**Chapter Preview: Chapter 2**

Answer the following questions briefly.

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

-Balance Sheet-

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

: provide the firm’s revenue and expenses over a period of time. Net income = earnings

: It does not provide the amount of cash the firm has generated.

-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.

-operating activity/investment activity/financing activity

**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).

: Enron was a global trader dealing in range of products including gas, oil, electricity, and internet.

: However, Enron executives had been manipulating Enron’s financial statements and artificially inflate the price of Enron’s stock and maintain its credit rating.

: The methods was simple -> Enron earned a lot of cash by selling assets at inflated prices to other firms and made an promise to buy back those assets at higher price in the future. And then Enron recorded the incoming cash as revenue and hid the promises.

: In the end, led Enron to the largest bankruptcy.