1. For Eastern Family, what percentage of sales is consumed by Cost of Goods Sold?   **Correct Answer: *58.90%***  Since Gross Margin = Gross Profit / Sales = 4110 / 10000 = 41.10%, the COGS / Sales = 1 –  Gross Margin = 58.90%.   1. Assume that the industry average ROE is 12%. For Eastern Family, which of the following   best describes their ROE:  **Correct Answer: *Eastern Family is generating lower return to owners than the industry.***  ROE for Eastern Family is 8.94% (474/5300 = 8.9%) which is less than the industry average.  44.  4. If the industry average ROE is 4.12% and ROA is 2.09%, the most plausible conclusion about  Macrosoft’s profitability is:    5.If the industry average ROE is 4.12% and ROA is 2.09%, the most plausible conclusion  about Macrosoft’s profitability is:  **Correct Answer: *Macrosoft is more profitable than the industry.***  For Macrosoft: ROE = NI/Equity = 462/8300 = 5.56%; ROA = 462/20900 = .0221 = 2.21%.  Hence, Macrosoft is generating higher ROA and ROE than the industry. Quick Check: The Granddaddy ofRatios: The DuPont DecompositionWhich one of the following is NOT included in the DuPont calculation? **Correct Answer: *Fixed asset turnover***  ROE = Net Margin x TAT x FLR = ROA x FLR.  2. Kyoto Restaurant has total asset turnover of 1.50, ROE of 18.00%, and net profit margin of 6.00%.  What is Kyoto’s financial leverage ratio?  **Correct Answer: *2.00***  ROE = Net Margin x TAT x FLR, so FLR = ROE / (Net Margin x TAT) = 0.18 / (0.06 x 1.50) = 2.00.   1. Consider Kyoto Restaurant. Kyoto’s ROE is lower than the industry average. However,   Kyoto’s total asset turnover and financial leverage ratio are identical to  the industry. The industry average net margin must be:  **Correct Answer: *Higher than Kyoto's net margin.***  Kyoto’s TAT and FLR are the same as the industry.  Since TAT x FLR x net margin = ROE, the  industry average net margin must be higher than Kyoto's since the industry has a higher ROE.   1. Big-Tokyo Inc. has a financial leverage ratio of 2.00, total asset turnover of 1.50 and   ROE of 18.00%. For Big-Tokyo’s industry, the average ROE is 16.00% and the industry  average total asset turnover (TAT) and financial leverage ratio (FLR) are the same as  Big-Tokyo. The industry average net margin must be:  **Correct Answer: *Lower than Big-Tokyo's.***  TAT and FLR are the same for the industry and Big-Tokyo.  Hence, since Big-Tokyo  has a higher ROE, Big-Tokyo must have a higher net margin than the industry. 4.8 Quick Check: How To Use Ratios: From Numbers to Information 1. Which one of the following is NOT an example of the use of meaningful comparison  standards for ratio analysis?  **Correct Answer: *Reporting ratios in annual financial statements.***   There are no required ratios for financial reporting. Simply including ratios for the year in an  annual report does not provide a comparison or standard for the calculated ratios. The other  answers are examples of internal goal monitoring, trend analysis, and cross-sectional analysis.  2. The timing of a firm’s fiscal year end would be most relevant to which of the following firms:  **Correct Answer: A snowboard shop.**  3.Which of the following best describes the problem associated with GAAP accounting  standards when performing ratio analysis?  **Correct Answer: *GAAP accounting standards allow for significant managerial discretion***  ***in reported financial statements.***  Within the confines of GAAP, managers still have significant discretion over reported results. 4.10 Quick Check: Refining the Analysis: Identifying Areas That Need Correction    1. Which one of the following statements is most likely correct?   **Correct Answer: *Firm B should have higher debt ratio than Firm A.***    Recall the DuPont equation: ROE = net margin x TAT x FLR. Both firms have the same net  profit margin, but Firm A has a higher TAT (total asset turnover) than Firm B.  Thus, the  equal ROEs for both firms imply that Firm B has a higher debt ratio (resulting in a  higher FLR; FLR = Assets/Equity) than Firm A.  Both firms have the same current ratio, but firm A has a higher quick ratio than firm B  implying Firm B's inventory is NOT more liquid than Firm A's.  Hence, firm A has  relatively less inventory than firm B.  The equal gross margin for both firms and the  higher quick ratio (lower inventory) suggests that inventory turnover is higher for firm  A than for firm B.  Thus, if anything, firm A’s inventory appears more liquid than firm  B’s inventory.  Firm A’s Sales/Current Assets is higher than Firm B’s and both companies have the same  fixed asset turnover.  So, Firm A should have higher total asset turnover than Firm B.   2. Eastern Family’s main competitor has Gross Margin of 40.32%, operating margin of 15.53%,  and net margin of 4.83%. Both Eastern Family and the competitor have the tax rate of 40%.  Given this information, Eastern Family must have:  **Correct Answer: *Lower interest expense than the competitor.***  Since Eastern Family has higher gross margin (41.10%), COGS is relatively low. Eastern Family  has higher operating expenses since the drop in operating margin (drop from net margin to  operating margin) is bigger than the competitor. You cannot tell dollar amount of sales with  the given ratios.  Given the other three answers can't be right, lower interest expense than competitor  (as a percent of sales) must be correct.  We can see this is the ratios. The difference between  operating margin and net margin is driven by **I**nterest and **T**axes (recall operating margin  is EBIT/Sales). As such, the change from operating to net margin indicates the percentage  of revenues consumed by interest and taxes.  For Eastern, the change is 8.76% (= operating  margin - net margin = 13.5% - 4.47%).  The equivalent change for the competitor is 10.7%.  Given that both firms pay the same percentage in taxes (i.e., 40% of EBT), the smaller change f  or Eastern Family is likely due to small interest expense on a relative basis.  Gross Margin = 4110/10000 = 41.1%; operating margin = 1350/10000 = 13.5%, net  margin = 474/10000 = 4.74%    3. The industry has the following ratios:  ·      Current ratio = 2.15  ·      Quick ratio = 1.5  ·      Inventory turnover = 1.95  ·      AR turnover = 4.5  Which one of the following statements is the most accurate about Eastern Family?  **Correct Answer: *Eastern Family takes longer to collect receivables than the industry.***  The accounts receivable turnover for Eastern Family is lower than the industry norm suggesting  that it takes the company longer to collect receivables than the industry average.You cannot  assess the company’s liquidity based on ONLY current ratio. Also, since Eastern Family's inventory turnover ratio is lower than the industry this would imply it is NOT better at managing its inventory.  Eastern Family's Current Ratio = 9700/3900 = 2.49; Quick Ratio = (9700-4000)/3900 = 1.46; Inventory turnover = 5890/4000 = 1.47; accounts receivable turnover = 10000/3000 = 3.33.   **Correct Answer: *Macrosoft’s higher current ratio and quick ratio could be due to***  ***the build up of illiquid current assets.***    For Macrosoft: 1) Current ratio = CA/CL = 12550/4260 = 2.94, 2) Quick ratio =  (CA-Inv)/CL = (12550 - 5300)/4260 = 1.70, 3) Inventory turnover =  Cost of goods sold/inventory = 8930/5300 = 1.68, and 4) AR Turnover =  credit sales/AR = 15000/3700 = 4.055; Therefore, Average Collection Period =  365/AR Turnover = 90.0 days. A common mistake is to interpret Macrosoft's higher  current and quick ratios as evidence the company is more liquid than the typical firm  in the industry.  Liquidity requires a broader view of the firm that can be gained by  looking only at the current ratio and quick ratio. Macrosoft has the same level of the  inventory turnover as the industry implying that inventories are NOT less liquid.  What about the other current assets? Notice that Macrosoft takes 90 days to collect  receivables compared to only 54.3 for the industry. The very long ACP relative to the  industry indicates the Macrosoft's AR are low quality (i.e., the firm has slow paying  customers or they are failing to write-off uncollectable receivables).  Hence, the high  level of both the current and quick ratio is likely due to the build up of low quality receivables.  The build-up of uncollectable/low-quality accounts receivable does nothing to provide liquidity for the firm.  Hence, the current and quick ratios, in isolation, are misleading for Macrosoft.   |  | | --- | |  | |
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