Chapter Preview: Chapter 2

Answer the following questions briefly.

1. **List the three major financial statements and define them.**
   1. **Balance sheet, or statement of financial position:**

The list of firm’s financial status about assets and liabilities on a particular point in time.

* 1. **Income statement, or statement of financial performance:**

The list of corporate earnings and spendings over a period.

* 1. **Statement of cash flow:**

The list of amounts of cash generated and allocated during the set period is based on information from balance sheet and income statement.

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

Shareholders’ equity is the difference between total assets and total liabilities. The book value of a firm's equity, recorded in the balance sheet, represents the historical cost-based valuation of the company's assets minus liabilities. However, this book value does not necessarily reflect the actual market value of shareholders' equity, as it does not account for investor expectations, market conditions, and future growth potential. The market value of shareholders' equity is determined by multiplying the current market price of shares by the total number of outstanding shares, which fluctuates based on investor perception and market dynamics.

1. **Define or explain the following measures and terms:**
   1. **Enterprise value (EV)**

= Market Value of Equity + Debt – Cash

How much do you need to pay to take over the entire enterprise.

* 1. **Value stocks/ growth stocks**

Firms with low market-to-book ratios / firms with high market-to-book ratios

Market-to-book ratios < 1.0 … overrated

Market-to-book ratios > 1.0 … underrated

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* 1. **Diluted EPS**

Diluted EPS represents EPS that reflects the potential increase in the number of shares in the future.

* 1. **Depreciation and Amortization**

Depreciation is a way of recognizing tangible assets wear out over time, reducing their values.

Amortization is a method for assessing how the value of intangible assets diminishes over time.

* 1. **Profitability ratios**

is ability to sell a product for more than the cost of producing. About efficiency of production

is how much a company earns before interest and tax (EBIT) from sales. About profitability of operation

is the ratio of net profit (after interest and tax) to total revenue. About evaluation of true profit.

* 1. **Liquidity ratios**

Estimate ability to repay debt in the short-term using liquid assets.

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* 1. **Working capital ratios**

A measure of how efficiently a company is using its working capital Interest coverage ratio.

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* 1. **Leverage ratios**

Evaluate the extent to which financing relies on debt.

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* 1. **Valuation ratio**

an indicator of corporate market value

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* 1. **Operating returns**

Criteria for evaluating a company's profitability based on profits generated from business activities

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

Enron was a natural gas company, but its aggressive business expansion seemed to be making great progress in various fields. In fact, Enron's management deceived investors and financial institutions by manipulating Enron's financial statements. As a result, Enron achieved a high return on books, greatly increasing its market value. However, due to the aftermath of fraudulent accounting, Enron eventually went bankrupt.