

CHAPTER 2

Understanding Financial Statements, Taxes & Cash Flows

True/False

1. The income statement represents a snapshot of account balances at one point in time.
ANSWER: False
DIFFICULTY: Easy
KEYWORDS: financial statements, balance sheet
2. Total equity on the balance sheet increases as dividends paid increases.
ANSWER: False
DIFFICULTY: Easy
KEYWORDS: financial statements, balance sheet
3. Cash flows from assets will always be less than cash flows from financing due to dividends.
ANSWER: False
DIFFICULTY: Moderate
KEYWORDS: cash flow from assets, cash flow from financing
4. The marginal tax rate would equal the average tax rate for firms with earnings less than \$50,000.
ANSWER: True
DIFFICULTY: Moderate
KEYWORDS: marginal tax rate, average tax rate
5. An income statement reports a firm's profit relative to its total investment in plant and equipment.
ANSWER: False
DIFFICULTY: Moderate
KEYWORDS: income statement, profit
6. A balance sheet is a statement of the financial position of the firm on a given date, including its asset holdings, liabilities, and equity.
ANSWER: True
DIFFICULTY: Easy
KEYWORDS: balance sheet
7. The income statement describes the financial position of a firm on a given date.
ANSWER: False
DIFFICULTY: Easy
KEYWORDS: income statement
8. Under current accounting rules, plant and equipment appear on a company's balance sheet valued at replacement value.
ANSWER: False
DIFFICULTY: Easy
KEYWORDS: balance sheet, fixed assets

9. The balance sheet describes the financial position of a firm on a given date.
ANSWER: True
DIFFICULTY: Easy
KEYWORDS: balance sheet
10. An advantage of balance sheet numbers is that assets reflect current market values.
ANSWER: False
DIFFICULTY: Moderate
KEYWORDS: balance sheet, market vs. book values
11. On an accrual basis income statement, revenues and expenses always match the firm's cash flow.
ANSWER: False
DIFFICULTY: Moderate
KEYWORDS: income statement, accrual basis
12. Corporate income statements are usually compiled on an accrual, rather than cash, basis.
ANSWER: True
DIFFICULTY: Moderate
KEYWORDS: income statement, accrual basis
13. A firm's balance sheet provides a representation of the current market value of the company.
ANSWER: False
DIFFICULTY: Moderate
KEYWORDS: balance sheet, market vs. book values
14. The balance sheet provides a statement of the firm's financial position.
ANSWER: True
DIFFICULTY: Easy
KEYWORDS: balance sheet measurement
15. The income statement provides a statement of results for the firm's operations.
ANSWER: True
DIFFICULTY: Easy
KEYWORDS: income statement measurement
16. The interest payments on corporate bonds are tax-deductible.
ANSWER: True
DIFFICULTY: Easy
KEYWORDS: tax-deductible expenses
17. Dividends paid to a firm's stockholders, both preferred and common stockholders, are tax-deductible to the paying company.
ANSWER: False
DIFFICULTY: Moderate
KEYWORDS: tax-deductible expenses

Multiple Choice

18. Which of the basic financial statements is best used to answer the question, "How profitable is the business?"
- a. Balance sheet
 - b. Statement of shareholder's equity
 - c. Income statement
 - d. Accounts receivable aging schedule

ANSWER: c

DIFFICULTY: Easy

KEYWORDS: income statement

19. What is sales revenue, minus cost of goods sold and operating expenses, known as for income statement purposes?
- a. Net profit
 - b. Retained earnings
 - c. Net income available to preferred shareholders
 - d. EBIT

ANSWER: d

DIFFICULTY: Moderate

KEYWORDS: income statement structure, net income

20. Which of the following streams of income is not affected by how a firm is financed (whether with debt or equity)?
- a. Net profit after tax but before dividends
 - b. Net working capital
 - c. Operating income
 - d. Income before tax

ANSWER: c

DIFFICULTY: Moderate

KEYWORDS: operating income

21. Which of the following is the least liquid current asset?
- a. Accruals
 - b. Marketable securities
 - c. Accounts receivable
 - d. Inventory

ANSWER: d

DIFFICULTY: Easy

KEYWORDS: current assets

22. Who owns the retained earnings of a public firm?
- a. The IRS
 - b. Common stockholders
 - c. Bondholders
 - d. Preferred stockholders

ANSWER: b

DIFFICULTY: Moderate

KEYWORDS: retained earnings, stockholders

23. Fixed assets includes which of the below?
- a. Inventory
 - b. Patents
 - c. Land
 - d. Copyrights

ANSWER: c

DIFFICULTY: Easy

KEYWORDS: fixed assets

24. How does "free cash flow" differ from net profit?
- a. It is determined by accrual basis accounting.
 - b. It takes into consideration a firm's ongoing investment in working capital and fixed assets.
 - c. It ignores depreciation and taxes.
 - d. It is less expensive.

ANSWER: b

DIFFICULTY: Moderate

KEYWORDS: free cash flow

25. Which of the following items is part of the computation of net operating working capital for purposes of determining free cash flow?
- a. Accounts payable
 - b. Fixed assets
 - c. Interest expense
 - d. Dividend payments

ANSWER: a

DIFFICULTY: Moderate

KEYWORDS: net operating working capital

26. You are about to determine your corporation's taxable income. Which of the below would not be included as a tax-deductible expense?
- a. Marketing expenses
 - b. Depreciation expense
 - c. Cost of goods sold
 - d. Dividend expense

ANSWER: d

DIFFICULTY: Moderate

KEYWORDS: tax-deductible expenses

27. Your firm has the following income statement items: sales of \$50,250,000; income tax of \$1,744,000; operating expenses of \$10,115,000; cost of goods sold of \$35,025,000; and interest expense of \$750,000. What is the amount of the firm's EBIT?
- a. \$15,552,000
 - b. \$58,000,000
 - c. \$5,110,000
 - d. \$4,630,000

ANSWER: c

DIFFICULTY: Moderate

KEYWORDS: operating income, EBIT

28. Your firm has the following income statement items: sales of \$50,250,000; income tax of \$1,744,000; operating expenses of \$10,115,000; cost of goods sold of \$35,025,000; and interest expense of \$750,000. What is the amount of the firm's gross profit?
- a. \$18,000,000
 - b. \$15,225,000
 - c. \$5,000,110
 - d. \$6,632,000

ANSWER: b

DIFFICULTY: Moderate

KEYWORDS: gross profit

29. Your firm has the following income statement items: sales of \$50,250,000; income tax of \$1,744,000; operating expenses of \$10,115,000; cost of goods sold of \$35,025,000; and interest expense of \$750,000. What is the amount of the firm's income before tax?
- a. \$4,360,000
 - b. \$750,000
 - c. \$10,865,000
 - d. \$25,115,000

ANSWER: a

DIFFICULTY: Moderate

KEYWORDS: earnings before tax

30. Your firm has the following balance sheet statement items: total current liabilities of \$805,000; total assets of \$2,655,000; fixed and other assets of \$1,770,000; and long-term debt of \$200,000. What is the amount of the firm's total current assets?
- a. \$885,000
 - b. \$1,550,000
 - c. \$600,000
 - d. \$325,000

ANSWER: a

DIFFICULTY: Moderate

KEYWORDS: current assets

31. Your firm has the following balance sheet statement items: total liabilities of \$1,005,000; total assets of \$2,655,000; fixed and other assets of \$1,770,000; and long-term debt of \$200,000. What is the amount of the firm's total stockholder's equity?
- a. \$3,650,885
 - b. \$550,000
 - c. \$1,650,000
 - d. \$833,000

ANSWER: c

DIFFICULTY: Moderate

KEYWORDS: stockholder's equity, components of equity

32. Your firm has the following balance sheet statement items: total current liabilities of \$805,000; total assets of \$2,655,000; fixed and other assets of \$1,770,000; and long-term debt of \$200,000. What is the amount of the firm's net working capital?
- a. \$25,000
 - b. \$325,000
 - c. \$770,000
 - d. \$80,000

ANSWER: d

DIFFICULTY: Moderate

KEYWORDS: net working capital

33. Your firm has the following income statement items: sales of \$50,250,000; income tax of \$1,744,000; operating expenses of \$8,750,000; cost of goods sold of \$35,025,000; depreciation and amortization of \$1,365,000; and interest expense of \$750,000. For purposes of determining free cash flow, what is the amount of the firm's after-tax cash flow from operations?
- a. \$255,223
 - b. \$4,731,000
 - c. \$2,385,000
 - d. \$7,775,000

ANSWER: b

DIFFICULTY: Moderate

KEYWORDS: after-tax cash flow from operations

34. Your firm has the following income statement items: sales of \$52,000,000; income tax of \$1,880,000; operating expenses of \$9,000,000; cost of goods sold of \$36,000,000; depreciation and amortization of \$1,500,000; and interest expense of \$800,000. For purposes of determining free cash flow, what is the amount of the firm's after-tax cash flow from operations?
- a. \$1,008,000
 - b. \$3,600,000
 - c. \$5,120,000
 - d. \$750,000

ANSWER: c

DIFFICULTY: Moderate

KEYWORDS: after-tax cash flow from operations

35. Browning Cookware, Inc. has the following income statement items: sales of \$50,250,000; operating expenses of \$10,115,000; cost of goods sold of \$35,025,000; and interest expense of \$750,000. If the firm's income tax rate is 34%, what is the amount of the firm's income tax liability?
- a. \$1,665,000
 - b. \$725,000
 - c. \$385,000
 - d. \$1,482,400

ANSWER: d

DIFFICULTY: Moderate

KEYWORDS: income tax liability

36. Use the following information to answer the questions below. In 2004, A & K, Inc. expects operating income (earnings before interest and taxes) of \$18,000,000. In addition, the corporation has \$20,000,000 of debt outstanding with a 10 percent interest rate and will pay \$1,000,000 in dividends to its common stockholders. Assume that A & K will receive no other sources of income during 2004. A & K's taxable income for 2004 will be:
- a. \$18,000,000.
 - b. \$17,000,000.
 - c. \$16,000,000.
 - d. \$15,000,000.

ANSWER: c

DIFFICULTY: Moderate

KEYWORDS: taxable income

37. A & K's total tax liability for 1995 will be:
- a. \$5,488,250.
 - b. \$5,530,000.
 - c. \$5,600,000.
 - d. \$6,080,000.

ANSWER: b

DIFFICULTY: Moderate

KEYWORDS: income tax liability

38. A & K's marginal tax rate for 1995 will be:
- a. 38 percent.
 - b. 35 percent.
 - c. 34 percent.
 - d. unknown because too little information is provided.

ANSWER: a

DIFFICULTY: Easy

KEYWORDS: marginal tax rate

Jones Company
Financial Information

	March 1995	March 1996
Net income	\$1,500	\$3,000
Accounts receivable	750	750
Accumulated depreciation	1,125	1,500
Common stock	4,500	5,250
Capital surplus	7,500	8,250
Retained earnings	1,500	2,250
Accounts payable	750	750

39. Based on the information given in Table 1, calculate the dividends paid in 1996.
- \$3,750
 - \$3,000
 - \$750
 - \$2,250

ANSWER: d

DIFFICULTY: Hard

KEYWORDS: dividends paid

Table 2
Bird Industries, Inc.
Balance Sheets

	1995	1996
Cash	\$ 1,000	\$?
Accounts receivable	5,000	6,000
Inventories	6,500	6,000
Land	10,000	12,000
Other fixed assets	8,000	9,000
Accumulated depreciation	(1,000)	(1,600)
Total assets	\$29,500	\$?
Accounts payable	\$3,200	\$ 6,800
Bonds	4,000	4,000
Common stock	17,000	16,000
Retained earnings	5,300	5,000
Total debt and equity	\$29,500	\$?

Bird Industries, Inc.
Income Statement

Sales	\$84,000
Cost of goods sold	<u>66,400</u>
Gross profit	\$17,600
Operating expenses	(13,000)
Depreciation	<u>(600)</u>
EBIT	\$ 4,000
Interest expense	<u>(500)</u>
EBT	\$ 3,500
Taxes	<u>(1,500)</u>
Net Income	<u>\$ 2,000</u>

40. Based on the information contained in Table 2, what was the total amount of Bird Industries' common

stock dividend for 1996?

- a. \$800
- b. \$2,300
- c. \$2,000
- d. Cannot be determined with available information

ANSWER: b

DIFFICULTY: Hard

KEYWORDS: dividends paid

41. Based on the information contained in Table 2, what was Bird Industries' cash balance as of December 31, 1996?
- a. \$300
 - b. \$400
 - c. \$100
 - d. \$1,100

ANSWER: b

DIFFICULTY: Moderate

KEYWORDS: cash balances

Table 3

Snark Enterprises, Inc.

Balance Sheets

	1996	1996
Cash	\$ 1,000	\$?
Accounts receivable	8,000	9,000
Inventories	4,000	7,000
Land	10,000	10,000
Other fixed assets	5,000	5,500
Accumulated depreciation	(1,600)	(2,000)
Total assets	\$26,400	\$?
Accounts payable	\$4,200	\$ 7,000
Bonds	4,000	4,000
Common stock	15,000	16,000
Retained earnings	3,200	3,800
Total debt and equity	\$26,400	\$?

Snark Enterprises, Inc.

Income Statement

Sales	\$44,900
Cost of goods sold	(22,000)
Gross profit	\$12,900
Operating expenses	(10,000)
Depreciation	(400)
NOI	\$ 2,500
Interest expense	(500)
EBT	\$ 2,000
Taxes	(1,000)
Net Income	\$ 1,000

42. Based on the information contained in Table 3, what was the total amount of Snark Enterprise's common

stock dividend for 1996?

- a. \$0
- b. \$400
- c. \$600
- d. Cannot be determined with available information

ANSWER: b

DIFFICULTY: Hard

KEYWORDS: stock dividend

43. Based on the information contained in Table 3, what is Snark Enterprise's cash balance as of December 31, 1996?
- a. \$1,100
 - b. \$900
 - c. \$1,300
 - d. None of the above

ANSWER: c

DIFFICULTY: Moderate

KEYWORDS: cash balances

44. Which of the following represents an attempt to measure the earnings of the firm's operations over a given time period?
- a. Balance sheet
 - b. Cash flow statement
 - c. Income statement
 - d. None of the above

ANSWER: c

DIFFICULTY: Easy

KEYWORDS: income statement measurement

45. Which of the following best represents operating income?
- a. Income after financing activities
 - b. Earnings before interest and taxes
 - c. Income from capital gains
 - d. Income from discontinued operations

ANSWER: b

DIFFICULTY: Moderate

KEYWORDS: operating income, EBIT

46. Which of the following best represents the stream of income that is available to common stockholders?

- a. Net profit after tax and after preferred dividend payments
- b. Earnings before interest and taxes
- c. Gross profit
- d. Operating profit

ANSWER: a

DIFFICULTY: Moderate

KEYWORDS: income available to shareholders

47. Which of the following best describes a balance sheet?
- a. Reports cash receipts and cash disbursements for a specific accounting period.
 - b. Reports investment activities for a specified accounting period.
 - c. Reports revenues and expenses for a specific accounting period.
 - d. Reports the amount and composition of assets and liabilities at a specified point in time.

ANSWER: d

DIFFICULTY: Moderate

KEYWORDS: balance sheet measurement

48. Which of the following would not be included as an asset on a corporate balance sheet?
- a. Accounts receivable
 - b. Common stock
 - c. Inventory
 - d. Buildings

ANSWER: b

DIFFICULTY: Easy

KEYWORDS: balance sheet assets

49. Which of the following would not be included as a liability in a corporate balance sheet?
- a. Accruals
 - b. Notes payable
 - c. Accounts payable
 - d. Bonds
 - e. Depreciation

ANSWER: e

DIFFICULTY: Easy

KEYWORDS: balance sheet liabilities

50. Which of the following would not be included as equity in a corporate balance sheet?
- a. Cash
 - b. Paid in capital
 - c. Preferred stock
 - d. Retained earnings
 - e. Common stock

ANSWER: a

DIFFICULTY: Easy

KEYWORDS: balance sheet equity

51. Which of the following does NOT represent cash outflows to the firm?
- a. Taxes

- b. Interest payments
- c. Dividends
- d. Purchase of plant and equipment
- e. Depreciation

ANSWER: e

DIFFICULTY: Moderate

KEYWORDS: cash outflows

52. Which of the following is NOT included in operating income?

- a. Cost of goods sold
- b. Sales
- c. Taxes
- d. Operating expenses

ANSWER: c

DIFFICULTY: Easy

KEYWORDS: income statement, operating income

53. Which of the following is NOT considered a fixed asset?

- a. Land
- b. Equipment
- c. Patents
- d. Building

ANSWER: c

DIFFICULTY: Easy

KEYWORDS: balance sheet accounts, fixed assets

54. Holding all other variables constant, which of the following will decrease total equity? An increase in:

- a. common stock issued
- b. dividends paid
- c. net income
- d. interest expense

ANSWER: b

DIFFICULTY: Moderate

KEYWORDS: balance sheet accounts, equity

55. Using the information provided, calculate net income for 2002. Assume a tax rate of 40 percent.

Year	<u>2002</u>
Inventory	\$5,000

- | | |
|----------------------|---------|
| Revenues | 200,000 |
| Depreciation expense | 5,000 |
| Cost of goods sold | 100,000 |
| Interest expense | 10,000 |
| Operating expenses | 30,000 |
- a. \$33,000
b. \$44,000
c. \$55,000
d. \$66,000

ANSWER: a

DIFFICULTY: Moderate

KEYWORDS: income statement

56. Based on the following selected financial information for Sheets Metalworks, calculate net income for 2003.

	<u>2002</u>	<u>2003</u>
Dividends paid	\$400	\$700
Accts. payable/accr.	300	500
Long-term debt	2,300	2,000
Common stock	2,200	3,000
Retained earnings	6,150	6,350

- a. \$100
b. \$300
c. \$500
d. \$700
e. \$900

ANSWER: e

DIFFICULTY: Moderate

KEYWORDS: income statement

57. Grass Gadgets had sales of \$30 million and net income of \$2 million in 2002. Grass paid a dividend of \$1.5 million. Assuming that their beginning balance for retained earnings was \$3 million, calculate their ending balance for retained earnings.
- a. \$2.5 million
b. \$3 million
c. \$3.5 million
d. \$4 million

ANSWER: c

DIFFICULTY: Easy

KEYWORDS: retained earnings, equity

58. Tax tables are based on _____ tax rates.
- a. marginal
b. average

- ANSWER:** a
DIFFICULTY: Easy
KEYWORDS: tax tables, tax rates

KEYWORDS: tax tables, tax rates

- ANSWER:** a
DIFFICULTY: Moderate
KEYWORDS: free cash flows

KEYWORDS: free cash flows

- ANSWER:** d
DIFFICULTY: Moderate
KEYWORDS: net operating working capital

KEYWORDS: net operating working capital

- ANSWER:** a
DIFFICULTY: Moderate
KEYWORDS: free cash flow

KEYWORDS: free cash flow

- ANSWER:** b
DIFFICULTY: Easy
KEYWORDS: treasury stock

KEYWORDS: treasury stock

Financial Data for Dooley Sportswear, December 31, 1996	
Inventory	\$206,250

Long-term debt	300,000
Interest expense	5,000
Accumulated depreciation	442,500
Cash	180,000
Net sales (all credit)	1,500,000
Common stock	800,000
Accounts receivable	225,000
Operating expenses	525,000
Notes payable-current	187,500
Cost of goods sold	937,500
Plant and equipment	1,312,500
Accounts payable	168,750
Marketable securities	95,000
Prepaid insurance	80,000
Accrued wages	65,000
Retained earnings-current-year	?
Federal income taxes	5,750

63. From the scrambled list of items presented in Table 4, prepare an income statement and a balance sheet for Dooley Sportswear Company.

ANSWER:

Dooley Sportswear Company Income Statement
for the Year Ending December 31, 1996

Net sales (all credit)	\$1,500,000
Cost of goods sold	<u>937,500</u>
Gross profits	562,500
Operating expenses	<u>525,000</u>
Net operating income	37,500
Interest expense	<u>5,000</u>
Net income before taxes	32,500
Federal income taxes	<u>5,750</u>
Net income	<u>\$26,750</u>

Dooley Sportswear Company Balance Sheet
December 31, 1996

Assets

Current assets

Cash	\$180,000
Marketable securities	95,000
Accounts receivable	225,000
Inventory	206,250
Prepaid insurance	<u>80,000</u>
Total current assets	\$786,250

Fixed assets

Plant and equipment	\$1,312,500
Less: accumulated depreciation	<u>442,500</u>
Net plant and equipment	<u>870,000</u>
Total assets	<u>\$1,656,250</u>

Liabilities and owner's equity

Current liabilities

Accounts payable	\$168,750
------------------	-----------

Accounts payable	187,500
Accrued wages	<u>65,000</u>
Total current liabilities	\$421,250
Noncurrent liabilities	
Long-term debt	300,000
<i>Owner's equity</i>	
Common stock	800,000
Retained earnings	<u>135,000</u>
Total owner's equity	<u>\$935,000</u>
Total liabilities & owner's equity	<u>\$1,656,250</u>

ANSWER: No answer in TestBank

DIFFICULTY: Hard

KEYWORDS: balance sheet, income statement, financial statement construction

64. Pearls, Inc. had sales in 1993 of \$2.1 million. The common stockholders received \$400,000 in cash dividends and preferred stockholders were paid \$200,000. Interest totaling \$150,000 was paid on outstanding debts. Operating expenses totaled \$300,000, and cost of goods sold was \$500,000. Stock that had been purchased for \$50,000 in 1987 was sold for \$70,000. What is the tax liability of Pearls, Inc.?

ANSWER:

Pearls Taxable Income

Sales \$2,100,000

Less:

Cost of goods sold \$500,000

Operating expenses 300,000

Operating profit \$1,300,000

Other income (Security Sale) 20,000

Earnings before interest & taxes \$1,320,000

Interest expense 150,000

Taxable income 1,170,000

Total taxes owed \$397,800

Taxes on operating earnings = $(.15)(50,000) + (.25)(25,000) + (.34)$

$(1,095,000) + (.05)(235,000) = 7,500 +$

$6,250 + 372,300 + 11,750 = \$397,800$ or

Because taxable income is over \$335,000

taxes can be computed $1,170,000 \times .34 =$

\$397,800

ANSWER: \$397,800

DIFFICULTY: Hard

KEYWORDS: tax liability

65. Goodwin Enterprises had a gross profit of \$2,500,000 for the year. Operating expenses and interest expense incurred in that same year were \$595,000 and \$362,000, respectively. Goodwin had 200,000 shares of common stock and 180,000 shares of preferred stock outstanding. Management declared a

\$2.50 dividend per share on the common and a \$1.50 dividend per share on the preferred. Securities purchased at a cost of \$37,500 in a previous year were resold at a price of \$50,500. Compute the taxable income and the resulting tax liability for Goodwin Enterprises for the year.

Use the following tax rates:

<u>Income</u>	<u>Tax rate</u>
\$0-\$50,000	15%
\$50,001-\$75,000	25%
\$75,001-\$100,000	34%
\$100,001-\$335,000	39%
over \$335,001	34%

ANSWER:

Gross profit	\$2,500,000
Operating expenses	(595,000)
Interest expense	(362,000)
Income before tax	\$1,543,000
Add: Gain on sales	13,000
Taxable Income	\$1,556,000

Income		Marginal Tax Rate	Tax Liability
\$50,000	×	15%	\$7,500
\$25,000	×	25%	\$6,250
\$25,000	×	34%	\$8,500
\$235,000	×	39%	\$91,650
<u>\$1,221,000</u>	×	34%	<u>\$415,140</u>
\$1,556,000			\$529,040

ANSWER: \$529,040

DIFFICULTY: Hard

KEYWORDS: tax liability