**Chapter Preview: Chapter 2**

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Answer the following questions briefly.

1. List the three major financial statements and define them

- Balance Sheet

It provide the firm’s assets, liabilities, and stockholder’s equity. The left side shows how the firm uses its capital, and the right side shows the source of capital and how a firm raises the money it needs.

- Income Statement

: It provide the firm’s revenue and expenses over a period of time.

- Cash flow

: It provides the information from the income statement and balance sheet to determine how much cash the firm has generated and how that cash has been allocated during a set period.

2. Discuss the difference between book value of shareholders’ equity and market value of shareholders’ equity.

: Book value = Asset – Liabilities; (Equity)

: Market value = # of stocks X price; (Expectation for future value)

: Book value is the price paid for a particular asset. As long as you own the asset, the price does not change. On the other hand, market value is the current price at which an asset can be sold.

: Market V / Book V > 1 -> growth stocks,

: Market V / Book V < 1 -> value stocks

3. Define or explain the following measures and terms:

- Enterprise value

: It is the cost to take over the business

: Enterprise value = Market Value of Equity + Debt - Cash

- diluted EPS (Earning Per Share)

: There will be more total shares because of the stock options and the convertible bonds. Therefore, It represents earnings per share for the company calculated.

- Depreciation and Amortization

: The two terms’ concepts are almost same. They are a way of recognizing that assets become less valuable the older they get. The difference between them is, Depreciation is about tangible assets and Amortization is about intangible assets like goodwill.

- Profitability ratios

: It represents the overall efficiency of corporate management. (based on Income Statement)

: Gross Margin = Gross Profit/sales -> ability to sell a product for more than cost of producing it.

: Operating Margin = Operating Income/Sales -> how much a company earns before interest and taxes from each dollar of sales

: Net profit Margin = Net Income/Sales -> revenues that is available to equity holders after the firm pays interest and taxes

- Liquidity ratios

: It indicates the ability to convert cash into cash within a short period of time, and the ability to raise cash necessary to settle short-term debt.

: Current Ratio = Current Assets/Current Liabilities

: Quick Ratio = Quick Assets(Current Assets - inventories)/Current Liabilities

: Cash Ratio = Cash/Current Liabilities

- Working capital ratios

: provide how efficiently the firm is utilizing its net working capital.

: Accounts Receivable Days = Accounts Receivable/Average Daily Sales

* To evaluate the speed at which a company turns sales into cash

: Accounts Payable Days = Accounts Payable/Average Daily Cost of Sales

: Inventory days = Inventories/Average Daily Cost of Sales

- Interest coverage ratios

: To assess a firm’s ability to meet its interest obligations by comparing its earnings with its interest expenses using interest coverage ratio.

: EBIT = earnings before interest, taxes

: EBITDA = earnings before interest, taxes, depreciation, amortizations ( EBIT + D + A)

: Interest coverage ratio = EBITDA/Interest

: high = good, low = worrying

- leverage ratios

: Measures whether you have the ability to respond to changes in external economic conditions, such as economic fluctuations or changes in market conditions, in the long run

- valuation ratio

: assess the market value of the firm

: P/E Ratio = Market Capitalization/Net Income = Share Price/Earnings Per Share

- operating returns

: assess the firm’s return on investment by comparing its income to its investment.

: ROE = Net Income/Book Value of Equity

: ROA = (Net Income + Interest Expense)/Book Value of Assets

: ROI = EBIT(1 – tax rate) / (Book Value of Equity + Net Debt)

4. Briefly explain the Enron scandals described in the text (or you can introduce any financial scandals comparable to the Enron in any countries).

Daewoo was a Korean conglomerate with several business divisions, including textiles, trading, construction, shipbuilding, and automobiles, etc.

However, with the IMF crisis in the late 1990s, debt repayment became difficult, and in this process, Daewoo's massive accounting fraud was revealed.

Daewoo inflated sales by claiming to have done construction even though it did not actually carry out the construction, and also hid its debt by borrowing money from overseas banks and laundering it through third-party capital increase.

As a result, Daewoo committed accounting fraud amounting to 41 trillion won, the largest amount in the world to this day, and the entire group was disbanded.