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SOLUTIONS TO PRACTICE EXERCISES LECTURE 1

Solutions Q1:

Users of financial statements include present and potential investors, financial analysts, and other interested outside parties (such as lenders, suppliers and other trade creditors, and customers). Financial managers within the firm also use the financial statements when making financial decisions.

Investors. Investors are concerned with the risk inherent in, and return provided by, their investments. Bondholders use the firm's financial statements to assess the ability of the company to make its debt payments. Stockholders use the statements to assess the firm's profitability and ability to make future dividend payments.

Financial analysts. Financial analysts gather financial information, analyze it, and make recommendations. They read financial statements to determine a firm's value and project future earnings, so that they can provide guidance to businesses and individuals to help them with their investment decisions.

Managers. Managers use financial statements to look at trends in their own business, and to compare their own results with that of competitors.

Solutions Q2:

a. Long-term liabilities would decrease by \$20 million, and cash would decrease by the same amount. The book value of equity would be unchanged.

b. Inventory would decrease by \$5 million, as would the book value of equity.

c. Long-term assets would increase by \$10 million, cash would decrease by \$5 million, and long-term liabilities would increase by \$5 million. There would be no change to the book value of equity.

d. Accounts receivable would decrease by \$3 million, as would the book value of equity.

e. This event would not affect the balance sheet.

f. This event would not affect the balance sheet.

Solutions Q3:

Although Global Conglomerate's book value of equity increased by \$1 million from 2017 to 2018, the increase in the book value of equity does not necessarily indicate an increase in Global's share price. The market value of a stock does not depend on the historical cost of the firm's assets, but on investors' expectation of the firm's future performance. There are many events that may affect Global's future profitability, and hence its share price, that do not show up on the balance sheet.

Solutions Q4:

a. ANF's market-to-book ratio = (25.52 x 69.35)/1,390 = 1.27.

   GPS's market-to-book ratio = (41.19 x 421)/2,983 = 5.81.

b. For the market, the outlook of Abercrombie and Fitch is less favorable than that of The Gap. For every dollar of equity invested in ANF, the market values that dollar today at \$1.27 versus \$5.81 for a dollar invested in the GPS. Equity investors are willing to pay relatively less today for shares of ANF than for GPS because they expect GPS to produce superior performance in the future.

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Solutions Q5:

a. 2015 Market Capitalization: 4 billion shares × \$16/share = \$64.

2018 Market Capitalization: 4 billion shares × \$11/share = \$44.

The change over the period is \$44 – \$64 = -\$20 billion.

b. 2015 Market-to-Book = 64/24.8 = 2.58.

2018 Market-to-Book = 44/35 = 1.26.

The change over the period is: 1.26 – 2.58 = -1.32.

c. 2015 Enterprise Value = \$64 – 21.7 + 119.2 = \$161.5 billion.

2018 Enterprise Value = \$44 – 26.5 + 154.3 = \$171.8 billion.

The change over the period is: \$171.8 – \$161.5 = \$10.3 billion.

Solutions Q6:

a. Apple's current ratio = 89.38/80.61 = 1.11.

b. Apple's quick ratio = (41.60 + 35.89)/80.61 = 0.96.

c. Apple's cash ratio = 41.60/80.61 = 0.52.

d. Apple generally has more liquid assets than HPQ relative to current liabilities, with the exception of a slightly lower current ratio, for instance, due to a lower proportion of inventory.

Solutions Q7:

a. **Firm A:** Market debt-equity ratio = 495.8/401.1 = 1.24

Firm B: Market debt-equity ratio = 83.8/35.9 = 2.33

b. **Firm A:** Book debt-equity ratio = 495.8/297.9 = 1.66

Firm B: Book debt-equity ratio = 83.8/38.3 = 2.19

c. **Firm A:** Interest coverage ratio = 106.8/45.2 = 2.36

Firm B: Interest coverage ratio = 8.4/7.5 = 1.12

d. Firm B has a lower coverage ratio and hence, will have more difficulty meeting its debt obligations than Firm A.

Solutions Q8:

a. Tesco's ROE = 16.36/81.39 = 20.10%.

Tesco's net profit margin = 16.36/485.65 = 3.37%.

Tesco's asset turnover = 485.65/203.49 = 2.39.

Tesco's equity multiplier = 203.49/81.39 = 2.50.

Tesco's ROE (DuPont) = 3.37% × 2.39 × 2.50 = 20.14% (difference due to rounding).

b. Compared to Aeon Group, Tesco has a superior profit margin, but a lower asset turnover and a lower equity multiplier (which could represent less leverage). Despite the higher profit margin, it has a smaller ROE that is driven by its lower asset turnover and leverage.