Learning Module 12: Introduction to Financial Statement Modeling

Q.4557 MNO Services, a rapidly expanding service provider, is developing a sales-based proforma model to project its financial standings for the next quarter. Over recent years, the company has observed an average revenue growth of 7%. MNO's Cost of Goods Sold (COGS) typically represents 50% of its sales. The projected administrative and operational costs, including Selling, General, and administrative expenses (SG&A), are expected to escalate by 4% yearly. The executive team is deliberating substantial investments in technological infrastructure to support its growing client base and operational capacity. The organization also foresees modifications in its capital structure, likely influencing its borrowing costs. As a financial consultant, which of the following steps would be most imperative in ensuring the precision and reliability of the proforma model for MNO Services?

A. Primarily focusing on forecasting revenue growth.

B. Preserving the COGS and SG&A expenses at levels consistent with historical trends.

C. Attentively considering the planned investments in technological infrastructure and anticipated alterations in the capital structure.

The correct answer is **C.**

In the formulation of a proforma model, it's critical to address all components, including revenue growth, COGS, and operating costs. However, for MNO Services, which is contemplating substantial investments in technology and expecting changes in its capital structure, it's imperative to concentrate on these areas. Estimating the effects of these investments and changes in the capital structure on borrowing costs and other related parameters is key to ensuring the accuracy of the proforma model.

A is incorrect. Although projecting revenue growth is critical, focusing only on this aspect may ignore other significant factors like technological investments and changes in the capital structure, which MNO Services is considering. Adequate attention to these aspects is crucial for a well-rounded and dependable proforma model.

B is incorrect. Solely depending on historical data for COGS and SG&A, without accommodating the anticipated growth and shifts in the company's operational scope, could result in inaccurate projections. These figures are likely to vary with the planned technological investments and modifications in the capital structure.

CFA Level I, Volume 3, Topic 5 - Financial Statements Analysis, Learning Module 12: Introduction to Financial Statement Modeling, LOS 12a: demonstrate the development of a sales-based pro forma company model.

Q.4560 Which of the following is the *most likely* outcome for a company that chooses price reduction in a market with highly competitive rivalry and strong bargaining power of buyers?

A. Diminish the bargaining power of buyers.

B. Attain a sustainable competitive advantage.

C. Erode profit margins without significant market share gain.

The correct answer is **C.**

In a market characterized by highly competitive rivalry and strong bargaining power of buyers, a company that opts for price reduction is likely to erode its profit margins without achieving a significant gain in market share, as competitors may respond with similar price cuts.

A and B are incorrect. Price reduction in such a market is unlikely to lead to a sustainable competitive advantage or significantly diminish the bargaining power of buyers.

CFA Level I, Volume 3, Topic 5 - Financial Statements Analysis, Learning Module 12: Introduction to Financial Statement Modeling, LOS 12c: explain how the competitive position of a company based on Porter's five forces analysis affects prices and costs.

Q.4561 Which of the following is *most likely* an outcome for established companies in an industry when new entrants emerge and increase competition?

A. Established companies will significantly raise their prices.

B. New entrants will have minimal impact on the pricing strategies of established companies.

C. Established companies may reevaluate and potentially lower their prices to retain market share.

The correct answer is **C.**

Established companies may lower their prices in response to new entrants to maintain competitiveness and retain market share. Increasing competition often leads to more aggressive pricing strategies rather than higher prices.

A is incorrect. Raising prices in a market with emerging competitors would generally not be a strategic move; it could alienate customers and drive them towards the new entrants who might offer more competitive pricing.

B is incorrect. New entrants typically have a significant impact on the dynamics of an industry, including pricing strategies. Established companies often need to respond to these changes to maintain their position in the market.

CFA Level I, Volume 3, Topic 5 - Financial Statements Analysis, Learning Module 12: Introduction to Financial Statement Modeling, LOS 12c: explain how the competitive position of a company based on Porter's five forces analysis affects prices and costs.

Q.4563 In a market where the bargaining power of suppliers is high, what is a likely effect on companies requiring specialized inputs from these suppliers?

A. Companies will experience a decrease in production costs.

B. Companies may be forced to elevate their product prices due to increased input costs.

C. Companies will gain significant leverage over these suppliers, leading to lower input prices.

The correct answer is **B.**

In markets where suppliers have strong bargaining power, they can dictate higher prices for their inputs, leading companies to face increased production costs. These companies may need to increase their product prices to maintain profitability.

A is incorrect. High supplier power typically results in increased, not decreased, production costs for companies that rely on these suppliers for inputs.

C is incorrect. High bargaining power of suppliers usually means that the suppliers hold the leverage, not the companies purchasing from them. As a result, companies are less likely to achieve lower input prices and more likely to face higher costs.

CFA Level I, Volume 3, Topic 5 - Financial Statements Analysis, Learning Module 12: Introduction to Financial Statement Modeling, LOS 12c: explain how the competitive position of a company based on Porter's five forces analysis affects prices and costs.

Q.4564 In a deflationary environment, if companies hold prices steady despite decreased costs, what is the *most likely* effect on the industry?

A. Sudden increase in industry-wide profit margins.

B. Intensified price competition and reduced industry revenues

C. Potential increase in sales volume due to higher consumer purchasing power.

The correct answer is **C.**

Holding prices steady in a deflationary environment might lead to an increase in sales volume as consumer purchasing power increases and prices remain attractive compared to the deflating market.

A is incorrect. While holding prices steady can maintain or slightly improve margins, it does not guarantee a sudden increase in industry-wide profit margins, especially if operational costs remain unchanged.

B is incorrect. Holding prices steady in a deflationary environment is more likely to avoid price wars. It does not intensify price competition but rather bets on increased volume to drive revenue growth.

CFA Level I, Volume 3, Topic 5 - Financial Statements Analysis, Learning Module 12: Introduction to Financial Statement Modeling, LOS 12d: explain how to forecast industry and company sales and costs when they are subject to price inflation or deflation.

Q.4565 Which of the following is *most likely* an outcome for companies that fail to renegotiate supplier contracts or optimize production in a deflationary scenario

A. Rapid growth in market share.

B. Improved profitability due to naturally decreasing costs.

C. Difficulty maintaining profitability due to decreased pricing power and revenue.

The correct answer is **C.**

Companies that do not proactively manage their costs in a deflationary scenario may struggle to maintain profitability as prices and revenue decrease, and they fail to reduce operational costs accordingly.

A is incorrect. Simply facing deflation does not guarantee market share growth, especially if a company does not adapt its cost structure or pricing strategy.

B is incorrect. While costs may naturally decrease in a deflationary scenario, failure to further optimize costs or renegotiate contracts can result in missed opportunities for improved profitability.

CFA Level I, Volume 3, Topic 5 - Financial Statements Analysis, Learning Module 12: Introduction to Financial Statement Modeling, LOS 12d: explain how to forecast industry and company sales and costs when they are subject to price inflation or deflation.

Q.4566 Which of the following factors is *least likely* to be considered when using the DCF approach for long-term forecasting?

A. Company's historical average multiple.

B. Terminal cash flow persisting in the future.

C. Future long-term growth rate differing from the historical rate.

The correct answer is **A.**

The company's historical average multiple is not a direct consideration in the DCF approach, which focuses on the present value of expected future cash flows and growth rates, rather than relying on historical earnings multiples.

B is incorrect. Considering whether terminal cash flow will persist is an essential part of the DCF approach, ensuring the realism and sustainability of future cash flow projections.

C is incorrect. Assessing whether the future long-term growth rate will differ from the historical rate is a crucial part of the DCF approach, affecting the projection of future cash flows and the terminal value.

Q.4567 Which of the following is *most likely* a challenge in forecasting industry sales and costs during periods of economic disruption?

A. Economic disruption does not significantly impact industries.

B. It's difficult to predict inflection points where the future significantly differs from the recent past.

C. Industries typically do not respond to changes in the business cycle, government regulation, or technology.

The correct answer is **B.**

Economic disruption can lead to inflection points, making it challenging to predict future industry sales and costs as the conditions may significantly differ from historical trends and patterns.

A is incorrect. Economic disruption can have a profound impact on industries, affecting sales volumes, prices, and costs.

C is incorrect. Industries are often highly responsive to changes in the business cycle, government regulation, and technological advances, all of which can significantly affect their performance.
