Chapter 1--Overview of Financial Reporting, Financial Statement Analysis, and Valuation

Student: ____

1. The tools for studying industry economics do **not** include
A. Value chain analysis
B. Classification using Porter's five forces
C. Classification of cash flows
D. Economic attributes framework

2. Which of the following is a question an analyst would ask when assessing the quality of a firm's financial statements?
A. Are the company's products designed to meet a specific market segment?
B. Has the firm integrated forward into retailing to final consumers?
C. Is the firm diversified across several geographical markets?
D. Do earnings include nonrecurring gains or losses?

3. Which of the following economic characteristics is consistent with a grocery store chain?
A. minimal competition
B. extensive competition
C. high net income to sales
D. differentiated product

4. On a common size basis, which of the following assets is normally largest for a electric utility?
A. Accounts receivable
B. Inventory
C. Property, Plant and Equipment
D. Cash and Marketable Securities

5. On a common size basis, which of the following assets is normally largest for a commercial bank?
A. Accounts and Notes Receivable
B. Inventory
C. Property, Plant and Equipment
D. Cash and Marketable Securities

6. Which of the following is **not** one of Porter's five forces?
A. Buyer Power
B. Supplier power
C. Threat of Regulation
D. Threat of Substitutes

7. When assessing buyer power using Porter's five forces which of the following is **not** consistent with low buyer power?
A. Brand loyalty
B. Control of distribution channel
C. Large number of suppliers
D. Low price

8. The second step in financial statement analysis is to identify the company strategy. Which of the following is a question an analyst should ask when performing a strategy analysis?
A. Are industry sales growing rapidly or slowly?
B. Do earnings include revenues that appear mismatched with the business model employed by the firm?
C. Does the industry include a large number of firms selling similar products?
D. What is the company's degree of geographical diversification?

9. The third step in financial statement analysis is to assess the quality of the firm's financial statements. Which of the following is a question an analyst should ask when performing this step?
A. Are industry sales growing rapidly or slowly?
B. Do earnings include revenues that appear mismatched with the business model employed by the firm?
C. Does the industry include a large number of firms selling similar products?
D. What is the company's degree of geographical diversification?

10. An example of an intangible asset is
A. a patent
B. land
C. investment in another company
D. raw material inventory

11. Which of the following would **not** appear as a liability on the balance sheet?
A. a labor contract
B. a note due to a bank
C. salary due employees at year-end
D. accounts payable

12. Which of the following assets would appear on the balance sheet at an amount greatly below its fair market value?
A. inventory
B. marketable securities
C. equipment
D. brand name

13. The accrual basis of accounting recognizes
A. revenue when cash is received from customers
B. expenses when paid
C. revenue when all or a substantial portion is performed
D. revenue when contracts are signed

14. Which of the following is **not** an activity reported in the cash flows financial statement?
A. operating
B. investing
C. manufacturing
D. financing

15. The accrual basis method of accounting can be best described as:
A. The recording of transactions and adjustments so that debits equal credits.
B. The method that equates assets with liabilities and owners' equity.
C. The method that recognizes revenue when money is received.
D. The method that matches incurred expenses with related revenues when they are earned.

16. A value chain for an industry sets forth
A. the layers of management the needed to be successful
B. sequence of activities involved in the creation, manufacture and distribution of its products.
C. Sequence of activities involved in a firm's research and development activities.
D. Whether the industry is horizontally or vertically integrated.

17. Which of the following economic characteristics is consistent with a commercial bank?
A. Low barriers to entry.
B. High levels of research and development.
C. Low profit margin on lending activities.
D. Low profit margin on fee-based financial services, such as merger consulting.

18. Which of the following economic characteristics is consistent with a pharmaceutical company?
A. Low barriers to entry.
B. High levels of research and development.
C. Low profit margins.
D. Low business risk.

19. Which of the following economic characteristics is consistent with a grocery store chain?
A. Low barriers to entry.
B. High levels of research and development.
C. High profit margins.
D. Low capital intensity.

20. When attempting to identify the economic characteristics of the industry in which a particular firm participates an analyst might ask which of the following questions?
A. Does technological change play an important role in the firm maintaining a competitive advantage?
B. Has the firm diversified across several geographic markets?
C. Has the firm recognized revenues at the proper time?
D. Has the firm structured transactions to make it look more profitable than economic conditions suggest?

21. Which of the following would not inhibit new entrants into a market?
A. Existing technological expertise.
B. Large required capital investment.
C. Lack of rivalry among current participants.
D. Existing patented technology.

22. Current assets are defined as
A. cash and cash equivalents.
B. all assets expected to be quickly used by the firm.
C. cash and other assets that the firm expects to sell or consume during the normal operating cycle of a business, usually one year.
D. cash and other assets that the firm expects maintain for a period including the normal operating cycle of a business, usually one year.

23. Which of the following is not an expense of a business?
A. Depreciation
B. Dividends
C. Salaries
D. Advertising

24. Which of the following is not a characteristic of an extraordinary item?
A. Material in amount.
B. Nonrecurring.
C. Unusual given the nature of the firm's activities.
D. Requires a cash outflow.

25. Which of the following activities reported in the Statement of Cash Flows is a financing activity?
A. Repayment of outstanding debt.
B. Investing in equity securities of other companies.
C. Payment of dividends.
D. Issuing debt.

26. The tools of effective financial statement analysis are also useful for assessing whether to extend ____________________ to a firm, either for a short-term or for a long-term.

____

27. The first step in financial statement analysis is to identify the ____ of the industry in which a firm participates.

____

28. Another important step in financial statement analysis is to assess the quality of a firm's ____ and if necessary adjust them for such characteristics as sustainability or comparability.

____

29. The fourth step in financial statement analysis is using the financial statements to analyze the current ____________________ and ____________________ of the firm.

____

30. When identifying the strategies that a particular firm pursues to gain a competitive advantage it is important to determine if its products are designed to meet the needs of a specific market segment or are they intended for a ____.

____

31. The ______________________________ sets forth the sequence of activities involved in the creation, manufacture and distribution of its products and services.

____

32. The higher the value added from any activity, the higher should be the ____________________ from engaging in that activity.

____

33. Normally, intense rivalries have a tendency to reduce ____________________.

____

34. The threat of new entrants is measured by whether there are entry barriers, such as capital investment, ____, patents, or regulation that inhibit new entrants.

____

35. The five economic attributes that are normally studied are demand, supply, manufacturing, ____________________ and investing and financing.

____

36. Obtaining a competitive advantage by being the first company to introduce new concepts or ideas is referred to as ____.

____

37. Resources that have the potential for providing a firm with future economic benefits are called ____________________.

____

38. Assets that do **not** represent a claim to a fixed amount of cash are called ____________________ assets.

____

39. ____________________ assets include the rights established by law or contract to the future use of property.

____

40. Labor contracts and purchase order commitments are examples of ____________________ contracts.

____

41. The residual interest in a company is referred to as ______________________________.

____

42. Under the ____________________ basis of accounting, a firm recognizes revenue when it performs all or a substantial portion, of the services it expects to perform and receives either cash or a receivable.

____

43. ___________________________________ equals net income for a period plus or minus the changes in shareholders' equity accounts other than from net income and transactions with owners.

____

44. Statements that express all items in a particular financial statement as a percentage of some common base are called _________________________ statements.

____

45. A firm obtains cash from short and long-term ____________________ and from issuing preferred and _________________________.

____

46. The ____ defines more clearly the explicit responsibility of managers for financial statements, the relation between the independent auditor and the firm audited and the kinds of services permitted and not permitted.

____

47. Under the Sarbanes-Oxley Act ____________________ assumes responsibility for establishing and maintaining adequate internal control structure and procedures.

____

48. Most financial statement analysis aims to assess a firm's ____________________ and ____________________.

____

49. ___________________________________ financial statements are helpful in highlighting the relative magnitude of changes in financial statement data from year to year.

____

50. Basic EPS is calculated as net income minus ____ divided by the weighted average number of shares outstanding.

____

51. Firms intending to issue new bonds or capital stock file a ____________________ with the SEC that describes the offering.

____

52. ______________________________ relates to the relative number of buyers and sellers in a particular industry.

____

53. How easily can new firms enter a market is a question one might ask when assessing ____.

____

54. How easily can customers switch to substitute products is a question one might ask when assessing the ___________________________________.

____

55. Nonmonetary assets include assets that are ____________________, such as inventories, and assets that are ____________________ such as brand names.

____

56. What are the six interconnected activities related to financial statement analysis?

57. What is an industry's value chain?

58. When assessing the threat of new entrants what questions might an analyst ask about an industry?

59. What three financial statements are prepared by business firms and what information does each provide?

60. Many people view the balance sheet as being a representation of a firm's economic position. What are some issues that reduce the quality of this representation?

61. Under the Sarbanes-Oxley Act financial statements must include both a Management Assessment and an Assurance Opinion. What information do the Management Assessment and an Assurance Opinion provide to financial statement users?

62. What are three activities reported in the statement of cash flows and what information does each activity provide?

63. What is comprehensive income?

64. What is the rationale for the statement of cash flows?

65. Many market participants argue that financial markets are efficient and that financial statement users cannot routinely analyze financial statements to find mispriced securities. This view would lead some to suggest that there is little value to financial statement analysis. Provide a discussion of the role of financial statement analysis in an efficient capital market and reasons why financial statement analysis is still valuable.

66. Prepare an analysis of the automobile manufacturing industry using Porter's five forces framework. For **each** component force provide support for your conclusion. In addition, at the completion of your analysis provide a conclusion, along with support, of whether **you** expect the automobile industry to report high or low profitability in the near future.

67. Prepare an analysis of the grocery industry using Porter's Five Forces framework. For **each** component force provide support for your conclusion. In addition, at the completion of your analysis provide a conclusion, along with support, of whether **you** expect the grocery industry to report high or low profitability in the near future.

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credit

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economic characteristics

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financial statements

29. The fourth step in financial statement analysis is using the financial statements to analyze the current ____________________ and ____________________ of the firm.
profitability, risk

30. When identifying the strategies that a particular firm pursues to gain a competitive advantage it is important to determine if its products are designed to meet the needs of a specific market segment or are they intended for a ____.
broader consumer market

31. The ______________________________ sets forth the sequence of activities involved in the creation, manufacture and distribution of its products and services.
value chain

32. The higher the value added from any activity, the higher should be the ____________________ from engaging in that activity.
profitability

33. Normally, intense rivalries have a tendency to reduce ____________________.
profitability

34. The threat of new entrants is measured by whether there are entry barriers, such as capital investment, ____, patents, or regulation that inhibit new entrants.
technological expertise

35. The five economic attributes that are normally studied are demand, supply, manufacturing, ____________________ and investing and financing.
marketing

36. Obtaining a competitive advantage by being the first company to introduce new concepts or ideas is referred to as ____.
first mover advantage

37. Resources that have the potential for providing a firm with future economic benefits are called ____________________.
assets

38. Assets that do **not** represent a claim to a fixed amount of cash are called ____________________ assets.
nonmonetary

39. ____________________ assets include the rights established by law or contract to the future use of property.
Intangible

40. Labor contracts and purchase order commitments are examples of ____________________ contracts.
executory

41. The residual interest in a company is referred to as ______________________________.
shareholders' equity

42. Under the ____________________ basis of accounting, a firm recognizes revenue when it performs all or a substantial portion, of the services it expects to perform and receives either cash or a receivable.
accrual

43. ___________________________________ equals net income for a period plus or minus the changes in shareholders' equity accounts other than from net income and transactions with owners.
Comprehensive income

44. Statements that express all items in a particular financial statement as a percentage of some common base are called _________________________ statements.
common-size *or*
common size

45. A firm obtains cash from short and long-term ____________________ and from issuing preferred and _________________________.
borrowing, common stock

46. The ____ defines more clearly the explicit responsibility of managers for financial statements, the relation between the independent auditor and the firm audited and the kinds of services permitted and not permitted.
Sarbanes-Oxley Act of 2002 *or*
Sarbanes Oxley Act of 2002

47. Under the Sarbanes-Oxley Act ____________________ assumes responsibility for establishing and maintaining adequate internal control structure and procedures.
management

48. Most financial statement analysis aims to assess a firm's ____________________ and ____________________.
profitability, risk

49. ___________________________________ financial statements are helpful in highlighting the relative magnitude of changes in financial statement data from year to year.
Percentage change

50. Basic EPS is calculated as net income minus ____ divided by the weighted average number of shares outstanding.
dividends on preferred stock

51. Firms intending to issue new bonds or capital stock file a ____________________ with the SEC that describes the offering.
prospectus

52. ______________________________ relates to the relative number of buyers and sellers in a particular industry.
Buyer power

53. How easily can new firms enter a market is a question one might ask when assessing ____.
threats of new entrants

54. How easily can customers switch to substitute products is a question one might ask when assessing the ___________________________________.
threat of substitutes

55. Nonmonetary assets include assets that are ____________________, such as inventories, and assets that are ____________________ such as brand names.
tangible, intangible

56. What are the six interconnected activities related to financial statement analysis?

1. Identify the economic characteristics of the industry in which a firm participates.
2. Identify the strategies that a particular firm pursues to gain and sustain a competitive advantage.
3. Assess the quality of a firm's financial statements and, if necessary, adjust them for such desirable characteristics such as sustainability or comparability.
4. Analyze the current profitability and risk of the firm using information in the financial statements.
5. Prepare forecasted financial statements.
6. Value the particular firm.

57. What is an industry's value chain?

The sequence of activities involved in the creation, manufacture and distribution of its products and services.

58. When assessing the threat of new entrants what questions might an analyst ask about an industry?

1. How easily can new firms enter the market?
2. Do new firms require a large capital investment?
3. Do new firms require large amounts of technological expertise?
4. Does regulation inhibit new firms from entering the market?

59. What three financial statements are prepared by business firms and what information does each provide?

1. Balance sheet--Point in time reporting of assets, liabilities and stockholders' equity.
2. Income statement--Measurement of operating performance for a period of time.
3. Statement of cash flows--The net cash flows for a period of time from the three business activities: operating, investing and financing.

60. Many people view the balance sheet as being a representation of a firm's economic position. What are some issues that reduce the quality of this representation?

1. Many valuable resources of a firm that generate cash flows, such as a patent, will only appear as assets if acquired, not when they are internally developed.
2. Nonmonetary assets appear at acquisition cost, even though their current market values might exceed acquisition cost.
3. Certain rights to use resources and commitments to make future payments may not appear as assets and liabilities.
4. Noncurrent liabilities appear at the present value of expected cash flows discounted at an interest rate determined when the liability arose, not at the current rate.

61. Under the Sarbanes-Oxley Act financial statements must include both a Management Assessment and an Assurance Opinion. What information do the Management Assessment and an Assurance Opinion provide to financial statement users?

The *Management Assessment* makes explicit management's responsibility for not only the financial statements but for the underlying accounting and control system that generates the financial statements.

The *Assurance Opinion* is provided by the independent auditor and is included with the opinion on the fairness of the amounts reported in the financial statements. The *Assurance Opinion* provides the auditor's opinion on the effectiveness of the internal control system.

62. What are three activities reported in the statement of cash flows and what information does each activity provide?

1. Operating activities - Provides information on cash generated and used by a firm in its normal activities of selling goods and providing services.
2. Investing activities - Provides information about the firm's use of cash in the acquisition of long-lived productive assets and cash provided by the disposal of long-lived productive assets. In addition, cash provided and used by investment in debt and equity securities are included in this category.
3. Financing activities - Provides information about cash provided and used by short- and long-term borrowing and from issuing or repurchasing capital stock. In addition, cash used for dividends is reported in this category.

63. What is comprehensive income?

Comprehensive income equals net income for a period plus or minus the changes in shareholders' equity accounts other than from net income and transactions with owners. Items affecting comprehensive income include foreign currency translation adjustments, cash flow hedge accounting, minimum pension liability adjustments and unrealized gains and losses from holding investment securities classified as available for sale.

64. What is the rationale for the statement of cash flows?

The statement of cash flows provides information on the sources and uses of cash. Even profitable firms sometimes find themselves in need of cash and unable to pay suppliers, employees, and other creditors. This may occur for two reasons:

1. The timing of cash receipts from customers does not necessarily coincide with the recognition of revenue, and the timing of cash expenditures does not necessarily coincide with the recognition of expenses under the accrual basis of accounting.

Normally cash expenditures precede the recognition of expenses and cash receipts occur after the recognition of revenue.

2. The firm may need to acquire new property, plant, and equipment; retire outstanding debt; or reacquire shares of its common stock when there is insufficient cash available.

65. Many market participants argue that financial markets are efficient and that financial statement users cannot routinely analyze financial statements to find mispriced securities. This view would lead some to suggest that there is little value to financial statement analysis. Provide a discussion of the role of financial statement analysis in an efficient capital market and reasons why financial statement analysis is still valuable.

1. Even if markets are perfectly efficient, someone must do the analysis to bring about appropriate prices.
2. A finding that the market is efficient on average does not preclude temporary mispricing of securities. Financial analysis can identify specific mispriced securities.
3. Research has shown that equity markets are not perfectly efficient, financial analysis has uncovered anomalies.
4. Financial analysis can adjust financial statements for the biases related to managers' preference of job security and compensation.
5. Financial analysis is valuable outside to the equity capital markets.

66. Prepare an analysis of the automobile manufacturing industry using Porter's five forces framework. For **each** component force provide support for your conclusion. In addition, at the completion of your analysis provide a conclusion, along with support, of whether **you** expect the automobile industry to report high or low profitability in the near future.

Buyer Power--HIGH--It appears that consumers are sensitive to price as many manufacturers have similar offerings in each auto product class. In addition, cars are a large part of most consumers budget. Working against high buyer power is brand loyalty and control of the distribution channel.

Supplier Power--LOW--Given auto makers size it is likely that these companies exert significant influence over suppliers, leading to low supplier power.

Rivalry among existing firms--HIGH--There is intense rivalry among auto firms, which is evidenced by heavy advertising. In addition, the market is mature so additional market share must come from other competitors leading to intense competition.

Threat of new entrants--MEDIUM--While entirely new auto companies are rare, non-U.S. companies entering the U.S. market is more common. Kia and Hyundai are companies that have recently started competing in the U.S. market.

Threat of substitutes--MEDIUM/LOW--It is doubtful that many U.S. consumers are going to switch to mass transit or bicycles due to the logistics of the U.S., however one threat to auto manufacturers is used cars. As cars become more reliable and longer lasting many consumers may switch from purchasing new cars to used.

67. Prepare an analysis of the grocery industry using Porter's Five Forces framework. For **each** component force provide support for your conclusion. In addition, at the completion of your analysis provide a conclusion, along with support, of whether **you** expect the grocery industry to report high or low profitability in the near future.

Suggested solution:

You may want to have students think about grocery chains different strategies. For example, Wal-Mart and Kroger's seem to be attempting to be the low cost providers (fewer brand choices, less service, less attractive stores), while Whole Foods and Harris Teeter are attempting to be full service providers (many brands, nicer looking stores, more services).

Here is a suggested solution for the Wal-mart/Kroger grocery segment:

Buyer Power--HIGH--It appears that consumers are sensitive to price as many grocery chains have similar offerings in each grocery chain. There is a high level of discounting so consumers do not appear to be brand loyal. However, many grocery chains offer additional discounts to frequent buyers or members which increase brand loyalty.

Supplier Power--MEDIUM to LOW--Given that there are fewer grocery chains, due to consolidation and bankruptcies it is likely that these companies exert more and more influence over suppliers, leading to low supplier power.

Rivalry among existing firms--HIGH--There is intense rivalry among grocery chains, which is evidenced by heavy advertising and discounting/coupons. In addition, the market is mature so additional market share must come from other competitors leading to intense competition.

Threat of new entrants--MEDIUM--There have been very few new U.S. grocery chains started, however there does appear to be more non-U.S. companies entering the U.S. market. Ahold, Tesco and Aldi are foreign companies that have recently started competing in the U.S. market.

Threat of substitutes--MEDIUM/LOW--With the rise of the Whole Foods segment many consumers are going upscale to obtain better services in exchange for higher prices. The general state of the economy plays an important role in how substitutes are viewed when examining the Wal-Mart/ Kroger segment of the grocery industry.