Corporate Finance, 3Ce **(Berk, DeMarzo, Strangeland)**
Chapter 2 Introduction to Financial Statement Analysis

2.1 The Disclosure of Financial Information

1) Canadian public companies are required to file their interim financial statements and annual financial statements with which one of the following authorities?
A) Provincial Security Commissions
B) Federal Security Commissions
C) Provincial Finance Ministry
D) Federal Finance Ministry
Answer: A
Diff: 1 Type: MC
Topic: 2.1 The Disclosure of Financial Information

2) As of January 1, 2011, Canadian publicly accountable companies must follow IFRS in their financial statements. IFRS rules are expected to be adopted in the US for fiscal years beginning ________.
A) January 1st, 2014
B) January 1st, 2017
C) January 1st, 2015
D) January 1st, 2016
Answer: D
Diff: 2 Type: MC
Topic: 2.1 The Disclosure of Financial Information

3) Under IFRS, every public company is required to produce ________ financial statements.
A) four
B) five
C) six
D) seven
Answer: B
Diff: 2 Type: MC
Topic: 2.1 The Disclosure of Financial Information

4) The third party who checks annual financial statements to ensure that they are prepared according to Canadian GAAP and verifies that the information reported is reliable is the
A) Toronto Stock Exchange Board.
B) Accounting Standards Board.
C) Provincial Securities Commission.
D) Auditor.
Answer: D
Diff: 2 Type: MC
Topic: 2.1 The Disclosure of Financial Information

5) Which of the following is NOT a financial statement that every public company is required by IFRS to produce?
A) Income Statement
B) Statement of Comprehensive Income
C) Balance Sheet
D) Statement of Changes in Equity
Answer: B
Diff: 3 Type: MC
Topic: 2.1 The Disclosure of Financial Information

6) What is the role of an auditor in financial statement analysis?
Answer: Key points:
1. To ensure that the annual financial statements are prepared accurately.
2. To ensure that the annual financial statements are prepared according to the Canadian GAAP.
3. To verify that the information used in preparing the annual financial statements is reliable.
Diff: 2 Type: ES
Topic: 2.1 The Disclosure of Financial Information

7) What are the five financial statements that all public companies are required to produce by IFRS?
Answer:
1. The Balance Sheet
2. The Income Statement
3. The Statement of Cash Flows
4. The Statement of Shareholders' Equity
5. The Statement of Changes in Equity
Diff: 3 Type: ES
Topic: 2.1 The Disclosure of Financial Information

2.2 The Balance Sheet

1) Cash is a
A) long-term asset.
B) current asset.
C) current liability.
D) long-term liability.
Answer: B
Diff: 1 Type: MC
Topic: 2.2 The Balance Sheet

2) Accounts payable is a
A) long-term liability.
B) current asset.
C) long-term asset.
D) current liability.
Answer: D
Diff: 1 Type: MC
Topic: 2.2 The Balance Sheet

3) A 30 year mortgage loan is a
A) long-term liability.
B) current liability.
C) current asset.
D) long-term asset.
Answer: A
Diff: 1 Type: MC
Topic: 2.2 The Balance Sheet

4) Shareholders' equity, the difference between the firm's ________, is an accounting measure of the firm's ________.
A) assets and liabilities; net value
B) assets and liabilities; book value
C) short-term liabilities and long-term liabilities; net value
D) short-term liabilities and long-term liabilities; book value
Answer: A
Diff: 1 Type: MC
Topic: 2.2 The Balance Sheet

5) Depreciation is ________ that the firm ________.
A) an actual cash expense; pays
B) not an actual cash expense; receives
C) not an actual cash expense; pays
D) an actual cash expense; receives
Answer: C
Diff: 2 Type: MC
Topic: 2.2 The Balance Sheet

6) Goodwill captures the value of other ________ that the firm acquired through acquisition. If the value of these ________ assets declines over time, the amount of goodwill listed on the balance sheet will be ________ by a write-down that captures the change in value of the acquired assets.
A) "tangibles"; tangible; reduced
B) "tangibles"; tangible; raised
C) "intangibles"; intangible; raised
D) "intangibles"; intangible; reduced
Answer: D
Diff: 2 Type: MC
Topic: 2.2 The Balance Sheet

7) Which of the following balance sheet equations is incorrect?
A) Assets - Liabilities = Shareholders' Equity
B) Assets = Liabilities + Shareholders' Equity
C) Assets - Current Liabilities = Long Term Liabilities
D) Assets - Current Liabilities = Long Term Liabilities + Shareholders' Equity
Answer: C
Diff: 2 Type: MC
Topic: 2.2 The Balance Sheet

8) Which of the following statements regarding the balance sheet is incorrect?
A) The balance sheet provides a snapshot of the firm's financial position at a given point in time.
B) The balance sheet lists the firm's assets and liabilities.
C) The balance sheet reports stockholders' equity on the right hand side.
D) The balance sheet reports liabilities on the left hand side.
Answer: D
Diff: 2 Type: MC
Topic: 2.2 The Balance Sheet

Use the table for the question(s) below.

Consider the following balance sheet:

Luther Corporation
Consolidated Balance Sheet
December 31, 2006 and 2005 (in $ millions)

Assets	**2006**	**2005**	**Liabilities and Stockholders' Equity**	**2006**	**2005**
Current Assets			*Current Liabilities*		
Cash	63.6	58.5	Accounts payable	87.6	73.5
Accounts receivable	55.5	39.6	Notes payable / short-term debt	10.5	9.6
Inventories	45.9	42.9	Current maturities of long-term debt	39.9	36.9
Other current assets	6.0	3.0	Other current liabilities	6.0	12.0
Total current assets	171.0	144.0	Total current liabilities	144.0	132.0
Long-Term Assets			*Long-Term Liabilities*		
Land	66.6	62.1	Long-term debt	239.7	168.9
Buildings	109.5	91.5	Capital lease obligations	---	---
Equipment	119.1	99.6	Total Debt	239.7	168.9
Less accumulated depreciation	(56.1)	(52.5)	Deferred taxes	22.8	22.2
Net property, plant, and equipment	239.1	200.7	Other long-term liabilities	---	---
Goodwill	60.0	--	Total long-term liabilities	262.5	191.1
Other long-term assets	63.0	42.0	Total liabilities	406.5	323.1
Total long-term assets	362.1	242.7	Stockholders' Equity	126.6	63.6
Total Assets	**533.1**	**386.7**	**Total liabilities and Stockholders' Equity**	**533.1**	**386.7**

9) What is Luther's net working capital in 2005?
A) $12 million
B) $27 million
C) $39 million
D) $63.6 million
Answer: A
Explanation: A) NWC = current assets - current liabilities = 144 - 132 = $12 million
Diff: 2 Type: MC
Topic: 2.2 The Balance Sheet

2.3 Balance Sheet Analysis

1) Market-to-book-ratio is also called the ________.
A) price-to-debt ratio
B) price-to-book ratio
C) price-to-asset ratio
D) price-to-equity ratio
Answer: B
Diff: 1 Type: MC
Topic: 2.3 Balance Sheet Analysis

2) Market-to-Book-Ratio is a ratio between ________.
A) market value of asset and book value of asset
B) market value of inventory and book value of inventory
C) market value of liabilities and book value of liabilities
D) market value of equity and book value of equity
Answer: D
Diff: 1 Type: MC
Topic: 2.3 Balance Sheet Analysis

3) A higher ________ implies less risk of the firm experiencing a cash shortfall in the near future.
A) return on asset ratio
B) market-to-book ratio
C) current ratio
D) return on equity ratio
Answer: C
Diff: 1 Type: MC
Topic: 2.3 Balance Sheet Analysis

4) ________ is the difference between total asset value and total liability value.
A) Market value
B) Residual value
C) Liquidity value
D) Liquidation value
Answer: C
Diff: 2 Type: MC
Topic: 2.3 Balance Sheet Analysis

5) The debt-to-equity ratio is calculated by dividing the ________ by ________.
A) total debt; total shareholders' equity
B) short-term debt; retained earnings
C) long-term debt; total equity
D) long-term debt; preferred equity
Answer: A
Diff: 2 Type: MC
Topic: 2.3 Balance Sheet Analysis

6) Enterprise Value is equal to ________.
A) market value of equity plus debt minus current assets
B) market value of current assets plus current liabilities minus inventory
C) market value of assets plus debt minus equity
D) market value of equity plus debt minus cash
Answer: D
Diff: 2 Type: MC
Topic: 2.3 Balance Sheet Analysis

7) Creditors often compare a firm's ________ and ________ to assess whether the firm has sufficient working capital to meet its short-term needs.
A) total assets; total liabilities
B) current assets; current liabilities
C) total assets; current liabilities
D) current assets; total liabilities
Answer: B
Diff: 2 Type: MC
Topic: 2.3 Balance Sheet Analysis

Use the table for the question(s) below.

Consider the following balance sheet:

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8) If in 2006 Luther has 10.2 million shares outstanding and these shares are trading at $16 per share, then Luther's market-to-book ratio would be closest to:
A) 0.39
B) 0.76
C) 1.29
D) 2.57
Answer: C
Explanation: C) MTB = market cap / book value of equity = (10.2 million × 16) / 126.6 = 163.2 / 126.6 = 1.289
Diff: 2 Type: MC
Topic: 2.3 Balance Sheet Analysis

9) When using the book value of equity, the debt to equity ratio for Luther in 2006 is closest to:
A) 2.21
B) 2.29
C) 2.98
D) 3.03
Answer: B
Explanation: B) D/E = Total Debt / Total Equity
Total Debt = (notes payable (10.5) + current maturities of long-term debt (39.9) + long-term debt (239.7) = 290.1 million
Total Equity = 126.6, so D/E = 290.1 / 126.6 = 2.29
Diff: 2 Type: MC
Topic: 2.3 Balance Sheet Analysis

10) Luther's current ratio for 2006 is closest to:
A) 0.84
B) 0.87
C) 1.15
D) 1.19
Answer: D
Explanation: D) current ratio = current assets / current liabilities = 171 / 144 = 1.19
Diff: 2 Type: MC
Topic: 2.3 Balance Sheet Analysis

11) Luther's quick ratio for 2005 is closest to:
A) 0.77
B) 1.31
C) 1.09
D) 0.92
Answer: A
Explanation: A) quick ratio = (current assets - inventory) / current liabilities
quick ratio = (144.0 - 42.9) / 132 = 0.77
Diff: 2 Type: MC
Topic: 2.3 Balance Sheet Analysis

12) If in 2006 Luther has 10.2 million shares outstanding and these shares are trading at $16 per share, then using the market value of equity, the debt to equity ratio for Luther in 2006 is closest to:
A) 1.71
B) 1.78
C) 2.31
D) 2.35
Answer: B
Explanation: B) D/E = Total Debt / Total Equity
Total Debt = (notes payable (10.5) + current maturities of long-term debt (39.9) + long-term debt (239.7) = 290.1 million
Total Equity = 10.2 × $16 = 163.2, so D/E = 290.1 / 163.2 = 1.78
Diff: 3 Type: MC
Topic: 2.3 Balance Sheet Analysis

13) If in 2006 Luther has 10.2 million shares outstanding and these shares are trading at $16 per share, then what is Luther's Enterprise Value?
A) -$63.3 million
B) $353.1 million
C) $389.7 million
D) $516.9 million
Answer: C
Explanation: C) Enterprise value = MVE + Debt - Cash = 10.2 × $16 + 290.1 - 63.6 = 389.7
Diff: 3 Type: MC
Topic: 2.3 Balance Sheet Analysis

14) The change in Luther's quick ratio from 2005 to 2006 is closest to:
A) a decrease of .10
B) an increase of .10
C) a decrease of .15
D) an increase of .15
Answer: B
Explanation: B) quick ratio in 2006 = (171.0 - 45.9)/144 = .87
quick ratio 2005 = (144.0 - 42.9) / 132 = .77
so the quick ratio increased by .87 - .77 = .10
Diff: 3 Type: MC
Topic: 2.3 Balance Sheet Analysis

15) P/B ratio is ________.
A) price-to-book ratio
B) profit-to-book ratio
C) property-to-book ratio
D) price-to-benefit ratio
Answer: A
Diff: 3 Type: MC
Topic: 2.3 Balance Sheet Analysis

16) The debt-equity ratio is a common ratio used to assess a firm's ________.
A) liquidity
B) return on equity
C) leverage
D) retained earnings
Answer: C
Diff: 3 Type: MC
Topic: 2.3 Balance Sheet Analysis

17) By comparing a firm's current assets and current liabilities, one can assess whether the firm has sufficient ________ to meet its ________ needs.
A) long-term capital; short-term
B) working capital; short-term
C) working capital; long-term
D) marketable securities; long-term
Answer: B
Diff: 3 Type: MC
Topic: 2.3 Balance Sheet Analysis

Use the table for the question(s) below.

Consider the following balance sheet:

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Consolidated Balance Sheet
December 31, 2006 and 2005 (in $ millions)

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Equipment	119.1	99.6	Total Debt	239.7	168.9
Less accumulated depreciation	(56.1)	(52.5)	Deferred taxes	22.8	22.2
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Goodwill	60.0	--	Total long-term liabilities	262.5	191.1
Other long-term assets	63.0	42.0	Total liabilities	406.5	323.1
Total long-term assets	362.1	242.7	Stockholders' Equity	126.6	63.6
Total Assets	**533.1**	**386.7**	**Total liabilities and Stockholders' Equity**	**533.1**	**386.7**

18) If on December 31, 2005 Luther has 8 million shares outstanding trading at $15 per share, then what is Luther's market-to-book ratio?
Answer: market-to-book = market value of equity / book value of equity
market-to-book = 8 million × $15 / $63.6 = 1.89
Diff: 3 Type: ES
Topic: 2.3 Balance Sheet Analysis

19) If on December 31, 2005 Luther has 8 million shares outstanding trading at $15 per share, then what is Luther's enterprise value?
Answer: Enterprise value = Market value of equity + Debt - Cash
market value of equity = 8 million × $15 = $120 million
Debt = notes payable + current maturities of long-term debt + long-term debt
Debt = 9.6 + 36.9 + 168.9 = 215.4
Cash = 58.5
So, enterprise value = $120 + 215.4 - 58.5 = $276.90
Diff: 3 Type: ES
Topic: 2.3 Balance Sheet Analysis

2.4 The Income Statement

1) Firms disclose the potential for the dilution from options they have awarded by reporting ________.
A) diluted total earnings before interest and taxes
B) diluted earnings per share
C) diluted dividend payment
D) diluted total earnings
Answer: B
Diff: 1 Type: MC
Topic: 2.4 The Income Statement

2) Which of the following statements regarding the income statement is incorrect?
A) The income statement shows the earnings and expenses at a given point in time.
B) The income statement shows the flow of earnings and expenses generated by the firm between two dates.
C) The last or "bottom" line of the income statement shows the firm's net income.
D) The first line of an income statement lists the revenues from the sales of products or services.
Answer: A
Diff: 2 Type: MC
Topic: 2.4 The Income Statement

3) Gross profit is calculated as
A) total sales - cost of sales - selling, general and administrative expenses - depreciation and amortization.
B) total sales - cost of sales - selling, general and administrative expenses.
C) total sales - cost of sales.
D) none of the above
Answer: C
Diff: 2 Type: MC
Topic: 2.4 The Income Statement

4) Which of the following is NOT an operating expense?
A) Interest expense
B) Depreciation and amortization
C) Selling, general and administrative expenses
D) Research and development
Answer: A
Diff: 2 Type: MC
Topic: 2.4 The Income Statement

Use the table for the question(s) below.

Consider the following income statement and other information:

Luther Corporation Consolidated Income Statement Year ended December 31 (in $ millions)		
	2006	**2005**
Total sales	610.1	578.3
Cost of sales	(500.2)	(481.9)
Gross profit	109.9	96.4
Selling, general, and administrative expenses	(40.5)	(39.0)
Research and development	(24.6)	(22.8)
Depreciation and amortization	(3.6)	(3.3)
Operating income	41.2	31.3
Other income	---	---
Earnings before interest and taxes (EBIT)	41.2	31.3
Interest income (expense)	(25.1)	(15.8)
Pretax income	16.1	15.5
Taxes	(5.5)	(5.3)
Net income	10.6	10.2
Price per share	$16	$15
Shares outstanding (millions)	10.2	8.0
Stock options outstanding (millions)	0.3	0.2
Stockholders' Equity	126.6	63.6
Total Liabilities and Stockholders' Equity	533.1	386.7

5) For the year ending December 31, 2006 Luther's earnings per share are closest to:
A) $1.01
B) $1.04
C) $1.58
D) $4.04
Answer: B
Explanation: B) EPS = Net Income / Shares Outstanding = $10.6 / 10.2 = $1.04
Diff: 1 Type: MC
Topic: 2.4 The Income Statement

6) Assuming that Luther has no convertible bonds outstanding, then for the year ending December 31, 2006 Luther's diluted earnings per share are closest to:
A) $1.01
B) $1.04
C) $1.53
D) $3.92
Answer: A
Explanation: A) Diluted EPS = Net Income / (shares outstanding + options contracts outstanding + shares possible from convertible bonds outstanding) = 10.6 / (10.2 + 0.3 + 0.0) = $1.01
Diff: 2 Type: MC
Topic: 2.4 The Income Statement

7) The income statement lists the firm's ________.
A) assets and equities over a period of time
B) assets and liabilities over a period of time
C) variable costs and fixed costs at the end of the fiscal year
D) revenues and expenses over a period of time
Answer: D
Diff: 1 Type: MC
Topic: 2.4 The Income Statement

8) The balance sheet shows the ________ of a firm ________. The income statement shows the flow of ________ generated by them ________.
A) assets and liabilities; between two dates; revenues and expenses; at a given point in time
B) revenues and expenses; between two dates; assets and liabilities; at a given point in time
C) assets and liabilities; at a given point in time; revenues and expenses; between two dates
D) revenues and expenses; at a given point in time; assets and liabilities; between two dates
Answer: C
Diff: 2 Type: MC
Topic: 2.4 The Income Statement

2.5 Income Statement Analysis

1) DuPont Identity expresses the ROE in terms of the firm's ________.
A) profitability, asset efficiency, and leverage
B) current assets, current liabilities, long-term debts
C) profitability, interest expense, and net income
D) total assets, total liabilities, and total equity
Answer: A
Diff: 1 Type: MC
Topic: 2.5 Income Statement Analysis

2) The P/E ratio is not useful when the firm's ________ are negative. In this case, it is common to look at the firm's ________ relative to sales.
A) operating earnings; enterprise value
B) net earnings; enterprise value
C) operating earnings; market value
D) net earnings; market value
Answer: B
Diff: 2 Type: MC
Topic: 2.5 Income Statement Analysis

Use the table for the question(s) below.

Consider the following income statement and other information:

Luther Corporation
Consolidated Income Statement
Year ended December 31 (in $ millions)

	2006	**2005**
Total sales	610.1	578.3
Cost of sales	(500.2)	(481.9)
Gross profit	109.9	96.4
Selling, general, and administrative expenses	(40.5)	(39.0)
Research and development	(24.6)	(22.8)
Depreciation and amortization	(3.6)	(3.3)
Operating income	41.2	31.3
Other income	---	---
Earnings before interest and taxes (EBIT)	41.2	31.3
Interest income (expense)	(25.1)	(15.8)
Pretax income	16.1	15.5
Taxes	(5.5)	(5.3)
Net income	10.6	10.2
Price per share	$16	$15
Shares outstanding (millions)	10.2	8.0
Stock options outstanding (millions)	0.3	0.2
Stockholders' Equity	126.6	63.6
Total Liabilities and Stockholders' Equity	533.1	386.7

3) Luther's Operating Margin for the year ending December 31, 2005 is closest to:
A) 1.8%
B) 2.7%
C) 5.4%
D) 16.7%
Answer: C
Explanation: C) Operating Margin = Operating Income / Sales
OM = 31.3 / 578.3 = .054 or 5.4%
Diff: 2 Type: MC
Topic: 2.5 Income Statement Analysis

4) Luther's Net Profit Margin for the year ending December 31, 2005 is closest to:
A) 1.8%
B) 2.7%
C) 5.4%
D) 16.7%
Answer: A
Explanation: A) Net Profit Margin = Net Income / Total Sales = 10.2 / 578.3 = .018 or 1.8%
Diff: 1 Type: MC
Topic: 2.5 Income Statement Analysis

5) Luther's earnings before interest, taxes, depreciation, and amortization (EBITDA) for the year ending December 31, 2006 are closest to:
A) $19.7 million
B) $37.6 million
C) $41.2 million
D) $44.8 million
Answer: D
Explanation: D) EBITDA = EBIT + Depreciation & Amortization = 41.2 + 3.6 = $ 44.8 million
Diff: 3 Type: MC
Topic: 2.5 Income Statement Analysis

6) Luther's return on equity (ROE) for the year ending December 31, 2006 is closest to:
A) 2.0%
B) 6.5%
C) 8.4%
D) 12.7%
Answer: C
Explanation: C) ROE = Net income / shareholders' equity = 10.6 / 126.6 = .084 or 8.4%
Diff: 3 Type: MC
Topic: 2.5 Income Statement Analysis

7) Luther's return on assets (ROA) for the year ending December 31, 2006 is closest to:
A) 2.0%
B) 6.5%
C) 8.4%
D) 12.7%
Answer: A
Explanation: A) ROA = Net income / total assets.
This is a little tricky in that total assets aren't given in the problem. The student must remember the basic balance sheet equation A = L + SE. Total Liabilities and Shareholders' Equity is given and this is the same as total assets. So ROA = 10.6 / 533.1 = .020 or 2.0%
Diff: 3 Type: MC
Topic: 2.5 Income Statement Analysis

8) Luther's price - earnings ratio (P/E) for the year ending December 31, 2006 is closest to:
A) 7.9
B) 10.1
C) 15.4
D) 16.0
Answer: C
Explanation: C) P/E = Price / EPS or Market Cap / Earnings = (10.2 × $16) / $10.6 = 15.4
Diff: 3 Type: MC
Topic: 2.5 Income Statement Analysis

9) Calculate Luther's return of equity (ROE), return of assets (ROA), and price-to-earnings ratio (P/E) for the year ending December 31, 2005.
Answer: ROE = NI / shareholder equity = 10.2 / 63.6 = .160 or 16.0%
ROA = NI/ total assets
Here total assets are not given, but we know that Total Assets = Total Liabilities + Shareholder Equity, so ROA = 10.2 / 386.7 = .026 or 2.6%
P/E = price / EPS or Market Cap / NI = (8.0 × $15) / $10.2 = 11.8
Diff: 3 Type: ES
Topic: 2.5 Income Statement Analysis

10) If Luther's accounts receivable were $55.5 million in 2006, then calculate Luther's accounts receivable days for 2006.
Answer: Accounts receivable days = $\frac{\text{accounts receivable}}{\text{sales / 365}} = \frac{55.5}{610.1/365}$ = 33.2 days
Diff: 2 Type: ES
Topic: 2.5 Income Statement Analysis

2.6 The Statement of Cash Flows

1) The statement of cash flows is divided into three sections: ________.
A) operating leverage, investment leverage, and financing leverage
B) cash inflows, cash outflows, and cash flow cycle
C) cash-in-use, cash-in-resource, and cash conversion cycle
D) operating activity, investment activity, and financing activity
Answer: D
Diff: 1 Type: MC
Topic: 2.6 The Statement of Cash Flows

2) Which of the following is NOT a section on the cash flow statement?
A) Income generating activities
B) Investing activities
C) Operating activities
D) Financing activities
Answer: A
Diff: 1 Type: MC
Topic: 2.6 The Statement of Cash Flows

3) Which of the following statements regarding net income transferred to retained earnings is correct?
A) Net income = net income transferred to retained earnings - dividends
B) Net income transferred to retained earnings = net income + dividends
C) Net income = net income transferred to retained earnings + dividends
D) Net income transferred to retained earnings - net income = dividends
Answer: C
Diff: 2 Type: MC
Topic: 2.6 The Statement of Cash Flows

4) Which of the following is NOT a reason why cash flow may not equal net income?
A) Amortization is added in when calculating net income.
B) Changes in inventory will change cash flows but not income.
C) Capital expenditures are not recorded on the income statement.
D) Depreciation is deducted when calculating net income.
Answer: A
Diff: 1 Type: MC
Topic: 2.6 The Statement of Cash Flows

5) Which of the following adjustments to net income is NOT correct if you are trying to calculate cash flow from operating activities?
A) Add increases in accounts payable.
B) Add back depreciation.
C) Add increases in accounts receivable.
D) Deduct increases in inventory.
Answer: C
Diff: 2 Type: MC
Topic: 2.6 The Statement of Cash Flows

6) Which of the following adjustments is NOT correct if you are trying to calculate cash flow from financing activities?
A) Add dividends paid.
B) Add any increase in long-term borrowing.
C) Add any increase in short-term borrowing.
D) Add proceeds from the sale of stock.
Answer: A
Diff: 2 Type: MC
Topic: 2.6 The Statement of Cash Flows

7) How many reasons are there that net income does not correspond to cash earned?
Answer: There are two reasons that net income does not correspond to cash earned. First, there are non-cash entries on the income statement, such as depreciation and amortization. Second, certain uses of cash, such as the purchase of a building or expenditures on inventory, are not reported on the income statement.
Diff: 2 Type: ES
Topic: 2.6 The Statement of Cash Flows

8) Why is the firm's statement of cash flows very important?
Answer: The firm's statement of cash flows utilizes 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. As we will see, from the perspective of an investor attempting to value the firm, the statement of cash flows provides what may be the most important information of the five financial statements.
Diff: 2 Type: ES
Topic: 2.6 The Statement of Cash Flows

Use the tables for the question(s) below.

Consider the following financial information:

Luther Corporation
Consolidated Balance Sheet
December 31, 2006 and 2005 (in $ millions)

Assets	**2006**	**2005**	**Liabilities and Stockholders' Equity**	**2006**	**2005**
Current Assets			*Current Liabilities*		
Cash	63.6	58.5	Accounts payable	87.6	73.5
Accounts receivable	55.5	39.6	Notes payable / short-term debt	10.5	9.6
Inventories	45.9	42.9	Current maturities of long-term debt	39.9	36.9
Other current assets	6.0	3.0	Other current liabilities	6.0	12.0
Total current assets	171.0	144.0	Total current liabilities	144.0	132.0
Long-Term Assets			*Long-Term Liabilities*		
Land	66.6	62.1	Long-term debt	239.7	168.9
Buildings	109.5	91.5	Capital lease obligations	---	---
Equipment	119.1	99.6	Total Debt	239.7	168.9
Less accumulated depreciation	(56.1)	(52.5)	Deferred taxes	22.8	22.2
Net property, plant, and equipment	239.1	200.7	Other long-term liabilities	---	---
Goodwill	60.0	--	Total long-term liabilities	262.5	
Other long-term assets	63.0	42.0	Total liabilities	406.5	323.1
Total long-term assets	362.1	242.7	Stockholders' Equity	126.6	63.6
Total Assets	**533.1**	**386.7**	**Total liabilities and Stockholders' Equity**	**533.1**	**386.7**

Luther Corporation Consolidated Income Statement Year ended December 31 (in $ millions)		
	2006	**2005**
Total sales	610.1	578.3
Cost of sales	(500.2)	(481.9)
Gross profit	109.9	96.4
Selling, general, and administrative expenses	(40.5)	(39.0)
Research and development	(24.6)	(22.8)
Depreciation and amortization	(3.6)	(3.3)
Operating income	41.2	31.3
Other income	---	---
Earnings before interest and taxes (EBIT)	41.2	31.3
Interest income (expense)	(25.1)	(15.8)
Pretax income	16.1	15.5
Taxes	(5.5)	(5.3)
Net income	10.6	10.2
Dividends Paid	5.1	5.0
Price per Share	$16	$15
Shares outstanding (millions)	10.2	8.0
Stock options outstanding (millions)	0.3	0.2
Stockholders' Equity	126.6	63.6
Total Liabilities and Stockholders' Equity	533.1	386.7

9) Calculate Luther's cash flow from operating activities for the year ending December 31, 2006.

Answer: Operating cash flow = NI + Depreciation - chg in AR + chg in AP - chg in INV

Operating cash flow = 10.6 + 3.6 - (55.5 - 39.6) + (87.6 - 73.5) - (45.9 - 42.9) = 9.4

Diff: 3 Type: ES

Topic: 2.6 The Statement of Cash Flows

10) Calculate Luther's cash flow from financing activities for the year ending December 31, 2006.
Answer: Cash flow from financing:

- dividends paid	(5.1)
+ sale or (purchase) of stock	57.5*
+ increase in ST borrowing	3.9
+ increase in LT borrowing	70.8
Cash flow from financing	127.1

NI transferred to RE(2006) = NI - Dividends paid = 10.6 - 5.1 = 5.6

sale of stock = Equity(2006) - NI transferred to RE(2006) - Equity(2005)
= 126.6 - 5.5 - 63.6 = 57.5

increase in ST borrowing = chg in notes payable + chg in current portion of LT debt
= (10.5 - 9.6) + (39.9 - 36.9) = 3.9

increase in LT borrowing = 239.7 - 168.9 = 70.8
Diff: 3 Type: ES
Topic: 2.6 The Statement of Cash Flows

11) Why does a firm's net income not correspond to cash generated?
Answer:
1. There are non-cash entries on the income statement, such as depreciation and amortization.
2. Certain uses of cash, such as the purchase of a building or expenditures on inventory, are not reported on the income statement.
Diff: 3 Type: ES
Topic: 2.6 The Statement of Cash Flows

2.7 Other Financial Statement Information

1) According to the IFRS, in addition to the balance sheet, income statement, and the statement of cash flows, a firm's complete financial statements will include all of the following EXCEPT
A) Management discussion and analysis.
B) Notes to the financial statements.
C) Securities Commission's commentary.
D) A statement of shareholders' equity.
Answer: C
Diff: 1 Type: MC
Topic: 2.7 Other Financial Statement Information

2) In the IFRS, in addition to the five financial statements, companies provide ________ with further details on the information provided in the statements.
A) pro forma statements
B) statements of cash used and sources
C) extensive notes
D) ratio analysis
Answer: C
Diff: 2 Type: MC
Topic: 2.7 Other Financial Statement Information

3) Off-balance sheet transactions are required to be disclosed
A) in the management discussion and analysis.
B) in the auditor's report.
C) in the Provincial Securities Commission's commentary.
D) in the statement of stockholders' equity.
Answer: A
Diff: 2 Type: MC
Topic: 2.7 Other Financial Statement Information

4) Details of acquisitions, spin-offs, leases, taxes, and risk management activities are given
A) in the management discussion and analysis.
B) in the Provincial Securities Commission's commentary.
C) in the auditor's report.
D) in the notes to the financial statements.
Answer: D
Diff: 2 Type: MC
Topic: 2.7 Other Financial Statement Information

5) Management is also required to disclose any ________, which are transactions or arrangements that can have a material impact on the firms future performance yet to do not appear on the ________.
A) earnings per share; income statement
B) investment decision; statement of cash flows
C) financing decision; statement of cash flows
D) off-balance sheet transactions; balance sheet
Answer: D
Diff: 3 Type: MC
Topic: 2.7 Other Financial Statement Information

6) What information do the notes to financial statements provide?
Answer: In addition to the financial statements, companies provide extensive notes with further details on the information provided in the statements. For example, the notes document important accounting assumptions that were used in preparing the statements. They often provide information specific to a firm's subsidiaries or its separate product lines. They show the details of the firm's stock-based compensation plans for employees and the different types of debt the firm has outstanding. Details of acquisitions, spin-offs, leases, taxes, and risk management activities are also given. The information provided in the notes is often very important to interpret fully the firm's financial statements.
Diff: 3 Type: ES
Topic: 2.7 Other Financial Statement Information

2.8 Accounting Manipulation

1) Following the Sarbanes-Oxley Act in United States, Canadian regulators adopted similar measures that came into effect in ________.
A) 2001
B) 2003
C) 2005
D) 2007
Answer: C
Diff: 1 Type: MC
Topic: 2.8 Accounting Manipulation

2) In 2002, the United States Congress passed ________ that requires, among other things, that CEO's and CFOs certify the accuracy and appropriateness of their firm's financial statements and increase the penalties against them if the financial statements later prove to be fraudulent.
A) the Sarbanes-Oxley Act
B) new American GAAP
C) the IFRS
D) revised GAAP
Answer: A
Diff: 2 Type: MC
Topic: 2.8 Accounting Manipulation

3) As the Bernard Madoff's Ponzi Scheme makes clear, when making an investment decision, it is important not only to review the firm's ________, but also to consider ________ who prepare the statement in the first place.
A) balance sheet; the reliability and reputation of the auditors
B) Financial Statements; the reliability and reputation of the government offices
C) Financial Statements; the reliability and reputation of the auditors
D) Financial Statements; the reliability and reputation of the bookkeepers
Answer: C
Diff: 2 Type: MC
Topic: 2.8 Accounting Manipulation

4) In WorldCom's case, the fraud was to reclassify $3.85 billion in ________ as ________.
A) capital budgeting; short-term investment
B) operating expenses; long-term investment
C) operating expenses; short-term investment
D) capital budgeting; long-term investment
Answer: B
Diff: 3 Type: MC
Topic: 2.8 Accounting Manipulation