Chapter 3: EVALUATION OF FINANCIAL PERFORMANCE

MULTIPLE CHOICE

1. Which of the following financial ratios are market-based ratios?
   a. debt-to-equity
   b. price-to-earnings
   c. return on investment
   d. gross profit margin

   ANS: B PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
   LOC: Knowledge of financial analysis and cash flows TOP: Market-based ratios

2. The appropriate standard for comparison of financial ratios probably should be the
   a. best firm in the industry
   b. worst firm in the industry
   c. industry average
   d. better performing firms in the industry

   ANS: D PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
   LOC: Knowledge of financial analysis and cash flows
   TOP: A word of caution about financial ratio analysis

3. ____ indicate the ability of the firm to meet its short-term financial obligations
   a. Activity ratios
   b. Liquidity ratios
   c. Leverage ratios
   d. Profitability ratios

   ANS: B PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
   LOC: Knowledge of financial analysis and cash flows TOP: Liquidity ratios

4. ____ indicate the firm's capacity to meet its debt obligations, both short-term and long-term.
   a. Liquidity ratios
   b. Activity ratios
   c. Financial leverage ratios
   d. Profitability ratios

   ANS: C PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
   LOC: Knowledge of financial analysis and cash flows
   TOP: Financial leverage management ratios

5. The primary weakness of the current ratio is
   a. it is difficult to calculate
   b. it includes some items, such as inventory, that may not be readily liquid
   c. it requires many years of past data
   d. it includes many non-current items in its calculation

   ANS: B PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
   LOC: Knowledge of financial analysis and cash flows TOP: Current ratio

6. The quick ratio is the same as current ratio except it does *not* consider
   a. cash
   b. accounts receivable

c. prepaid items
d. inventories

ANS: D PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows TOP: Quick ratio

7. The fixed asset turnover ratio is influenced by
a. the age of the assets employed
b. the depreciation method used by the firm
c. the firm's choice of a production technology
d. all of the above

ANS: D PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows TOP: Asset management ratios

8. The greater the amount of financial leverage used by a firm, the greater its ____, all other things being equal.
a. profitability
b. liquidity
c. risk
d. size

ANS: C PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows
TOP: Financial leverage management ratios

9. The best accounting-based measure of a firm's profitability is
a. gross profit margin
b. net profit margin
c. return on fixed assets
d. return on total assets

ANS: D PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows TOP: Profitability ratios

10. Financial ratio analysis is most often performed as a
a. comparative analysis
b. trend analysis
c. point in time analysis
d. comparative analysis and a trend analysis

ANS: D PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows TOP: Trend analysis

11. A firm's return on equity is a function of its net profit margin, ____ and equity multiplier.
a. current ratio
b. cost of goods
c. total asset turnover
d. fixed asset turnover

ANS: C PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows TOP: A foundation concept

12. Primary sources of comparative financial data include
a. Dun and Bradstreet
b. New York Times

c. Richard Moore, Inc.
d. Framingham Financial Library

ANS: A PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows
TOP: Sources of comparative financial data

13. The data from ____ is especially useful when analyzing small firms.
a. Prentice-Hall
b. Robert Morris Associates
c. Dan Bradbury Ltd.
d. Securities and Exchange Commission

ANS: B PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows
TOP: Sources of comparative financial data

14. In an inflationary period, a firm is likely to show temporary profit increases because
a. accounts receivable collections increase
b. cash balances decline
c. inventory profits are realized
d. all of the above

ANS: C PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows
TOP: Inflation and financial statement analysis

15. If a firm wanted to report high profits, it would choose which method of inventory accounting in inflationary times?
a. FIFO
b. LIFO
c. FILO
d. GIGO

ANS: A PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows
TOP: Inflation and financial statement analysis

16. Financial ratios can be used to analyze a firm's performance from
a. day to day
b. period to period
c. purchase to purchase
d. sale to sale

ANS: B PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows TOP: Trend analysis

17. The earnings per share figure
a. is a comparative ratio
b. is the best measure of a firm's profitability
c. can only be computed if a firm has no debt
d. is only one measure of a firm’s profitability

ANS: D PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows TOP: Market-based ratios

18. The retained earnings figure represents
    a. a pool of cash readily available to the firm and its stockholders
    b. an accounting of that portion of a firm's assets that were financed from past earnings
    c. a permanent part of the firm's equity base
    d. a deferred liability owed to preferred stockholders

    ANS: B PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
    LOC: Knowledge of financial analysis and cash flows TOP: Earnings quality

19. Which ratio is frequently used in conjunction with the analysis of a bond's quality?
    a. times interest earned
    b. deferred liability ratio
    c. receivables turnover
    d. dividend coverage ratio

    ANS: A PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
    LOC: Knowledge of financial analysis and cash flows TOP: Financial leverage ratios

20. The current ratio would normally be increased by
    a. paying off some current liabilities with cash
    b. selling bonds and investing the proceeds in marketable securities
    c. buying treasury stock
    d. paying off some current liabilities with cash and selling bonds and investing the proceeds in marketable securities

    ANS: D PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
    LOC: Knowledge of financial analysis and cash flows TOP: Current ratio

21. The following policy that is consistent with an increase in a firm's return on total assets is:
    a. costs increase more than revenues
    b. the firm's net working capital (current assets minus current liabilities) position declines
    c. the firm sells off some unused assets and pays the proceeds to existing stockholders in the form of an extra dividend
    d. the firm's net working capital (current assets minus current liabilities) position declines, and the firm sells off some unused assets and pays the proceeds to existing stockholders in the form of an extra dividend

    ANS: D PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
    LOC: Knowledge of financial analysis and cash flows TOP: Profitability ratios

22. If a firm wishes to retain the same return on equity when its net profit margin and total asset turnover has declined, it must
    a. decrease its equity multiplier
    b. increase its equity multiplier
    c. increase sales and increase assets
    d. reduce sales and increase assets

    ANS: B PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
    LOC: Knowledge of financial analysis and cash flows
    TOP: Return on stockholders' equity

23. A fresh fruit wholesaler would normally be expected to have
    a. high profit margin and high asset turnover
    b. low profit margin and low asset turnover
    c. low profit margin and high asset turnover

d. high profit margin and low asset turnover

ANS: C PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows TOP: Return on investment

24. The ratio group most likely to be used to indicate a firm's ability to meet short-term financial obligations would be
    a. liquidity ratios
    b. financial leverage ratios
    c. activity ratios
    d. profitability ratios

ANS: A PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows TOP: Liquidity ratios

25. The following ratio(s) that would probably *not* be used to assess the profitability of a firm is:
    a. return on stockholders' equity
    b. return on total assets
    c. times interest earned
    d. both return on stockholders' equity and return on total assets

ANS: C PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows
TOP: Financial leverage management ratios

26. In general, firm's with ____ risk and ____ earnings growth prospects will have higher P/E multiples.
    a. low, low
    b. high, low
    c. low, high
    d. high, high

ANS: C PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows TOP: Price to earnings ratio

27. The analysis of financial statements is affected by inflation because
    a. the value of long-term debt will increase
    b. the value of fixed assets may be understated
    c. the life of long-term assets are decreased
    d. inventory increases

ANS: B PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows
TOP: Inflation and financial statement analysis

28. An increase in the average collection period may suggest all of the following except
    a. easing of credit terms
    b. customers are not paying their bills on time
    c. sales have decreased
    d. firm could have a liquidity problem in the future

ANS: C PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows TOP: Asset management ratios

29. Asset management ratios indicate
    a. how well a firm is using its assets to support sales
    b. how efficiently a firm is allocating its liabilities

c. the return on assets
d. the profitability of the firm

ANS: A PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows TOP: Asset management ratios

30. Christy would like to improve the current ratio of her firm, which is now 0.5, so that she will have a better chance of obtaining a working capital loan. Which of the following options would improve her current ratio?
a. use cash to pay off notes payable
b. collect some of her accounts receivables
c. purchase additional inventory on credit
d. borrow short-term funds to pay off some payables

ANS: C PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows TOP: Liquidity ratios

31. The major types of financial ratios include all of the following except
a. market-based
b. liquidity
c. financial leverage
d. equity

ANS: D PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows
TOP: Basic classifications of financial ratios

32. Financial leverage ratios measure the
a. amount of interest paid by the firm
b. firm's use of fixed-charge financing
c. amount of equity funds retired by the firm
d. static ratio

ANS: B PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows
TOP: Financial leverage management ratios

33. ____ ratios indicate how efficiently a firm is using its assets to generate sales.
a. Liquidity
b. Asset management
c. Financial leverage
d. Equity

ANS: B PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows
TOP: Basic classifications of financial ratios

34. A common-size balance sheet shows the firm's assets and liabilities as a percentage of:
a. stockholders' equity
b. industry averages
c. total assets
d. net sales

ANS: C PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows TOP: Key financial statements

35. A common-size income statement shows the firm's income and expense items as a percentage of ____.
    a. stockholders' equity
    b. net sales
    c. industry averages
    d. total assets

ANS: B PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows TOP: Key financial statements

36. The ____ ratio, sometimes called the "acid test," is a more stringent measure of ____ than the current ratio.
    a. quick; liquidity
    b. fixed-asset turnover; activity
    c. net profit margin; gross profit margin
    d. equity, activity

ANS: A PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows TOP: Quick ratio

37. Return on stockholders' equity is equal to ____ times ____ times ____.
    a. net profit margin; fixed asset turnover; equity multiplier ratio
    b. gross profit margin; total asset turnover; equity multiplier ratio
    c. net profit margin; total asset turnover; equity multiplier ratio
    d. net profit margin; total asset turnover; debt-to-equity ratio

ANS: C PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows
TOP: Return on stockholders' equity

38. When considering the quality of a firm's earnings, high quality earnings tend to be ____
    a. cash earnings
    b. earnings derived from regularly recurring transactions
    c. cash earnings and earnings derived from regularly recurring transactions
    d. earnings per share

ANS: C PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows TOP: Earnings quality

39. The fixed charge coverage ratio includes all of the following *except* ____ in the denominator.
    a. lease payments
    b. preferred dividends before tax
    c. before tax sinking fund
    d. common stock dividends

ANS: D PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows TOP: Fixed charge coverage ratio

40. The ____ ratio is a more severe measure of a firm's ability to meet fixed financial obligations than is the times interest earned ratio.
    a. acid test
    b. debt
    c. fixed charge coverage
    d. debt to equity

ANS: C PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows TOP: Fixed charge coverage ratio

41. If a firm's current ratio is 1.5,
   a. its current liabilities exceed its current assets
   b. it is possible for its quick ratio to be 2.0
   c. it is possible for its quick ratio to be 1.0
   d. its current assets equal its current liabilities

ANS: C PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows | Finance applications in spreadsheets
TOP: Liquidity ratios

42. If a firm's total asset turnover ratio is 2.0,
   a. its annual sales are less than its total assets
   b. it is possible that its fixed asset turnover ratio is 1.5
   c. its total assets are two times its annual sales
   d. its annual sales are two times its total assets

ANS: D PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows | Finance applications in spreadsheets
TOP: Total asset turnover ratio

43. If a firm's return on investment, i.e., earnings after taxes divided by total assets, is 7%, and the firm has no preferred stock financing, it is
   a. possible that its return on stockholders' equity is 10%.
   b. possible that its return on stockholders' equity is 5%.
   c. <u>not</u> possible for its debt-to-equity ratio to be 1.0.
   d. <u>not</u> possible for its net profit margin to be 7%.

ANS: A PTS: 1 OBJ: TYPE: Fact NAT: Analytic skills
LOC: Knowledge of financial analysis and cash flows | Finance applications in spreadsheets
TOP: Return on investment ratio

44. If a firm's price to earnings (P/E) ratio is 10,
   a. it is not possible for it to be paying dividends also
   b. its market to book ratio has to be at least 2.0
   c. its net profit margin is positive
   d. its return on stockholders' equity is negative

ANS: C PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows | Finance applications in spreadsheets
TOP: Price to earnings ratio

45. The analysis of the financial performance and condition of a firm with sizable international operations is generally more complicated than analyzing a firm whose operations are largely domestic for all of the following reasons except:
   a. problems with the translation of foreign operating results
   b. problems with definition of capital
   c. fluctuating exchange rates
   d. all of the above are correct reasons

ANS: B PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Understand derivative market TOP: Financial analysis of multinational firms

46. The work of the external independent auditor includes a letter that states that the financial information represents fairly the financial position of the company and that these statements were:

a. an accurate picture of the company's market position
b. based on the company's accounting information system (AIS)
c. constructed in conformity with generally accepted accounting principles
d. developed using management's choice of accounting enhancement techniques

ANS: C PTS: 1 OBJ: TYPE: Fact
NAT: Ethical understanding and reasoning
LOC: Understand the role of the finance function
TOP: Ethical issues: Accuracy of financial statements

47. The Market Value Added (MVA) is the ____.
a. indicator of how successful a firm has been at increasing its financing its assets
b. return on total capital minus cost of capital
c. indication of an increase in operating efficiency
d. positively related to the present value of all expected future EVA.

ANS: D PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Understand the role of the finance function
TOP: The market value added concept

48. Economic value added (EVA) is a measure of operating performance that indicates how successful a firm has been at:
a. increasing the growth in earnings
b. increasing the MVA of the enterprise in any given year
c. increasing the rate of return on investment
d. all of the above

ANS: B PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Understand the role of the finance function TOP: Economic value added

49. Firms with a positive economic value added (EVA):
a. have increasing growth in earnings
b. have an increasing rate of return on investment
c. have a return on capital greater than their cost of capital
d. have a high return on book value

ANS: C PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Understand the role of the finance function TOP: Economic value added

50. Deferred taxes may occur due to the use of
a. different tax schedules
b. different depreciation methods for taxes and financial reporting
c. long-term equipment
d. different cash flow methods

ANS: B PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Understand the role of the finance function TOP: Deferred taxes

51. The ____ ratio indicates the percentage of a firm's earnings that are distributed as dividends.
a. dividend yield
b. payout
c. return on earnings
d. earnings

ANS: B PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows TOP: Payout ratio

52. Firms with ____ growth rates would be expected to have ____ payout ratios.
a. high, low
b. high, high
c. low, low
d. low, high

ANS: A PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Understand the role of the finance function TOP: Payout ratio

53. Stocks with ____ dividend yield often indicate ____ expected future growth.
a. high, high
b. low, low
c. low, high
d. high, low

ANS: C PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Understand the role of the finance function TOP: Dividend yield

54. To increase the return on stockholders' equity, management could increase the ____.
a. current ratio
b. price-to-earnings ratio
c. dividend yield
d. equity multiplier

ANS: D PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Understand the role of the finance function TOP: Analyzing profitability

55. Although ratios can provide valuable information, they can also be misleading for the following reason(s):
a. ratios are only as reliable as the accounting data on which they are based.
b. compilation of industry norms often do not report information about the distribution of values.
c. comparative analysis depends on the availability of data for appropriately defined industries.
d. all of the above are correct.

ANS: D PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows
TOP: A word of caution about financial ratio analysis

56. A component of earnings that recognizes the return that the firm is expected to earn on assets that have not been placed in services is called ____.
a. earnings allowance
b. allowance for funds used during construction
c. capital budgeted
d. budgeted earnings

ANS: B PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows TOP: Earnings quality

57. Companies can avoid paying income taxes on inventory profits by using the ____ inventory valuation method.
a. LIFO
b. FIFO

c. Priced out
d. Priced in

ANS: A PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows
TOP: Inflation and financial statement analysis

58. Nuking Gnats Pest Service, Inc. has a debt ratio of 50% and an equity multiplier of 2. What is Nuking Gnats' stockholders' equity if total debt is $100,000?
a. $100,000
b. $150,000
c. $200,000
d. $50,000

ANS: A
Solution:
Debt/T.A = 0.5; T.A = $100,000/0.5 = $200,000
Equity = T.A - Debt = $200,000 - $100,000 = $100,000

PTS: 1 OBJ: TYPE: E. Prob NAT: Analytic skills
LOC: Knowledge of financial analysis and cash flows | Finance applications in spreadsheets
TOP: Ratio manipulation

59. Given the following information, calculate the inventory for Big Show Videos: Quick ratio = 1.2; Current assets = $12,000; Current ratio = 2.5
a. $4,800
b. $6,240
c. $7,200
d. $5,660

ANS: B
Solution:
C.L. = $12,000/2.5 = $4,800
Inv = $12,000 - 1.2($4,800) = $6,240

PTS: 1 OBJ: TYPE: E. Prob NAT: Analytic skills
LOC: Knowledge of financial analysis and cash flows | Finance applications in spreadsheets
TOP: Ratio manipulation

60. A firm with an equity multiplier of 4.0, will have a debt ratio of
a. 0.25
b. 1.00
c. 0.75
d. 4.00

ANS: C
Solution:
T.A/Equity = 4, so T.A = (4)Equity
Debt = T.A - Equity = 4E - E = 3E
T.D./T.A = 3E/4E = 0.75

PTS: 1 OBJ: TYPE: E. Prob NAT: Analytic skills
LOC: Knowledge of financial analysis and cash flows | Finance applications in spreadsheets
TOP: Ratio manipulation

61. A firm with a debt ratio of 0.75, will have an equity multiplier of
a. 0.25
b. 1.00
c. 0.75
d. 4.00

ANS: D
Solution:
T.D/T.A = 0.75, so T.D = 0.75 T.A.
Equity = T.A - T.D = T.A - 0.75 T.A = 0.25 T.A
Equity multiplier. = T.A./0.25 T.A. = 4

PTS: 1 OBJ: TYPE: E. Prob NAT: Analytic skills
LOC: Knowledge of financial analysis and cash flows | Finance applications in spreadsheets
TOP: Ratio manipulation

62. What is the market price of a share of stock for a firm that pays dividends of $1.20 per share, has a P/E of 14, and a dividend payout ratio of 0.4?
a. $16.80
b. $42
c. $3
d. $28

ANS: B
Solution:
EPS = DPS/payout = $1.20/0.4 = $3.0
Price = P/E (EPS) = 14($3) = $42

PTS: 1 OBJ: TYPE: E. Prob NAT: Analytic skills
LOC: Knowledge of financial analysis and cash flows | Finance applications in spreadsheets
TOP: Ratio manipulation

63. What is the return on investment for a firm that has a debt ratio of 0.65, a net profit margin of 6.5%, sales of $740,000, and a total asset turnover of 4?
a. 26.0%
b. 16.9%
c. 6.5%
d. 4.6%

ANS: A
Solution:
Return on investment = Total asset turnover times net profit margin = 4(6.5%) = 26%

PTS: 1 OBJ: TYPE: E. Prob NAT: Analytic skills
LOC: Knowledge of financial analysis and cash flows | Finance applications in spreadsheets
TOP: Return on investment

64. What is the return on stockholders' equity for a firm with a net profit margin of 5.2 percent, sales of $620,000, an equity multiplier of 1.8, and total assets of $380,000?
a. 8.48%
b. 5.74%
c. 15.27%
d. 9.36%

ANS: C

Solution:
ROE = 5.2%($620,000/$380,000) 1.8 = 15.27%

PTS: 1 OBJ: TYPE: E. Prob NAT: Analytic skills
LOC: Knowledge of financial analysis and cash flows | Finance applications in spreadsheets
TOP: Return on equity

65. What is the cost of sales for a firm with a gross profit margin of 30 percent, a net profit margin of 4 percent, and earnings after taxes of $20,000?
a. $200,000
b. $350,000
c. $150,000
d. $125,000

ANS: B
Solution:
Sales = EAT/0.04 = $20,000/0.04 = $500,000
Cost of sales = (1 - 0.3)$500,000 = $350,000

PTS: 1 OBJ: TYPE: E. Prob NAT: Analytic skills
LOC: Knowledge of financial analysis and cash flows | Finance applications in spreadsheets
TOP: Ratio manipulation

66. If a firm has a total asset turnover of 8 times and a return on total assets of 15%, its net profit margin must be
a. 1.875%
b. 1.95%
c. 2.05%
d. 2.25%

ANS: A
Solution:
NPM = 15% / 8 = 1.875%

PTS: 1 OBJ: TYPE: E. Prob NAT: Analytic skills
LOC: Knowledge of financial analysis and cash flows | Finance applications in spreadsheets
TOP: Ratio manipulation

67. A firm's current ratio is 1.5 and its quick ratio is 1.0. If its current liabilities are $10,000, what are its inventories?
a. $ 5,000
b. $10,000
c. $15,000
d. $20,000

ANS: A
Solution:
1.5 = current assets / $10,000
Current assets = $15,000
1.0 = ($15,000 - inventories) / $10,000
Inventories = $5,000

PTS: 1 OBJ: TYPE: E. Prob NAT: Analytic skills
LOC: Knowledge of financial analysis and cash flows | Finance applications in spreadsheets
TOP: Liquidity ratio calculation

68. A firm's price to earnings ratio is 8 and its market to book ratio is 2. If its earnings per share are $4.00, what is the book value per share?
a. $ 8.00
b. $32.00
c. $64.00
d. $16.00

ANS: D
Solution:
$P = 8 \times \$4 = \$32$; $BV = \$32/2 = \$16.00$

PTS: 1 OBJ: TYPE: E. Prob NAT: Analytic skills
LOC: Knowledge of financial analysis and cash flows | Finance applications in spreadsheets
TOP: Market-based ratio calculation

69. Flash In The Pan Cooking School is considering the issuance of additional long-term debt to finance expansion. At the present time the company has $160 million of 10% debentures outstanding. Its after-tax net income is $48 million, and the company's (marginal) income tax rate is 40%. The company is required by the debenture holders to maintain its coverage ratio at 4.0 or greater. Determine Flash's present coverage ratio.
a. 3.33
b. 2.78
c. 5.00
d. 6.00

ANS: D
Solution:
EBT = $48 million / (1 - 0.40) = $80 million
EBIT = EBT + I = $80 million + ($160 million × 0.10) = $96 million
Coverage Ratio = EBIT/I = $96 million/$16 million = 6.0 times

PTS: 1 OBJ: TYPE: E. Prob NAT: Analytic skills
LOC: Knowledge of financial analysis and cash flows | Finance applications in spreadsheets
TOP: Coverage ratio calculation

70. Stepping Out Shoe Mfg. has inventory purchases of $2,200 during the month of June. If the June 1 accounts payables were $1,700 and June 30 accounts payables were $1,900, what was the cash payment?
a. $3,900
b. $2,000
c. $1,900
d. $1,700

ANS: B
Solution:
Cash payment = $1,700 + $2,200 - $1,900 = $2,000

PTS: 1 OBJ: TYPE: E. Prob NAT: Analytic skills | Technology
LOC: Knowledge of financial analysis | Spreadsheet applications
TOP: Cash flow calculation

71. Last year, Monroe Bro Products had $25,000 net cash provided by its operating activities. Its investing activities used $30,000, and its financing activities provided $10,000. Its cash and cash equivalents balance at the beginning of the year was $15,000. By how much did Monroe's cash and cash equivalents increase?
a. -$10,000
b. $0
c. $5,000
d. $15,000

ANS: C
Solution:
Cash increase = $25,000 - $30,000 + $10,000 = $5,000

PTS: 1 OBJ: TYPE: E. Prob NAT: Analytic skills
LOC: Knowledge of financial analysis and cash flows | Finance applications in spreadsheets
TOP: Statement of cash flows

72. Newfangled Dangle Systems had earnings after tax of $1,000,000 last year. Included in its expenses were $50,000 of interest, $100,000 of deferred taxes, and $150,000 of depreciation. In addition, the company paid dividends of $200,000 to its stockholders last year. What was Newfangled's after-tax cash flow last year?
a. $1,500,000
b. $1,300,000
c. $1,150,000
d. $1,250,000

ANS: D
Solution:
ATCF = $1,000,000 + $150,000 + $100,000 = $1,250,000

PTS: 1 OBJ: TYPE: E. Prob NAT: Analytic skills
LOC: Knowledge of financial analysis and cash flows | Finance applications in spreadsheets
TOP: Cash flow analysis

73. If a firm has interest expenses of $10,000 per year, sales of $700,000, a tax rate of 40%, and a net profit margin of 7%, what is the firm's times interest earned ratio?
a. 8.17
b. 4.90
c. 13.25
d. 9.17

ANS: D
Solution:
EAT = $700,000(0.07) = $49,000; EBT = $49,000/0.6 = $81,667
EBIT = $81,667 + $10,000 = $91,667; TIE = $91,667/$10,000 = 9.17

PTS: 1 OBJ: TYPE: C. Prob NAT: Analytic skills
LOC: Knowledge of financial analysis and cash flows | Finance applications in spreadsheets
TOP: Times interest earned calculation

74. How much cash and marketable securities does Gray Day Computer Co. have if the firm has a current ratio of 2.5, a quick ratio of 1.2, and current liabilities of $12,000. Gray's credit sales are $98,000 and its average collection period is 40 days? (Assume 365 days per year.)
a. $3,660
b. $14,440

c. $10,740
d. $12,660

ANS: A
Solution:
C.A = 2.5 (C.L.) = 2.5 ($12,000) = $30,000
C.A. - Inv = 1.2 (C.L.) = 1.2 ($12,000) = $14,400
Inv = $30,000 - $14,400 = $15,600
A.R. = 40 ($98,000/365) = $10,740
Cash = $30,000 - $15,600 - $10,740 = $3,660

PTS: 1 OBJ: TYPE: C. Prob NAT: Analytic skills
LOC: Knowledge of financial analysis and cash flows | Finance applications in spreadsheets
TOP: Ratio manipulation

75. What is the market price per share of Big Whoop, Inc. if the firm had net income of $200,000, earnings per share of $2.70, total equity of $800,000, and a market to book ratio of 1.5?
a. $16.20
b. $10.80
c. $7.20
d. $12.40

ANS: A
Solution:
Number of shares = $200,000/$2.70 = 74,074
Book value = $800,000/74,074 = $10.80
Market value = 1.5($10.80) = $16.20

PTS: 1 OBJ: TYPE: C. Prob NAT: Analytic skills
LOC: Knowledge of financial analysis and cash flows | Finance applications in spreadsheets
TOP: Ratio manipulation

76. If Power-On Inc. has a total asset turnover of 1.8, a fixed asset turnover of 3.2, a debt ratio of 0.5 and a total debt of $200,000, then fixed assets are
a. $56,250
b. $711,111
c. $225,000
d. $62,250

ANS: C
Solution:
T.A = $200,000/0.5 = $400,000
Sales = 1.8(T.A) = 1.8($400,000) = $720,000
F.A. = Sales/3.2 = $720,000/3.2 = $225,000

PTS: 1 OBJ: TYPE: C. Prob NAT: Analytic skills
LOC: Knowledge of financial analysis and cash flows | Finance applications in spreadsheets
TOP: Ratio manipulation

77. What would be the times interest earned of a company, if its total interest charges are $20,000, sales are $220,000, and its net profit margin is 6 percent? Assume a tax rate of 40 percent.
a. 2.65
b. 1.1
c. 2.1
d. 1.2

ANS: C
Solution:
EAT = Sales (0.06) = \$220,000(0.06) = \$13,200
EBT = EAT/(l - T) = \$13,200/0.6 = \$22,000
EBIT = EBT + I = \$22,000 + \$20,000 = \$42,000
TIE = EBIT/I = \$42,000/\$20,000 = 2.1

PTS: 1 OBJ: TYPE: C. Prob NAT: Analytic skills
LOC: Knowledge of financial analysis and cash flows | Finance applications in spreadsheets
TOP: Ratio manipulation

78. Determine the cost of sales for a firm with the following financial ratios and data:

Current ratio = 3.0; Quick ratio = 2.0; Current liabilities \$1,000,000; Inventory turnover 6 times
a. \$2,000,000
b. \$6,000,000
c. \$3,000,000
d. \$1,000,000

ANS: B
Solution:
C.A. = 3(\$1,000,000) = \$3,000,000
(\$3,000,000 - Inven.)/\$1,000,000 = 2.0
Inven. = \$1,000,000
Cost of Sales = \$1,000,000 × 6 = \$6,000,000

PTS: 1 OBJ: TYPE: C. Prob NAT: Analytic skills
LOC: Knowledge of financial analysis and cash flows | Finance applications in spreadsheets
TOP: Ratio manipulation

79. AK, Inc. is considering issuing additional long-term debt to finance an expansion. The company currently has \$20 million in 5% debt outstanding. Its earnings after-tax (EAT) are \$3.0 million, and its marginal and average tax rate is 40 percent. The company is required by the debt holders to maintain its times interest earned ratio at 3.0 or greater. How much additional 10 percent debt can the company issue now and maintain its times interest earned ratio at 3.0? Assume for this calculation that earnings before interest and taxes remains at its present level.
a. \$10 million
b. \$ 6 million
c. \$ 1 million
d. \$5 million

ANS: A
Solution:
EBT = \$3.0 / (1 - 0.40) = \$5.0
EBIT = \$5.0 + \$1.0 = \$6.0
Interest permitted = EBIT / T.I.E. = \$6.0 / 3.0 = \$2.0
Additional interest = \$2.0 - \$1.0 = \$1.0
Additional debt = \$1.0 / 0.1 = \$10, or \$10 million

PTS: 1 OBJ: TYPE: C. Prob NAT: Analytic skills
LOC: Knowledge of financial analysis and cash flows | Finance applications in spreadsheets
TOP: Times interest earned calculation

80. Given the following information, determine Salem Company's fixed assets.

Sales = $10,000,000
Total asset turnover = 4 times
Current ratio = 2.40
Current liabilities = $500,000
Total assets = current assets + fixed assets
a. $1,200,000
b. $4,800,000
c. $1,300,000
d. Cannot be determined

ANS: C
Solution:
Total assets = $10,000,000/4 = $ 2,500,000
Current assets = 2.40 × $500,000 = $1,200,000
Fixed assets = $2,500,000 - $1,200,000 = $1,300,000

PTS: 1 OBJ: TYPE: C. Prob NAT: Analytic skills
LOC: Knowledge of financial analysis and cash flows | Finance applications in spreadsheets
TOP: Ratio manipulation

81. Given the following information, determine Taylor Company's cash balance.

Sales = $10,000,000 (all on credit)
Current ratio = 3.0
Current liabilities = $800,000
Average collection period = 36.5 days (Assume 365 days/year)
Quick ratio = 1.50
Current assets = cash + accounts receivable + inventory
a. $200,000
b. $1,400,000
c. $2,400,000
d. $500,000

ANS: A
Solution:
Current assets = 3.0 × $800,000 = $2,400,000
Accounts receivables = ($10,000,000/365) × 36.5 = $1,000,000
($2,400,000 - Inventory)/$800,000 = 1.50
$2,400,000 - Inventory = $1,200,000
Inventory = $1,200,000
Cash = $2,400,000 - $1,000,000 - $1,200,000 = $200,000

PTS: 1 OBJ: TYPE: C. Prob NAT: Analytic skills
LOC: Knowledge of financial analysis and cash flows | Finance applications in spreadsheets
TOP: Ratio manipulation

82. What is the net profit margin for TJX Inc. if the current ratio = 2; total asset turnover =1.5; total assets = $100,000; and EBIT = $30,000? Assume the marginal tax rate for TJX is 40% and that interest expenses are $10,000.
a. 20%
b. 8%
c. 12%
d. 6%

ANS: B
Solution:
Sales = 1.5(100,000) = $150,000
EAT = (30,000 - 10,000)(1-.4) = $12,000
NPM= 12,000/150,000 = .08 or 8%

PTS: 1 OBJ: TYPE: C. Prob NAT: Analytic skills
LOC: Knowledge of financial analysis and cash flows | Finance applications in spreadsheets
TOP: Ratio manipulation

83. Your current assets consist of cash, accounts receivable, and inventory. Total current liabilities equal $200,000. The average collection period is 20 days on average daily credit sales of $2,500. The current ratio is 1.3 and the quick ratio is 0.625. What is the balance in the cash account?
a. $ 75,000
b. $ 65,000
c. $135,000
d. $ 50,000

ANS: A
Solution:
ACP = Rec./2500 = 20, so Rec = 20(2500) = 50,000
CR = CA/CL = 1.3, so CA = 1.3(200,000) =260,000
QR = (CA - Inv)/CL = 0.625, so Inv = $135,000
Cash = 260,000 - 50,000 - 135,000 = $75,000

PTS: 1 OBJ: TYPE: C. Prob NAT: Analytic skills
LOC: Knowledge of financial analysis and cash flows | Finance applications in spreadsheets
TOP: Ratio manipulation

84. Wall Mart Pictures and Decor Company has a net profit margin of 10% and its inventory turnover is 9, what is its annual cost of sales? You also know that Wall Mart's average inventory is $96,700 and its annual sales are $1,000,000.
a. $870,000
b. $850,000
c. $870,300
d. $790,000

ANS: C
Solution:
Inventory turnover = COS/Avg. Inventory = 9
so COS = 9($96,700) = $870,300

PTS: 1 OBJ: TYPE: C. Prob NAT: Analytic skills
LOC: Knowledge of financial analysis and cash flows | Finance applications in spreadsheets
TOP: Ratio manipulation

85. Greg is interested in investing in a small company, and he thinks Good Buy Co. might be a good investment. He has been given the following information and would like to know the return on stockholder's equity. Assume Good Buy's marginal tax rate is 40%.

Earning before taxes	$3 million
Net profit margin	3.6%
Total liabilities	$15.0 million
Total stockholder's equity	$10.0 million

a. 12%
b. 20%
c. 15%
d. 18%

ANS: D
Solution:
EAT = 3,000,000(1-.4) = $1,800,000
NPM = EAT/sales = 0.036
so Sales = 1,800,000/.036 = $50,000,000
E.M. = TA/ Equity = 25/10 = 2.5
R.O.E. = NPM × Total asset turnover × Equity multiplier
R.O.E. = 0.036 × 50/25 × 2.5 = 0.18 or 18%

PTS: 1 OBJ: TYPE: C. Prob NAT: Analytic skills
LOC: Knowledge of financial analysis and cash flows | Finance applications in spreadsheets
TOP: Ratio manipulation

86. Given the following information, calculate the return on equity for Regrets Only Dating Services, Inc.:

Net Profit margin = 5%
Total asset turnover = 2
Debt ratio = 0.73
a. 14%
b. 7.3%
c. 37%
d. 21%

ANS: C
Solution:
Debt ratio = TD/TA = 0.73 so TD = 0.73TA
Equity = TA - TD = TA - 0.73TA = 0.27TA
Equity multiplier = TA/Equity = TA/0.27TA = 3.7
R.O.E. = NPM × TAT × EM
= 0.05 × 2 × 3.7 = 0.37 or 37%

PTS: 1 OBJ: TYPE: C. Prob NAT: Analytic skills
LOC: Knowledge of financial analysis and cash flows | Finance applications in spreadsheets
TOP: Return on stockholders' equity

87. All of the following are users of financial information EXCEPT:
a. customers
b. bankers
c. analysts
d. unions

ANS: A PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows TOP: Uses of financial analysis

88. Successful financial ratio analysis requires all of the following EXCEPT:
a. Some industries use special ratios that are unique to each company.
b. A single ratio is all that is needed to indicate specific areas of weakness that must be addressed.

c. Ratios are meaningful only when it is compared to a standard.
d. Ratios must be used in conjunction with other data to obtain meaningful information.

ANS: B PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows TOP: Interpreting Financial Ratios

89. If a firm's common size income statement shows that the earnings after tax percentage is too low, the firm may have spent too much money:
a. on total assets as a percentage of long-term liabilities.
b. on expenses as a percentage of current assets.
c. on cost of goods sold as a percentage of sales.
d. on taxes paid as a percentage of stockholders' equity.

ANS: C PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows TOP: Key financial statements

90. The sales-to-inventory ratio:
a. is superior to the inventory turnover ratio.
b. as a determination of financial performance, is good comparison tool.
c. is technically inferior to other commonly used ratios.
d. was developed by the Dupont Corporation and is satisfactory when used to make comparisons between the firm and the industry as a whole.

ANS: C PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows TOP: Asset management ratios

91. The type of ratio that indicates the firm's ability to provide adequate returns in the form of dividends and share price appreciation is:
a. Profitability ratios
b. Asset management ratios
c. Liquidity ratios
d. Financial leverage management ratios

ANS: A PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows
TOP: Basic classifications of financial ratios

92. A firm has revenue of $60,000, its total operating costs including depreciation and cost of goods sold are $50,620, depreciation is $4,620 and its interest expense on outstanding loans is $2,000. What is the firm's EBIT?
a. $55,380
b. $2,760
c. $9,380
d. $12,000

ANS: C PTS: 1 OBJ: TYPE: E. Prob
NAT: Analytic skills LOC: Knowledge of financial analysis and cash flows
TOP: Key financial statements

93. Market based ratios can be which of the following:
I. Price-to-earnings ratio
II. Dividend yield
a. I only
b. II only
c. Both I and II

d. Neither I nor II

ANS: A PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows
TOP: Basic Classifications of Ratios

94. Nukin' Gnats Pest Control is trying to determine its cash flow per share. It has revenue of $50,000, $35,000 of expenses, $4,000 of depreciation and $3,000 of interest expense. The firm is in the 40% tax bracket. The firm has 75,000 shares of common stock outstanding. Its cash flow per share is:
a. $.08
b. $.07
c. $.92
d. $.46

ANS: B
$50,000 - $35,000 - $4,000 - $3,000 = $8,000 X .60 = $4,800 EAT
$4,800 + $4,000 = $5,200/75,000 = $.0693

PTS: 1 OBJ: TYPE: E. Prob NAT: Analytic skills
LOC: Knowledge of financial analysis and cash flows TOP: Price to earnings ratio

95. Most analysts prefer using price to free cash flow rather than price-to-earnings (P/E) ratio because price to free cash flow is:
a. Easier to compute.
b. More accurate than cash flow per share.
c. A stricter measure that reduces the cash flow by the amount of capital expenditures.
d. More reliable as a measure of performance.

ANS: C PTS: 1 OBJ: TYPE: Fact
LOC: Knowledge of financial analysis and cash flows

96. Nukin' Gnats Pest Control is trying to determine its cash flow per share. It has revenue of $50,000, $35,000 of expenses, $4,000 of depreciation and $3,000 of interest expense. The firm is in the 40% tax bracket. The firm has 75,000 shares of common stock outstanding. The firm has a $15 price per share. Its price to cash flow is:
a. .0057
b. .0098
c. .0076
d. .0029

ANS: D PTS: 1 OBJ: TYPE: E. Prob
NAT: Analytic skills LOC: Knowledge of financial analysis and cash flows
TOP: Price to earnings ratio

97. Heavily using debt to finance assets results in higher ______________________ as compared to ROI.
a. Return on Sales
b. Return on Stockholders' Equity
c. Return on Assets
d. Times Interest Earned

ANS: B PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows
TOP: Analyzing Profitability Through Return on Stockholders' Equity

ESSAY

1. What are the main purposes of financial analysis and what does it identify?

ANS:
Financial analysis identifies the major strengths and weaknesses of a business. It indicates whether a firm has enough cash to meet obligations; a reasonable accounts receivable collection period; an efficient inventory management policy sufficient plant, property and equipment; and an adequate capital structure. These are necessary in determining whether or not the firm is maximizing shareholder wealth.

PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows TOP: Uses of financial analysis

2. List the major financial ratio groups and briefly indicate what they analyze.

ANS:
1. Liquidity ratios - they indicate the firm's ability to meet short-term financial obligations. Whether or not the company can pay its day-to-day bills.
2. Asset management ratios - they indicated how efficiently a firm is using its assets to generate sales.
3. Financial leverage ratios - they indicate a firm's capacity to meet its short-term and long-term debt obligations.
4. Profitability ratios - they measure how effectively a firm's management generates profits on sales, assets, and stockholder's investments.
5. Market-based ratios - they measure the financial market evaluation of the firm's performance.
6. Dividend policy ratios - they indicate the dividend practices of the firm.

PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows
TOP: Basic classifications of financial ratios

3. What information can be determined by common size financial statements?

ANS:
Common size financial statements can:
1. identify trends in financial performance. Negative trends can be identified and monitored.

2. can indicate the percentage of sales invested in each item on the balance sheet and income statement. These percentages can be compared with like percentages of larger or smaller companies and can be used as a comparison tool.

PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows TOP: Key financial statements

4. What information can Asset Management Ratios provide?

ANS:
Asset Management Ratios indicate:
1. how much a firm has invested in a particular type of asset relative to the revenue being produced by the asset.
2. how efficiently the firm is allocating its resources.
3. whether or not the firm has achieved an effective asset structure in generating sales

revenue.
4. whether or not the firm has achieved the best mix of cash, receivables, inventories, plant, property and equipment (total assets).

PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows TOP: Asset management ratios

5. What factors make it possible for firms with virtually identical plants to have significantly different fixed-asset turnover ratios?

ANS:
The following factors make is possible for identical firms to have different fixed-asset turnover ratios:
1. the cost of the assets when acquired.
2. the length of time since acquisition.
3. the depreciation policies adopted by the firm.
4. the extent to which fixed assets are leased rather than owned.

PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows TOP: Asset management ratios

6. There are numerous sources which provide financial analysis via the internet. List some of those resources.

ANS:
Internet data Sources for financial analysis are:
1. Research/Computstat
2. Thomson Reuters Worldscope
3. Thomson Reuters Datastream
4. Value Line
5. Yahoo
6. MSN
7. Thomson ONE - Business School Edition

PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows
TOP: Sources of comparative financial data

7. List some earnings management tricks used by some companies.

ANS:
Some of the tricks used by some companies are:
1. Timing storage openings and asset sales in a way that keeps earnings growing at a smooth rate.

Acceleration (or delay) of shipments at the end of a quarterly reporting period to either increase sales in a weak quarter or defer sales into the next quarter when the current quarter's numbers are especially strong.

3. Capitalizing normal operating expenses.

4. Taking "big bath" write-offs and using "spin" control for bad earnings.

5. Extending depreciation of assets.

PTS: 1 OBJ: TYPE: Fact NAT: Reflective thinking
LOC: Knowledge of financial analysis and cash flows TOP: Earnings quality