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Financial Reporting and Analysis

1. When the financial statements materially depart from accounting standards and are not fairly presented, the audit opinion would be a(n):

A. adverse opinion  
B. qualified opinion  
C. disclaimer of opinion

Answer: A

An adverse opinion occurs when the financial statements materially depart from accounting standards and are not fairly presented. A qualified opinion is one in which there is some limitation or exception to accounting standards.



2. Assume U.S. GAAP (generally accepted accounting principles) applies unless otherwise noted. An analyst gathers the following information from a company's accounting records (all figures in thousands):

Assets, 31 December 2008	\$5,250	
Liabilities, 31 December 2008		2,200
Contributed capital, 31 December 2008		1,400
Retained earnings, 1 January 2008	800	
Dividends declared during 2008	200	

The analyst's estimate of net income (\$ thousands) for 2008 is closest to:

A. 650.  
B. 850.  
C. 1,050.

Answer: C

Total assets = liabilities + owner's equity. Owner's equity = \$5,250 - 2,200 = 3,050. Owners equity = contributed capital + ending retained earnings. Ending retained earnings = 3,050 - 1,400 = 1,650. Ending retained earnings = beginning retained earnings + net income - dividends. 1,650 = 800 + net income - 200; Net income = \$1,050

3. According to the International Accounting Standards Board's Conceptual Framework for Financial Reporting, the two fundamental qualitative characteristics that make financial information useful are best described as:

A. Timeliness and accrual accounting.  
B. Understandability and verifiability.  
C. Relevance and faithful representation.

Answer: C



Relevance and faithful representation are the two fundamental characteristics according to IFRS.

4. A company, with a tax rate of 40%, sold a capital asset with a net book value of \$500,000 for \$570,000 during the year. Which of the following amounts (in \$) will most likely be reported on its income statement for the year related to the asset sale?

A. 42,000  
B. 70,000  
C. 570,000



Answer: B

The disposition of a capital asset is reported as a net gain or loss ( $\$570,000 - \$500,000 = \$70,000$ ) on the income statement before tax affects.

5. A company suffered a substantial loss when its production facility was destroyed in an earthquake against which it was not insured. Geological scientists were surprised by the earthquake because there was no evidence that one had ever occurred in that area in the past. Which of the following statements is most accurate? The company should report the loss on its income statement:

A. As an unusual item if it reports under US GAAP.  
B. Net of taxes if it reports under US GAAP.  
C. As an extraordinary item net of taxes if it reports under IFRS.

Answer = B

Suffered a substantial loss in a nature disaster is a case of extraordinary item which is net of taxes if reports under U.S. GAAP.

6. Assume U.S. GAAP (generally accepted accounting principles) applies unless otherwise noted. For the most recent year a manufacturing company reports the following items on their income statement:

Interest expense \$62,500

Loss on disposal of fixed assets \$50,000

Realized gain on sale of available-for-sale securities \$17,750

Which of the items is classified as an operating item in the company's income statement?

A. Interest expense.  
B. Loss on disposal of fixed assets.  
C. Realized gain on sale of available-for-sale securities.



Answer: B

The loss on the disposal of fixed assets is an unusual or infrequent item but it is still part of normal operating activities. The interest expense is the result of financing activities and would be classified as a non-operating expense by nonfinancial service companies. The realized gain on sale of available for sale securities is an investing activity and would also be classified as a

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non-operating gain by a manufacturing company.

7. Assume U.S. GAAP (generally accepted accounting principles) applies unless otherwise noted. An analyst gathers the following information about a company:

Shares of common stock outstanding	1,000,000
Net income for the year	\$1,500,000
Par value of convertible bonds with a 4 percent coupon rate	\$10,000,000
Par value of cumulative preferred stock with a 7 percent dividend rate	\$2,000,000
Tax rate	30%

The bonds were issued at par and can be converted into 300,000 common shares. All securities were outstanding for the entire year. Diluted earnings per share is closest to:

- A. \$1.05
- B. \$1.26
- C. \$1.36



Answer: B

Dividends of \$140,000 ( $0.07 \times 2,000,000$ ) should be deducted from net income amount available to common shareholders:  $\$1,360,000 = (\$1,500,000 - \$140,000)$ . Basic EPS would be  $\$1,360,000 / 1,000,000$  or \$1.36 per share. Diluted EPS would consider the convertible bonds if they were dilutive. Interest on the bonds is \$400,000 and the after-tax amount add back to net income is  $\$400,000 (1 - 0.30) = \$280,000$ . Diluted EPS, assuming conversion, is  $(\$1,360,000 + \$280,000) / (1,000,000 + 300,000) = \$1,640,000 / 1,300,000 = \$1.26$  per share. The bonds are dilutive.

8. Assume U.S. GAAP (generally accepted accounting principles) applies unless otherwise noted. At the end of the year, a company sold equipment for \$30,000 cash. The company paid \$110,000 for the equipment several years ago and had recorded accumulated depreciation of \$70,000 at the time of its sale. All else equal, the equipment sale will result in the company's cash flow from:
- A. investing activities increasing by \$30,000
  - B. investing activities decreasing by \$10,000
  - C. operating activities being \$10,000 less than net income

Answer: A

The book value of the equipment at the time of sale is  $\$110,000 - \$70,000 = \$40,000$ . The proceeds are \$30,000; therefore a loss of \$10,000 is reported on the income statement. The loss reduces net income, but it is a non-cash amount, so is added back to net income in the calculation of the cash from operations. Therefore, cash from operations is higher than net income, not lower. The total amount of the proceeds, \$30,000, is the cash inflow from the transaction and is shown as a cash inflow from investing activities.

9. The following information (in millions) on a company is available:

Cost of goods sold                      \$ 500



Increase in total assets	250
Increase in total liabilities	200
Change in inventory	(30)
Change in accounts payable	(25)
The amount of cash (in millions) that the company paid to its suppliers is closest to:	
A. \$445	
B. \$495	
C. \$505	

Answer = B

Cost of goods sold	\$500
Less: Decrease in inventory	(30)
Equals purchases from suppliers	\$470
Plus: Decrease in accounts payable	25
Cash paid to suppliers	\$495



10. The following information (U.S. \$ millions) for two companies operating in the same industry during the same time period is available:

	Company A	Company B
Net sales	120	300
Total assets	70	140
Total liabilities	25	40

If both companies achieve a return on equity of 15% for the period, which of the following statements is most likely correct? Compared to Company B, Company A has a:

- A. higher net profit margin
- B. higher total asset turnover
- C. lower financial leverage multiplier

Answer: A

<b>The DuPont system can be used to break down the ROE into three components:</b>				
<b>ROE = Profit margin x total asset turnover x financial leverage multiplier.</b>				
Component	Company A		Company B	
<b>Total asset turnover (sales/total assets)</b>	120/170	1.71	300/140	2.14
Company A has a lower total asset turnover, not higher				
<b>Equity (total assets – total liabilities)</b>	70-25	\$45	140-40	\$100
<b>Financial leverage multiplier (assets/equity)</b>	70/45	1.56	140/100	1.4

