

# Chapter2 preview

## 1. List the three major financial statements and define them.

The three primary financial statements used to understand a company's financial position and performance are as follows:

### **Balance Sheet**

- A financial statement that presents a company's assets, liabilities, and stockholders' equity at a specific point in time.
- It shows what the company owns and owes, providing insight into its financial health.

### **Income Statement**

- A statement that reports a company's revenues and expenses over a given period, reflecting the firm's profitability.
- It helps investors and stakeholders evaluate the company's performance and earnings potential.

### **Statement of Cash Flows**

- A report that tracks the company's cash inflows and outflows across operating, investing, and financing activities during a period.
- It provides a clearer picture of the firm's liquidity and cash management.

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

The difference between book value and market value arises from the methods used to evaluate a company's worth.

- **Book Value:** The value of shareholders' equity based on accounting records, calculated as assets - liabilities on the balance sheet.
- **Market Value:** The value determined by stock market investors, reflecting factors such as growth potential, brand value, and future earnings expectations.

- Market value is generally higher than book value, especially for high-growth firms, as it considers future opportunities and investor sentiment.

### 3. Define or explain the following measures and terms

- **Enterprise Value (EV)**
  - Represents the total value of a company, calculated as Market Capitalization + Total Debt - Cash.
  - It provides a measure of a firm's actual worth by excluding cash reserves.
- **Value Stocks & Growth Stocks**
  - Value Stocks: Stocks that appear undervalued based on financial metrics, often having low market-to-book ratios.
  - Growth Stocks: Stocks with high growth potential, typically characterized by high market-to-book ratios.
- **Diluted Earnings Per Share (Diluted EPS)**
  - A conservative measure of earnings per share that accounts for potential dilution from stock options, convertible bonds, and other securities.
- **Depreciation and Amortization**
  - Depreciation: The process of allocating the cost of tangible assets (e.g., buildings, machinery) over their useful life.
  - Amortization: The gradual expense recognition of intangible assets (e.g., patents, licenses) over time.
- **Profitability Ratios**
  - Metrics that assess a company's ability to generate profits, such as Return on Assets (ROA), Return on Equity (ROE), and Operating Margin.
- **Liquidity Ratios**
  - Measures that evaluate a firm's ability to meet short-term obligations, including the Current Ratio and Quick Ratio.

- **Working Capital Ratios**
  - Indicators of operational efficiency, calculated using  $\text{Working Capital} = \text{Current Assets} - \text{Current Liabilities}$ .
- **Interest Coverage Ratio**
  - Assesses a firm's ability to pay interest expenses, calculated as  $\text{EBIT} / \text{Interest Expense}$ .
- **Leverage Ratios**
  - Ratios that measure a company's reliance on debt, such as Debt-to-Equity Ratio.
- **Valuation Ratios**
  - Metrics used to evaluate a company's market value, such as the Price-to-Earnings (P/E) Ratio and EV/EBITDA.
- **Operating Returns**
  - Measures of operational efficiency, including Return on Invested Capital (ROIC).

## 4. Briefly explain the Enron scandals described in the text.

The **Enron scandal** is one of the most infamous cases of corporate fraud, where Enron used **accounting manipulation** to hide debt and inflate earnings, ultimately leading to its bankruptcy in 2001.

Enron used **Special Purpose Entities (SPEs)** to keep liabilities off its balance sheet while artificially inflating profits.

Investors and auditors failed to detect the fraud, leading to **one of the largest corporate bankruptcies** in history.

As a result, the **Sarbanes-Oxley Act (SOX)** was enacted to enforce stricter corporate financial reporting and internal controls.

The Enron scandal underscored the importance of **corporate transparency, ethical management, and stringent accounting regulations** in financial markets.