



Pearson

Chapter 2

Introduction to financial statement analysis

Write 'True' if the statement is correct and 'False' if the statement is incorrect.

1) In Australia, publicly traded companies can choose whether or not they wish to release periodic financial statements.

Answer: False

Difficulty: Basic

Learning Objective: 2.1 Understand why the disclosure of financial information through financial statements is critical to investors

Topic 2.1: Firms' disclosure of financial information

AACSB: Application of Knowledge

2) Financial statements are accounting reports issued periodically by a firm which present information on the past performance of the firm, a summary of the firm's assets and the financing of those assets, and a prediction of the firm's future performance.

Answer: False

Difficulty: Basic

Learning Objective: 2.1 Understand why the disclosure of financial information through financial statements is critical to investors

Topic 2.1: Firms' disclosure of financial information

AACSB: Application of Knowledge

3) International Financial Reporting Standards are taking root throughout the world. However, it is unlikely that Australia will report according to IFRS before the second half of the 21st century.

Answer: False

Difficulty: Basic

Learning Objective: 2.1 Understand why the disclosure of financial information through financial statements is critical to investors

Topic 2.1: Firms' disclosure of financial information

AACSB: Reflective Thinking Skills

Choose the one alternative that best completes the statement or answers the question.

4) What is the main reason that it is necessary for public companies to follow the rules and format set out in the Generally Accepted Accounting Principles (GAAP) when creating financial statements?

A) It makes it easier to compare the financial results of different firms.



- B) It ensures that important information is not omitted and superfluous information is not included.
- C) It is easier to find specific information in such a report if it is laid out in a clear and consistent manner.
- D) It ensures that information on the performance of private companies is readily available to the public.

Answer: A

Difficulty: Basic

Learning Objective: 2.1 Understand why the disclosure of financial information through financial statements is critical to investors

Topic 2.1: Firms' disclosure of financial information

AACSB: Reflective Thinking Skills

5) Which of the following best describes why firms produce financial statements?

- A) to provide interested parties, both inside and outside the company, with an overview of the short- and long-term financial condition of a business
- B) to show what activities the company has undertaken in the previous financial year, and what activities are planned for the near future
- C) to provide a means of enticing new investors to a firm
- D) to use as a tool when planning future investments within the firm

Answer: A

Difficulty: Basic

Learning Objective: 2.1 Understand why the disclosure of financial information through financial statements is critical to investors

Topic 2.1: Firms' disclosure of financial information

AACSB: Reflective Thinking Skills

6) The International Financial Reporting Standards set out by the International Accounting Standards Board are NOT accepted by the exchanges in which of the following countries or regions?

- A) France
- B) the United Kingdom
- C) the United States
- D) Germany

Answer: C

Difficulty: Basic

Learning Objective: 2.1 Understand why the disclosure of financial information through financial statements is critical to investors

Topic 2.1: Firms' disclosure of financial information

AACSB: Reflective Thinking Skills

7) Which of the following is NOT one of the financial statements that must be produced by a public company?

- A) the statement of cash flows
- B) the statement of activities
- C) the income statement



D) the balance sheet

Answer: B

Difficulty: Basic

Learning Objective: 2.1 Understand why the disclosure of financial information through financial statements is critical to investors

Topic 2.1: Firms' disclosure of financial information

AACSB: Application of Knowledge

8) Which of the following is NOT a financial statement that every public company is required to produce?

A) statement of sources and uses of cash

B) income statement

C) balance sheet

D) statement of changes in equity

Answer: A

Difficulty: Moderate

Learning Objective: 2.1 Understand why the disclosure of financial information through financial statements is critical to investors

Topic 2.1: Firms' disclosure of financial information

AACSB: Application of Knowledge

9) The third party who checks annual financial statements to ensure that they are prepared according to Generally Accepted Accounting Principles (GAAP) and verifies that the information reported is reliable is the

A) Australian Securities and Investments Commission (ASIC).

B) auditor.

C) Australian Securities Exchange.

D) Australian Accounting Standards Board.

Answer: B

Difficulty: Basic

Learning Objective: 2.1 Understand why the disclosure of financial information through financial statements is critical to investors

Topic 2.1: Firms' disclosure of financial information

AACSB: Application of Knowledge

Write your answer in the space provided or on a separate sheet of paper.

10) What is the role of an auditor in financial statement analysis?

Answer: Key points:

1. to ensure that the annual financial statements are prepared accurately

2. to ensure that the annual financial statements are prepared according to the Australian equivalent of International Financial Reporting Standards (A-IFRS)

3. to provide evidence to support the reliability of the information

Difficulty: Moderate



Learning Objective: 2.1 Understand why the disclosure of financial information through financial statements is critical to investors

Topic 2.1: Firms' disclosure of financial information

AACSB: Application of Knowledge

11) What are the four financial statements that all public companies must produce?

Answer:

1. balance sheet
2. income statement
3. statement of cash flows
4. statement of changes in equity

Difficulty: Moderate

Learning Objective: 2.1 Understand why the disclosure of financial information through financial statements is critical to investors

Topic 2.1: Firms' disclosure of financial information

AACSB: Application of Knowledge

Write 'True' if the statement is correct and 'False' if the statement is incorrect.

12) The balance sheet shows the assets, liabilities, and shareholders' equity of a firm at a given point in time.

Answer: True

Difficulty: Moderate

Learning Objective: 2.2 Understand the function of the balance sheet

Topic 2.2: The Balance Sheet

AACSB: Application of Knowledge

13) Shareholders' equity is the difference between a firm's assets and liabilities, as shown on the balance sheet.

Answer: True

Difficulty: Basic

Learning Objective: 2.2 Understand the function of the balance sheet

Topic 2.2: The Balance Sheet



AACSB: Application of Knowledge

Choose the one alternative that best completes the statement or answers the question.

14) Which of the following amounts would be included on the right side of a balance sheet?

- A) the amount of money owed to the company by customers who have not yet paid for goods and services they have received
- B) the amount of deferred tax liability held by the company
- C) the value of government bonds held by the company
- D) the cash held by the company

Answer: B

Difficulty: Moderate

Learning Objective: 2.2 Understand the function of the balance sheet

Topic 2.2: The Balance Sheet

AACSB: Application of Knowledge

15) Which of the following best describes why the left and right sides of a balance sheet are equal?

- A) By definition, the assets plus the liabilities will be the same as the shareholders' equity.
- B) In a properly run business, the value of liabilities will not exceed the assets held by the company.
- C) The assets must equal liabilities plus shareholders' equity, because shareholders' equity is the difference between the assets and the liabilities.
- D) By accounting convention, the assets of a company must be equal to the liabilities of that company.

Answer: C

Difficulty: Basic

Learning Objective: 2.2 Understand the function of the balance sheet

Topic 2.2: The Balance Sheet

AACSB: Analytical Thinking

16) A company that produces pharmaceutical drugs is preparing a balance sheet. Which of the following would be most likely to be considered a long-term asset on this balance sheet?

- A) the inventory of chemicals used to produce the drugs made by the company
- B) commercial paper held by the company
- C) a patent for a drug held by the company
- D) the cash reserves of the company

Answer: C

Difficulty: Basic

Learning Objective: 2.2 Understand the function of the balance sheet

Topic 2.2: The Balance Sheet

AACSB: Analytical Thinking

17) A delivery company is creating a balance sheet. Which of the following would most likely be considered a short-term liability on this balance sheet?

- A) revenue received for the delivery of items that have not yet been delivered



- B) the depreciation over the last year in the value of the vehicles owned by the company
- C) a loan which must be paid back in two years' time
- D) prepaid rent on the offices occupied by the company

Answer: A

Difficulty: Basic

Learning Objective: 2.2 Understand the function of the balance sheet

Topic 2.2: The Balance Sheet

AACSB: Application of Knowledge

18) A small company has current assets of \$1 112 000 and current liabilities of \$717 000. Which of the following statements about that company is most likely to be true?

- A) Since net working capital is nearly zero, the company is well run and will have little difficulty attracting investors.
- B) Since net working capital is negative, the company will not have enough funds to meet its obligations.
- C) Since net working capital is high, the company will likely have little difficulty meeting its obligations.
- D) Since net working capital is very high, the company will have ample money to invest after it meets its obligations.

Answer: C

Difficulty: Basic

Learning Objective: 2.2 Understand the function of the balance sheet

Topic 2.2: The Balance Sheet

AACSB: Reflective Thinking Skills

19) What is the main problem in using a balance sheet to provide an accurate assessment of the value of a company's equity?

- A) The balance sheet does not accurately represent the book value of assets held by the company.
- B) The equity shown on the balance sheet does not reflect the market capitalisation of the company.
- C) Knowing at a single point in time what assets a firm possesses and the liabilities a firm owes does not give any indication of what those assets can produce in the future.
- D) Valuable assets such as the company's reputation, the quality of its work force, and the strength of its management are not captured on the balance sheet.

Answer: D

Difficulty: Moderate

Learning Objective: 2.2 Understand the function of the balance sheet

Topic 2.2: The Balance Sheet

AACSB: Reflective Thinking Skills



Use the table for the question(s) below.

Balance Sheet

Assets

Current Assets

Cash	75
Accounts receivable	33
Inventories	26
Total current assets	134

Long-term Assets

Net property, plant, and equipment	182
Total long-term assets	182

Total Assets **316**

Liabilities

Current Liabilities

Accounts payable	63
Notes payable/short-term debt	11
Total current liabilities	74

Long-term Liabilities

Long-term debt	192
Total long-term liabilities	192

Total Liabilities **266**

Shareholders' Equity **50**

Total Liabilities and **316**

Shareholders' Equity

20) The above diagram shows a balance sheet for a certain company. All quantities shown are in millions of dollars. What is the company's net working capital?

- A) \$60 million
- B) \$11 million
- C) \$50 million
- D) \$48 million

Answer: A

Difficulty: Basic

Learning Objective: 2.2 Understand the function of the balance sheet

Topic 2.2: The Balance Sheet

AACSB: Analytical Thinking

21) The above diagram shows a balance sheet for a certain company. If the company pays back all of its accounts payable today using cash, what will its net working capital be?

- A) \$48 million
- B) \$60 million
- C) \$11 million
- D) \$50 million

Answer: B

Difficulty: Basic

Learning Objective: 2.2 Understand the function of the balance sheet

Topic 2.2: The Balance Sheet

AACSB: Analytical Thinking



22) The above diagram shows a balance sheet for a certain company. If the company buys new property, plant and equipment today using its entire cash balance, what will its net working capital be?

- A) -\$5 million
- B) -\$15 million
- C) \$15 million
- D) \$60 million

Answer: B

Difficulty: Basic

Learning Objective: 2.2 Understand the function of the balance sheet

Topic 2.2: The Balance Sheet

AACSB: Analytical Thinking

23) The above diagram shows a balance sheet for a certain company. All quantities shown are in millions of dollars. How would the balance sheet change if the company's long-term assets were judged to depreciate at an extra \$5 million per year?

- A) Net property, plant, and equipment would rise to \$187 million, and Total Assets and Shareholders' Equity would be adjusted accordingly.
- B) Net property, plant, and equipment would fall to \$177 million, and Total Assets and Shareholders' Equity would be adjusted accordingly.
- C) Long-term Liabilities would fall to \$172 million, and Total Liabilities and Shareholders' Equity would be adjusted accordingly.
- D) Long-term Liabilities would rise to \$182 million, and Total Liabilities and Shareholders' Equity would be adjusted accordingly.

Answer: B

Difficulty: Basic

Learning Objective: 2.2 Understand the function of the balance sheet

Topic 2.2: The Balance Sheet

AACSB: Analytical Thinking

24) The above diagram shows a balance sheet for a certain company. All quantities shown are in millions of dollars. If the company has 4 million shares outstanding, and these shares are trading at a price of \$12.45 per share, what does this tell you about how investors view this firm's book value?

- A) Investors consider that the firm's market value is worth less than its book value.
- B) Investors consider that the firm's market value is worth more than its book value.
- C) Investors consider that the firm's market value and its book value are roughly equivalent.
- D) Investors consider that the firm's market value is worth very much less than its book value.

Answer: C

Difficulty: Basic

Learning Objective: 2.2 Understand the function of the balance sheet

Topic 2.2: The Balance Sheet

AACSB: Analytical Thinking



25) Which of the following balance sheet equations is INCORRECT?

- A) $\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity}$
- B) $\text{Assets} - \text{Current Liabilities} = \text{Long-term Liabilities} + \text{Shareholders' Equity}$
- C) $\text{Assets} - \text{Liabilities} = \text{Shareholders' Equity}$
- D) $\text{Assets} - \text{Current Liabilities} = \text{Long-term Liabilities}$

Answer: D

Difficulty: Moderate

Learning Objective: 2.2 Understand the function of the balance sheet

Topic 2.2: The Balance Sheet

AACSB: Application of Knowledge

26) Net property, plant, and equipment is a

- A) Long-term Asset.
- B) Current Asset.
- C) Long-term Liability.
- D) Current Liability.

Answer: A

Difficulty: Basic

Learning Objective: 2.2 Understand the function of the balance sheet

Topic 2.2: The Balance Sheet

AACSB: Application of Knowledge

27) Accounts payable is a

- A) Long-term Liability.
- B) Current Liability.
- C) Long-term Asset.
- D) Current Asset.

Answer: B

Difficulty: Basic

Learning Objective: 2.2 Understand the function of the balance sheet

Topic 2.2: The Balance Sheet

AACSB: Application of Knowledge

28) A 30-year mortgage loan is a

- A) Long-term Liability.
- B) Current Asset.
- C) Long-term Asset.
- D) Current Liability.

Answer: A

Difficulty: Basic

Learning Objective: 2.2 Understand the function of the balance sheet

Topic 2.2: The Balance Sheet



AACSB: Application of Knowledge

29) Which of the following statements regarding the balance sheet is INCORRECT?

- A) The balance sheet reports shareholders' equity on the right-hand side.
- B) The balance sheet provides a snapshot of the firm's financial position at a given point in time.
- C) The balance sheet reports liabilities on the left-hand side.
- D) The balance sheet lists the firm's assets and liabilities.

Answer: C

Difficulty: Moderate

Learning Objective: 2.2 Understand the function of the balance sheet

Topic 2.2: The Balance Sheet

AACSB: Application of Knowledge

Use the table for the question(s) below.

Luther Corporation Consolidated Balance Sheet 30 June 2017 and 2018 (in \$ millions)

			Liabilities and		
Assets	2018	2017	Shareholders' Equity	2018	2017
<i>Current Assets</i>			<i>Current Liabilities</i>		
Cash	63.6	58.5	Accounts payable	87.6	73.5
Accounts receivable	55.5	39.6	Notes payable/ short-term debt	10.5	9.6
Inventories	45.9	42.9	Current maturities of long- term debt	39.9	36.9
Other current assets	6.0	3.0	Other current liabilities	6.0	12.0
Total current assets	171.0	144.0	Total current liabilities	144.0	132.0
<i>Long-term Assets</i>			<i>Long-term Liabilities</i>		
Land	66.6	62.1	Long-term debt	239.7	168.9
Buildings	109.5	91.5	Capital lease obligations	---	---
Equipment	119.1	99.6	Total Debt	239.7	168.9
Less accumulated depreciation	(56.1)	(52.5)	Deferred taxes	22.8	22.2
Net property, plant, and equipment	239.1	200.7	Other long-term liabilities	---	---
Goodwill	60.0	--	Total long-term liabilities	262.5	191.1
Other long-term assets	63.0	42.0	Total liabilities	406.5	323.1
Total long-term assets	362.1	242.7	Shareholders' Equity	126.6	63.6
			Total liabilities and		
Total Assets	533.1	386.7	Shareholders' Equity	533.1	386.7



30) Refer to the balance sheet above. What is Luther's net working capital in 2018?

- A) \$27 million
- B) \$63.6 million
- C) \$12 million
- D) \$39 million

Answer: A

Difficulty: Moderate

Learning Objective: 2.2 Understand the function of the balance sheet

Topic 2.2: The Balance Sheet

AACSB: Analytical Thinking

Write the word or phrase that best completes each statement or answers the question.

31) How does a firm select the date for preparation of its balance sheet?

Answer: The balance sheet is prepared on the fiscal closing date for the accounts of a firm. In Australia, the balance date is generally 30 June each year; however some companies - particularly companies that have overseas parents - may select a different balance date.

Difficulty: Complex

Learning Objective: 2.2 understand the function of the balance sheet

Topic 2.2: The Balance Sheet

AACSB: Analytical Thinking

32) What will be the effect on the balance sheet if a firm buys a new processing plant through a new loan?

Answer: The Assets side will increase under Net property, plant, and equipment with the net effect of the new processing plant while the Liabilities side will correspondingly show the new debt that was incurred in paying for the plant.

Difficulty: Complex

Learning Objective: 2.2 understand the function of the balance sheet

Topic 2.2: The Balance Sheet

AACSB: Reflective Thinking Skills

Write 'True' if the statement is correct and 'False' if the statement is incorrect.

33) In general, a successful firm will have a market-to-book ratio that is substantially greater than 1.

Answer: True

Difficulty: Basic

Learning Objective: 2.3 Use the balance sheet to analyse a firm

Topic 2.3: Balance Sheet analysis

AACSB: Application of Knowledge



Choose the one alternative that best completes the statement or answers the question.

Use the table for the question(s) below.

Luther Corporation Consolidated Balance Sheet 30 June 2017 and 2018 (in \$ millions)

Assets	2018	2017	Liabilities and Shareholders' Equity	2018	2017
<i>Current Assets</i>			<i>Current Liabilities</i>		
Cash	63.6	58.5	Accounts payable	87.6	73.5
Accounts receivable	55.5	39.6	Notes payable/ short-term debt	10.5	9.6
Inventories	45.9	42.9	Current maturities of long-term debt	39.9	36.9
Other current assets	6.0	3.0	Other current liabilities	6.0	12.0
Total current assets	171.0	144.0	Total current liabilities	144.0	132.0
<i>Long-term Assets</i>			<i>Long-term Liabilities</i>		
Land	66.6	62.1	Long-term debt	239.7	168.9
Buildings	109.5	91.5	Capital lease obligations	---	---
Equipment	119.1	99.6	Total Debt	239.7	168.9
Less accumulated depreciation	(56.1)	(52.5)	Deferred taxes	22.8	22.2
Net property, plant, and equipment	239.1	200.7	Other long-term liabilities	---	---
Goodwill	60.0	--	Total long-term liabilities	262.5	191.1
Other long-term assets	63.0	42.0	Total liabilities	406.5	323.1
Total long-term assets	362.1	242.7	Shareholders' Equity	126.6	63.6
Total Assets	533.1	386.7	Total liabilities and Shareholders' Equity	533.1	386.7

34) Refer to the balance sheet above. If in 2017, Luther has 5.2 million shares outstanding and these shares are trading at \$16 per share, then Luther's market-to-book ratio would be closest to:

- A) 1.29
- B) 1.31
- C) 1.76
- D) 1.39

Answer: B

Difficulty: Moderate

Learning Objective: 2.3 Use the balance sheet to analyse a firm



Topic 2.3: Balance Sheet analysis
AACSB: Analytical Thinking

35) Refer to the balance sheet above. When using the book value of equity, the debt-equity ratio for Luther in 2017 is closest to:

- A) 3.98
- B) 3.43
- C) 3.21
- D) 3.39

Answer: D

Difficulty: Moderate

Learning Objective: 2.3 Use the balance sheet to analyse a firm

Topic 2.3: Balance Sheet analysis

AACSB: Analytical Thinking

36) Refer to the balance sheet above. If in 2017, Luther has 5.2 million shares outstanding and these shares are trading at \$16 per share, then using the market value of equity, the debt-equity ratio for Luther in 2017 is closest to:

- A) 2.71
- B) 2.61
- C) 2.59
- D) 2.55

Answer: C

Difficulty: Moderate

Learning Objective: 2.3 Use the balance sheet to analyse a firm

Topic 2.3: Balance Sheet analysis

AACSB: Analytical Thinking

37) Refer to the balance sheet above. If in 2018, Luther has 10.2 million shares outstanding and these shares are trading at \$16 per share, then what is Luther's enterprise value?

- A) \$353.1 million
- B) \$516.9 million
- C) -\$63.3 million
- D) \$389.7 million

Answer: D

Difficulty: Moderate

Learning Objective: 2.3 Use the balance sheet to analyse a firm

Topic 2.3: Balance Sheet analysis

AACSB: Analytical Thinking



38) Refer to the balance sheet above. Luther's current ratio for 2017 is closest to:

- A) 1.15
- B) 1.09
- C) 1.17
- D) 1.18

Answer: B

Difficulty: Moderate

Learning Objective: 2.3 Use the balance sheet to analyse a firm

Topic 2.3: Balance Sheet analysis

AACSB: Analytical Thinking

39) Refer to the balance sheet above. Luther's quick ratio for 2017 is closest to:

- A) 0.77
- B) 1.09
- C) 0.92
- D) 1.31

Answer: A

Difficulty: Moderate

Learning Objective: 2.3 Use the balance sheet to analyse a firm

Topic 2.3: Balance Sheet analysis

AACSB: Analytical Thinking

40) Refer to the balance sheet above. The change in Luther's quick ratio from 2017 to 2018 is closest to:

- A) an increase of 0.10
- B) an increase of 0.15
- C) a decrease of 0.15
- D) a decrease of 0.10

Answer: A

Difficulty: Complex

Learning Objective: 2.3 Use the balance sheet to analyse a firm

Topic 2.3: Balance Sheet analysis

AACSB: Analytical Thinking

Write your answer in the space provided or on a separate sheet of paper.

41) Refer to the balance sheet above. If on 30 June 2017 Luther has 8 million shares outstanding trading at \$15 per share, then what is Luther's market-to-book ratio?

Answer: market-to-book = market value of equity/book value of equity

market-to-book = 8 million $\times$ \$15/\$63.6 = 1.89

Difficulty: Moderate

Learning Objective: 2.3 Use the balance sheet to analyse a firm

Topic 2.3: Balance Sheet analysis

AACSB: Analytical Thinking

42) Refer to the balance sheet above. If on 30 June 2017, Luther has 8 million shares outstanding trading at \$15 per share, then what is Luther's enterprise value?

Answer: Enterprise value = Market value of equity + Debt - Cash

Market value of equity = 8 million $\times$ \$15 = \$120 million

Debt = Notes payable + Current maturities of long-term debt + Long-term debt

Debt = 9.6 + 36.9 + 168.9 = 215.4

Cash = 58.5

So, enterprise value = \$120 + 215.4 - 58.5 = \$276.90.

Difficulty: Moderate

Learning Objective: 2.3 Use the balance sheet to analyse a firm

Topic 2.3: Balance Sheet analysis

AACSB: Analytical Thinking

Choose the one alternative that best completes the statement or answers the question.

43) A public company has a book value of \$128 million. They have 20 million shares outstanding, with a market price of \$4 per share. Which of the following statements is true regarding this company?

A) Investors may consider this firm to be a growth company.

B) The value of the firm's assets is greater than their liquidation value.

C) The firm's market value is more than its book value.

D) Investors believe the company's assets are not likely to be profitable as its market value is worth less than its book value.

Answer: D

Difficulty: Basic

Learning Objective: 2.3 Use the balance sheet to analyse a firm

Topic 2.3: Balance Sheet analysis

AACSB: Analytical Thinking



44) GenCorp has a total debt of \$140 million and shareholders' equity of \$50 million. It also has 25 million shares outstanding, with a market price of \$3.50 per share. What is GenCorp's market debt-equity ratio?

- A) 1.60
- B) 0.63
- C) 1.02
- D) 0.36

Answer: A

Difficulty: Moderate

Learning Objective: 2.3 Use the balance sheet to analyse a firm

Topic 2.3: Balance Sheet analysis

AACSB: Analytical Thinking

45) A company has a share price of \$24.50 and \$118 million shares outstanding. Its market-to-book ratio is 4.2, its book debt-equity ratio is 3.2, and it has cash of \$800 million. How much would it cost to take over this business assuming you pay its enterprise value?

- A) \$4.2 billion
- B) \$1.5
- C) \$3.6 billion
- D) \$2.8 billion

Answer: A

Difficulty: Complex

Learning Objective: 2.3 Use the balance sheet to analyse a firm

Topic 2.3: Balance Sheet analysis

AACSB: Analytical Thinking

46) Convex Industries has inventories of \$150 million, current assets of \$1.05 billion, and current liabilities of \$400 million. What is its quick ratio?

- A) 2.25
- B) 2.12
- C) 0.44
- D) 0.38

Answer: A

Difficulty: Moderate

Learning Objective: 2.3 Use the balance sheet to analyse a firm

Topic 2.3: Balance Sheet analysis

AACSB: Analytical Thinking

47) Which ratio would you use to measure the financial health of a firm by assessing that firm's leverage?

- A) market debt-equity ratio
- B) current or quick ratio
- C) debt-equity or equity multiplier ratio
- D) market-to-book ratio



Answer: C

Difficulty: Basic

Learning Objective: 2.3 Use the balance sheet to analyse a firm

Topic 2.3: Balance Sheet analysis

AACSB: Application of Knowledge

48) Company A has current assets of \$42 billion and current liabilities of \$31 billion. Company B has current assets of \$2.7 billion and current liabilities of \$1.8 billion. Which of the following statements is correct, based on this information?

A) Company A has less leverage than Company B.

B) Company A has greater leverage than Company B.

C) Company A and Company B have roughly equivalent enterprise values.

D) Company A is less likely than Company B to have sufficient working capital to meet its short-term needs.

Answer: D

Difficulty: Complex

Learning Objective: 2.3 Use the balance sheet to analyse a firm

Topic 2.3: Balance Sheet analysis

AACSB: Analytical Thinking

Use the table for the question(s) below.

Balance Sheet

Assets	2017	2018	Liabilities	2017	2018
<u>Current Assets</u>			<u>Current Liabilities</u>		
Cash	50	46	Accounts payable	42	48
Accounts receivable	22	12	Notes payable/short-term debt	7	5
Inventories	17	38			
Total current assets	89	96	Total current liabilities	49	53
<u>Long-term Assets</u>			<u>Long-term Liabilities</u>		
Net property, plant and equipment	121	116	Long-term debt	128	136
Total long-term assets	121	116	Total long-term liabilities	128	136
			Total Liabilities	177	189
			Shareholders' Equity	33	23
Total Assets	210	212	Total Liabilities and Shareholders' Equity	210	212

49) If the above balance sheet is for a retail company, what indications about this company would best be drawn from the changes in the balance sheet between 2017 and 2018?

A) The company has reduced its debt.

B) The company has added a major new asset in terms of plant and equipment.



- C) The company is having difficulties selling its product.
- D) The company has experienced a significant rise in its market value.

Answer: C

Difficulty: Moderate

Learning Objective: 2.3 Use the balance sheet to analyse a firm

Topic 2.3: Balance Sheet analysis

AACSB: Analytical Thinking

50) If the above balance sheet is for a retail company, what indications about this company would best be drawn from the changes in shareholders' equity between 2017 and 2018?

- A) The company is very profitable because it is obviously collecting receivables faster.
- B) The company's net income in 2018 was negative.
- C) The company is selling its property, plant and equipment, which may result in a long-term deficiency in production capacity.
- D) No conclusions can be drawn regarding shareholders' equity without additional information.

Answer: B

Difficulty: Moderate

Learning Objective: 2.3 Use the balance sheet to analyse a firm

Topic 2.3: Balance Sheet analysis

AACSB: Analytical Thinking

51) If the above balance sheet is for a retail company, what indications about this company would best be drawn from the changes in quick ratio between 2017 and 2018?

- A) The company has reduced the risk that it will experience a cash shortfall in the near future.
- B) The risk that the company will experience a cash shortfall in the near future is unchanged.
- C) The company has increased the risk that it will experience a cash shortfall in the near future.
- D) The company has eliminated the risk that it will experience a cash shortfall in the near future.

Answer: C

Difficulty: Moderate

Learning Objective: 2.3 Use the balance sheet to analyse a firm

Topic 2.3: Balance Sheet analysis

AACSB: Analytical Thinking

52) If the above balance sheet is for a retail company, how has the company's leverage changed between 2017 and 2018?

- A) The company has experienced no significant change in its leverage.
- B) The company has experienced a significant increase in its leverage.
- C) The company has experienced a very significant decrease in its leverage.
- D) The company has experienced a significant decrease in its leverage.

Answer: B

Difficulty: Complex

Learning Objective: 2.3 Use the balance sheet to analyse a firm



Topic 2.3: Balance Sheet analysis
AACSB: Analytical Thinking

Write 'True' if the statement is correct and 'False' if the statement is incorrect.

53) The income statement reports the firm's revenues and expenses, and it computes the firm's bottom line of net income, or earnings.

Answer: True

Difficulty: Basic

Learning Objective: 2.4 Understand how the income statement is used

Topic: The income statement

AACSB: Application of Knowledge

Choose the one alternative that best completes the statement or answers the question.

54) What is a firm's 'net income'?

A) a measure of the firm's profitability over a given period

B) the difference between the sales and other income generated by the firm, and all costs, taxes, and expenses incurred by the firm in a given period

C) the last or 'bottom' line of the income statement

D) all of the above

Answer: D

Difficulty: Complex

Learning Objective: 2.4 Understand how the income statement is used

Topic 2.4: The Income Statement

AACSB: Application of Knowledge

55) A firm's gross profit is equal to the difference between sales revenues and the costs associated with those sales.

Answer: True

Difficulty: Complex

Learning Objective: 2.4 Understand how the income statement is used

Topic 2.4: The Income Statement

AACSB: Application of Knowledge

56) Corporate taxes are considered to be an operating expense on the income statement.

Answer: False

Difficulty: Moderate

Learning Objective: 2.4 Understand how the income statement is used

Topic 2.4: The Income Statement

AACSB: Application of Knowledge



Use the table for the question(s) below.

Income Statement for Xenon Manufacturing:

	2017	2018
Total sales	202	212
Cost of sales	-148	-172
Gross Profit	54	40
Selling, general, and administrative expenses	-22	-20
Research and development	-8	-7
Depreciation and amortisation	-4	-3
Other income	4	6
Earnings before interest and taxes (EBIT)	24	16
Interest income (expense)	-7	-4
Pre-tax income	14	12
Taxes	-4	-3
Net Income	10	9

57) Consider the above Income Statement for Xenon Manufacturing. All values are in millions of dollars. If Xenon Manufacturing has 25 million shares outstanding, what is its EPS in 2018?

- A) \$0.84
- B) \$0.40
- C) \$0.36
- D) \$0.63

Answer: C

Difficulty: Moderate

Learning Objective: 2.4 Understand how the income statement is used

Topic 2.4: The Income Statement

AACSB: Analytical Thinking



Use the table for the question(s) below.

Income Statement for CharmCorp:

	2017	2018
Total sales	600	540
Cost of sales	-532	-488
Gross Profit	68	52
Selling, general, and administrative expenses	-36	-21
Research and development	-4	-5
Depreciation and amortisation	-5	-5
Operating Income	23	21
Other income	1	5
Earnings before interest and taxes (EBIT)	24	26
Interest income (expense)	-7	-7
Pre-tax income	14	19
Taxes	-4	-5
Net Income	10	14

58) Consider the above Income Statement for CharmCorp. All values are in millions of dollars. If CharmCorp has 6 million shares outstanding, and its managers and employees have stock options for 1 million shares, what is its diluted EPS in 2018?

- A) \$2.33
- B) \$2.00
- C) \$1.67
- D) \$1.42

Answer: B

Difficulty: Complex

Learning Objective: 2.4 Understand how the income statement is used

Topic 2.4: The Income Statement

AACSB: Analytical Thinking

59) Which of the following statements regarding the income statement is INCORRECT?

- A) The last or 'bottom' line of the income statement shows the firm's net income.
- B) The income statement shows the flow of earnings and expenses generated by the firm between two dates.
- C) The first line of an income statement lists the revenues from the sales of products or services.
- D) The income statement shows the earnings and expenses at a given point in time.

Answer: D

Difficulty: Moderate



Learning Objective: 2.4 Understand how the income statement is used

Topic 2.4: The Income Statement

AACSB: Application of Knowledge

60) 'Gross profit' is calculated as

A) Total sales - Cost of sales.

B) Total sales - Cost of sales - Selling, general, and administrative expenses - Depreciation and amortisation.

C) Total sales - Cost of sales - Selling, general, and administrative expenses.

D) none of the above

Answer: A

Difficulty: Moderate

Learning Objective: 2.4 Understand how the income statement is used

Topic 2.4: The Income Statement

AACSB: Application of Knowledge

61) Which of the following is NOT an operating expense?

A) depreciation and amortisation

B) research and development

C) selling, general, and administrative expenses

D) interest expense

Answer: D

Difficulty: Moderate

Learning Objective: 2.4 Understand how the income statement is used

Topic 2.4: The Income Statement

AACSB: Application of Knowledge



Use the table for the question(s) below.

Luther Corporation Consolidated Income Statement Year ended 30 June (in \$ millions)

	2018	2017
Total sales	610.1	578.3
Cost of sales	(500.2)	(481.9)
Gross profit	109.9	96.4
Selling, general, and administrative expenses	(40.5)	(39.0)
Research and development	(24.6)	(22.8)
Depreciation and amortisation	(3.6)	(3.3)
Operating income	41.2	31.3
Other income	---	---
Earnings before interest and taxes (EBIT)	41.2	31.3
Interest income (expense)	(25.1)	(15.8)
Pre-tax income	16.1	15.5
Taxes	(5.5)	(5.3)
Net income	10.6	10.2
Price per share	\$16	\$15
Shares outstanding (millions)	10.2	8.0
Share options outstanding (millions)	0.3	0.2
Shareholders' Equity	126.6	63.6
Total Liabilities and Shareholders' Equity	533.1	386.7

62) Refer to the income statement above. For the year ending 30 June 2018, Luther's earnings per share are closest to:

- A) \$1.01
- B) \$1.04
- C) \$4.04
- D) \$1.58

Answer: B

Difficulty: Basic

Learning Objective: 2.4 Understand how the income statement is used

Topic 2.4: The Income Statement

AACSB: Analytical Thinking



63) Refer to the income statement above. Assuming that Luther has no convertible bonds outstanding, then for the year ending 30 June 2018, Luther's diluted earnings per share are closest to:

- A) \$1.04
- B) \$1.01
- C) \$1.53
- D) \$3.92

Answer: B

Difficulty: Moderate

Learning Objective: 2.4 Understand how the income statement is used

Topic 2.4: The Income Statement

AACSB: Analytical Thinking

Write the word or phrase that best completes each statement or answers the question.

64) How does a firm select the dates for preparation of its income statement?

Answer: The income statement is prepared on the fiscal closing date for the accounts of a firm that may or may not coincide with the fiscal year-end of 30 June. Typically, the income statement spans the flow between two adjacent balance sheets.

Difficulty: Moderate

Learning Objective: 2.4 Understand how the income statement is used

Topic 2.4: The Income Statement

AACSB: Analytical Thinking

65) What will be the effect on the income statement if a firm buys a new processing plant through a new loan?

Answer: The effect on the income statement will be in the form of a depreciation expense for the first year on the new processing plant.

Difficulty: Complex

Learning Objective: 2.4 Understand how the income statement is used

Topic 2.4: The Income Statement

AACSB: Application of Knowledge

Write 'True' if the statement is correct and 'False' if the statement is incorrect.

66) Price-earnings ratios tend to be high for fast-growing firms.

Answer: True

Difficulty: Basic

Learning Objective: 2.4 Understand how the income statement is used

Topic 2.4: The Income Statement

AACSB: Reflective Thinking Skills



Choose the one alternative that best completes the statement or answers the question.

Use the table for the question(s) below.

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Research and development	(24.6)	(22.8)
Depreciation and amortisation	(3.6)	(3.3)
Operating income	41.2	31.3
Other income	---	---
Earnings before interest and taxes (EBIT)	41.2	31.3
Interest income (expense)	(25.1)	(15.8)
Pre-tax income	16.1	15.5
Taxes	(5.5)	(5.3)
Net income	10.6	10.2
Price per share	\$16	\$15
Shares outstanding (millions)	10.2	8.0
Share options outstanding (millions)	0.3	0.2
Shareholders' Equity	126.6	63.6
Total Liabilities and Shareholders' Equity	533.1	386.7

67) Refer to the income statement above. Luther's operating margin for the year ending 30 June 2017 is closest to:

- A) 2.7%
- B) 16.7%
- C) 1.8%
- D) 5.4%

Answer: D

Difficulty: Basic

Learning Objective: 2.5 Analyse a firm through its income statement, including using the DuPont Identity

Topic 2.5: Income Statement analysis

AACSB: Analytical Thinking



68) Refer to the income statement above. Luther's net profit margin for the year ending 30 June 2017 is closest to:

- A) 16.7%
- B) 1.8%
- C) 5.4%
- D) 2.7%

Answer: B

Difficulty: Basic

Learning Objective: 2.5 Analyse a firm through its income statement, including using the DuPont Identity

Topic 2.5: Income Statement analysis

AACSB: Analytical Thinking

69) Refer to the income statement above. Luther's earnings before interest, taxes, depreciation, and amortisation (EBITDA) for the year ending 30 June 2018 is closest to:

- A) \$41.2 million
- B) \$37.6 million
- C) \$44.8 million
- D) \$19.7 million

Answer: C

Difficulty: Basic

Learning Objective: 2.5 Analyse a firm through its income statement, including using the DuPont Identity

Topic 2.5: Income Statement analysis

AACSB: Analytical Thinking

70) Refer to the income statement above. Luther's return on equity (ROE) for the year ending 30 June 2018 is closest to:

- A) 2.0%
- B) 12.7%
- C) 8.4%
- D) 6.5%

Answer: C

Difficulty: Moderate

Learning Objective: 2.5 Analyse a firm through its income statement, including using the DuPont Identity

Topic 2.5: Income Statement analysis

AACSB: Analytical Thinking

71) Refer to the income statement above. Luther's return on assets (ROA) for the year ending 30 June 2018 is closest to:



- A) 8.4%
- B) 12.7%
- C) 2.0%
- D) 6.5%

Answer: C

Difficulty: Complex

Learning Objective: 2.5 Analyse a firm through its income statement, including using the DuPont Identity

Topic 2.5: Income Statement analysis

AACSB: Analytical Thinking

Use the table for the question(s) below.

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Depreciation and amortisation	-4	-3
Other income	4	6
Earnings before interest and taxes (EBIT)	24	16
Interest income (expense)	-7	-4
Pre-tax income	14	12
Taxes	-4	-3
Net Income	10	9

72) Consider the above Income Statement for Xenon Manufacturing. All values are in millions of dollars. Calculate the operating margin for 2017 and 2018. What does the change in the operating margin between these two years imply about the company?

- A) The efficiency of Xenon Manufacturing has significantly fallen between 2017 and 2018.
- B) The ability of Xenon Manufacturing to sell its goods and services for more than the costs of producing them rose between 2017 and 2018.
- C) The efficiency of Xenon Manufacturing has significantly risen between 2017 and 2018.
- D) The leverage of Xenon Manufacturing fell slightly between 2017 and 2018.

Answer: A

Difficulty: Complex



Learning Objective: 2.5 Analyse a firm through its income statement, including using the DuPont Identity
Topic 2.5: Income Statement analysis
AACSB: Analytical Thinking

73) Consider the above Income Statement for Xenon Manufacturing. All values are in millions of dollars. Calculate the gross margin for 2017 and 2018. What does the change in the gross margin between these two years imply about the company?

- A) The leverage of Xenon Manufacturing fell slightly between 2017 and 2018.
- B) The ability of Xenon Manufacturing to sell its goods and services for more than the costs of producing them rose between 2017 and 2018.
- C) The ability of Xenon Manufacturing to sell its goods and services for more than the costs of producing them fell between 2017 and 2018.
- D) The efficiency of Xenon Manufacturing has significantly risen between 2017 and 2018.

Answer: C

Difficulty: Complex

Learning Objective: 2.5 Analyse a firm through its income statement, including using the DuPont Identity

Topic 2.5: Income Statement analysis

AACSB: Analytical Thinking

74) In 2009, an agricultural company introduced a new cropping process which reduced the cost of growing some of its crops. If sales in 2008 and 2009 were steady at \$25 million, but the gross margin increased from 2.3% to 3.4% between those years, by what amount was the cost of sales reduced?

- A) \$575 000
- B) \$325 000
- C) \$275 000
- D) \$425 000

Answer: C

Difficulty: Moderate

Learning Objective: 2.5 Analyse a firm through its income statement, including using the DuPont Identity

Topic 2.5: Income Statement analysis

AACSB: Analytical Thinking

75) Firm A:

Assets

Current assets	4
Fixed assets	10
Total assets	14

Firm B:

Assets

Current assets	7
Fixed assets	7
Total assets	14



Firm A:

Total sales	12
<u>Cost of sales</u>	<u>-5</u>
Gross Profit	7

Firm B:

Total sales	12
<u>Cost of sales</u>	<u>-7</u>
Gross Profit	5

Above are portions of the balance sheet and income statement for two companies in 2008. Based upon this information, which of the following statements is most likely to be true?

- A) Fixed asset turnover ratios indicate that firm A is generating more sales for the assets they employ than firm B.
- B) Asset turnover ratios indicate that firm A is generating greater revenue per dollar of assets than firm B.
- C) Fixed asset turnover ratios indicate that firm A is generating fewer sales for the assets they employ than firm B.
- D) Both asset turnover ratios and fixed asset turnover ratios indicate that firm A is generating greater revenue per dollar of assets than firm B.

Answer: C

Difficulty: Complex

Learning Objective: 2.5 Analyse a firm through its income statement, including using the DuPont Identity

Topic 2.5: Income Statement analysis

AACSB: Analytical Thinking

76) Balance Sheet

Assets

Current Assets

Cash	50
Accounts receivable	22
Inventories	17
Total current assets	89

Long-term Assets

Net property, plant, and equipment	121
Total long-term assets	121

Total Assets 210

Liabilities

Current Liabilities

Accounts payable	42
Notes payable/short-term debt	7
Total current liabilities	49

Long-term Liabilities

Long-term debt	128
Total long-term liabilities	128

Total Liabilities 177

Shareholders' Equity 33

Total Liabilities and Shareholders' Equity 210

Income Statement

Total sales 312



Operating Income	53
<u>Other income</u>	-
Earnings before interest and taxes (EBIT)	53

<u>Cost of sales</u>	-210
Gross Profit	102
Selling, general, and administrative expenses	-34
Research and development	-10
<u>Depreciation and amortisation</u>	-5

<u>Interest income (expense)</u>	-20
Pre-tax income	33
<u>Taxes</u>	-8
Net Income	25

The balance sheet and income statement of a particular firm are shown above. What does the account receivable days ratio tell you about this company?

- A) It takes on average about 6 weeks to collect payment from its customers.
- B) It takes on average about 7 weeks to collect payment from its customers.
- C) It takes on average about 11 weeks to collect payment from its customers.
- D) It takes on average about 4 weeks to collect payment from its customers.

Answer: D

Difficulty: Moderate

Learning Objective: 2.5 Analyse a firm through its income statement, including using the DuPont Identity

Topic 2.5: Income Statement analysis

AACSB: Analytical Thinking

77) Which of the following is the LEAST likely explanation for a firm's high ROE?

- A) The firm has very efficient use of its assets.
- B) The firm is growing.
- C) The firm is able to find investment opportunities that are very profitable.
- D) The firm enjoys high sales margins.

Answer: B

Difficulty: Moderate

Learning Objective: 2.5 Analyse a firm through its income statement, including using the DuPont Identity

Topic 2.5: Income Statement analysis

AACSB: Analytical Thinking

78) Which of the following firms would be expected to have a high ROE based on that firm's high operating efficiency?



- A) a high-end fashion retailer that has a very high mark-up on all items it sells
- B) a grocery store chain that has very high turnover, selling many multiples of their assets per year
- C) a medical supply company that provides very precise instruments at a high price to large medical establishments

such as hospitals

D) a brokerage firm that has high levels of leverage

Answer: B

Difficulty: Basic

Learning Objective: 2.5 Analyse a firm through its income statement, including using the DuPont Identity

Topic 2.5: Income Statement analysis

AACSB: Reflective Thinking Skills

79) Which of the following firms would be expected to have a high ROE based on that firm's high profitability?

A) a grocery store chain that has very high turnover, selling many multiples of their assets per year

B) a brokerage firm that has high levels of leverage

C) a low-end retailer that has a low mark-up on all items it sells

D) a medical supply company that provides very precise instruments at a high price to large medical establishments such as hospitals

Answer: D

Difficulty: Basic

Learning Objective: 2.5 Analyse a firm through its income statement, including using the DuPont Identity

Topic 2.5: Income Statement analysis

AACSB: Reflective Thinking Skills

80) Manufacturer A has a profit margin of 2.0%, an asset turnover of 1.7 and an equity multiplier of 4.9. Manufacturer B has a profit margin of 2.3%, an asset turnover of 1.1 and an equity multiplier of 4.7. How much asset turnover should manufacturer B have to match manufacturer A's ROE?

A) 3.09%

B) 4.77%

C) 1.54%

D) 3.00%

Answer: C

Difficulty: Complex

Learning Objective: 2.5 Analyse a firm through its income statement, including using the DuPont Identity

Topic 2.5: Income Statement analysis



AACSB: Analytical Thinking

81)		Firm A	Firm B	Firm C	Firm D
Net Income		\$34.1 million	\$5.7 million	\$31.1 million	
		\$13.2 million			
Market Capitalisation			\$310 million	\$53 million	
		\$112 million			
Earnings per share	\$280 million	\$4.10	\$4.05	\$6.75	\$12.70

The above data is for four regional trucking firms. Based on price-earnings ratios, which firm's stock is the best value?

- A) Firm A
- B) Firm B
- C) Firm C
- D) Firm D

Answer: B

Difficulty: Moderate

Learning Objective: 2.5 Analyse a firm through its income statement, including using the DuPont Identity

Topic 2.5: Income Statement analysis

AACSB: Analytical Thinking

82) Why must care be taken when comparing a firm's share price to its operating income?

- A) Share price is a quantity related to the entire firm, while operating income is an amount that is related solely to equity holders.
- B) Both share price and operating income are related solely to equity holders.
- C) Share price is a quantity related to equity holders, while operating income is an amount that is related to the whole firm.
- D) Both share price and operating income are related to the whole firm.

Answer: C

Difficulty: Basic

Learning Objective: 2.5 Analyse a firm through its income statement, including using the DuPont Identity

Topic 2.5: Income Statement analysis

AACSB: Analytical Thinking

Write 'True' if the statement is correct and 'False' if the statement is incorrect.

83) The firm's statement of cash flows only uses the balance sheet and net income to determine the amount of cash a firm has generated and how it has used that cash during a given period.

Answer: False

Difficulty: Basic

Learning Objective: 2.6 Interpret a statement of cash flows

Topic 2.6: The Statement of Cash Flows



AACSB: Application of Knowledge

Choose the one alternative that best completes the statement or answers the question.

84) Which of the following is NOT a reason that the income statement does not accurately indicate how much cash a firm

has earned?

- A) It includes cash inflows from services rendered.
- B) It does not include entries for expenditures on inventory.
- C) It does not include entries for collection of money from account receivables.
- D) It includes entries for the depreciation of assets.

Answer: A

Difficulty: Basic

Learning Objective: 2.6 Interpret a statement of cash flows

Topic 2.6: The Statement of Cash Flows

AACSB: Application of Knowledge

85) Which of the following is a way that the Operating Activity section of the statement of cash flows adjusts Net Income from the balance sheet?

- A) It adds the cash that flows from investors to the firm.
- B) It adds all non-cash entries related to the firm's operating activities.
- C) It removes the cash used for investment purposes.
- D) It subtracts all expenses and costs related to the firm's operating activities.

Answer: B

Difficulty: Basic

Learning Objective: 2.6 Interpret a statement of cash flows

Topic 2.6: The Statement of Cash Flows

AACSB: Reflective Thinking Skills

86) Allen Company bought a new copy machine to be depreciated straight line for three years. Where would this purchase be reflected on the Statement of Cash Flows?

- A) It would be an addition to property, plant and equipment, so it would be an investing activity.
- B) It would be an addition to cash, so would be reflected in the change in cash.
- C) It would be an expense on the income statement, so it would be reflected in operating cash flows.
- D) None of the above options is correct.

Answer: A

Difficulty: Basic

Learning Objective: 2.6 Interpret a statement of cash flows

Topic 2.6: The Statement of Cash Flows

AACSB: Reflective Thinking Skills

87) A printing company prints a brochure for a client, and then bills them for this service. At the time the



printing company's financial disclosure statements are prepared, the client has not yet paid the bill for this service.

How will this transaction be recorded?

A) The sale will be added to Net Income on the income statement and retained in Net Income on the statement of cash flows.

B) The sale will be added to Net Income on the income statement but deducted from Net Income on the statement of cash flows.

C) The sale will neither be added to Net Income on the income statement nor used to adjust Net Income on the statement of cash flows.

D) The sale will not be added to Net Income on the income statement but added to Net Income on the statement of cash flows.

Answer: B

Difficulty: Basic

Learning Objective: 2.6 Interpret a statement of cash flows

Topic 2.6: The Statement of Cash Flows

AACSB: Reflective Thinking Skills

88) A manufacturer of plastic bottles for the medical trade purchases a new compression blow moulder for its bottle production plant. How will the cost to the company of this piece of equipment be recorded?

A) It will be depreciated over time on the income statement and subtracted as a capital expenditure on the statement of cash flows.

B) It will be depreciated over time on the income statement and therefore not be recorded separately on the statement of cash flows.

C) It will be depreciated over time on the income statement and subtracted as Inventory on the statement of cash flows.

D) It will be subtracted from Gross Profit on the income statement and therefore not be recorded separately on the statement of cash flows.

Answer: A

Difficulty: Basic

Learning Objective: 2.6 Interpret a statement of cash flows

Topic 2.6: The Statement of Cash Flows

AACSB: Reflective Thinking Skills

89) A software company acquires a smaller company in order to acquire the patents that it holds. The cost of this acquisition will be recorded on the statement of cash flows as an outflow under Investment Activities.

Answer: True

Difficulty: Basic

Learning Objective: 2.6 Interpret a statement of cash flows

Topic 2.6: The Statement of Cash Flows

AACSB: Reflective Thinking Skills



Use the table for the question(s) below.

AOS Industries Statement of Cash Flows for 2018

Operating activities	
Net Income	3.2
Depreciation and amortisation	1.4
Cash effect of changes in	
Accounts receivable	2.1
Accounts payable	1.1
Inventory	0.8
Cash from operating activities	2.8
Investment activities	
Capital expenditures	2.2
Acquisitions and other investing activity	-0.4
Cash from investing activities	2.6
Financing activities	
Dividends paid	-1.5
Sale or purchase of stock	2.1
Increase in short-term borrowing	1.4
Increase in long-term borrowing	3.2
Cash from financing activities	5.2
Change in Cash and Cash Equivalents	5.4

90) Consider the above statement of cash flows. If all amounts shown above are in millions of dollars, what was AOS Industries' retained earnings figure for 2018?

- A) \$2.1 million
- B) \$1.7 million
- C) \$1.3 million
- D) \$5.4 million

Answer: B

Difficulty: Moderate

Learning Objective: 2.6 Interpret a statement of cash flows

Topic 2.6: The Statement of Cash Flows

AACSB: Analytical Thinking

91) Consider the above statement of cash flows. If all amounts shown above are in millions of dollars, how much money did AOS Industries raise by issuing debt in 2018?

- A) \$4.6 million
- B) \$1.4 million



C) \$3.2 million

D) \$5.2 million

Answer: A

Difficulty: Basic

Learning Objective: 2.6 Interpret a statement of cash flows

Topic 2.6: The Statement of Cash Flows

AACSB: Analytical Thinking

92) Consider the above statement of cash flows. Which of the following is true of AOS Industries' operating cash flows?

A) It charged more on its accounts payable than it paid back.

B) It sold more inventory than it bought.

C) It collected more cash from its customers than they charged.

D) All of the above are true.

Answer: D

Difficulty: Basic

Learning Objective: 2.6 Interpret a statement of cash flows

Topic 2.6: The Statement of Cash Flows

AACSB: Analytical Thinking

93) Consider the above statement of cash flows. In 2018, AOS Industries had contemplated buying a new warehouse for \$2 million, the cost of which would be depreciated over 10 years. If AOS Industries has a tax rate of 25%, what would be the impact for the amount of cash held by AOS at the end of 2018?

A) It would have \$150 000 less cash at the end of 2018.

B) It would have \$2 000 000 less cash at the end of 2018.

C) It would have \$1 950 000 less cash at the end of 2018.

D) It would have an additional \$50 000 in cash at the end of 2018.

Answer: C

Difficulty: Complex

Learning Objective: 2.6 Interpret a statement of cash flows

Topic 2.6: The Statement of Cash Flows

AACSB: Analytical Thinking

Write the word or phrase that best completes each statement or answers the question.

94) How can we cross-check the statement of cash flows?

Answer: The last item in the statement of cash flows should equal the difference in cash balances between two adjacent balance sheets.

Difficulty: Complex

Learning Objective: 2.6 Interpret a statement of cash flows

Topic 2.6: The Statement of Cash Flows

AACSB: Application of Knowledge



95) What will be the effect on the statement of cash flows if a firm buys a new processing plant through a new loan?

Answer: The new loan entry should show as a cash inflow for the firm, while the payment for the new processing plant will be entered as a cash outflow.

Difficulty: Complex

Learning Objective: 2.6 Interpret a statement of cash flows

Topic 2.6: The Statement of Cash Flows

AACSB: Reflective Thinking Skills

Write 'True' if the statement is correct and 'False' if the statement is incorrect.

96) The managements of public companies are not legally required to disclose any off-balance sheet transactions.

Answer: False

Difficulty: Basic

Learning Objective: 2.7 Identify management discussion and analysis and the statement of changes in equity

Topic 2.7: Other financial statement information

AACSB: Application of Knowledge

Choose the one alternative that best completes the statement or answers the question.

97) A firm whose primary business is in a line of regional grocery stores would be most likely to have to include which of the following facts, if true, in the firm's management discussion and analysis (MD&A)?

A) that a large number of funds were allocated to advertising to increase awareness of the firm's brand in new areas it had expanded into this year

B) that some senior members of the management team have retired in this financial year

C) that the firm has plans to expand into the organic food business in the next financial year by purchasing

several small organic food retailers

D) that the company has lost a class action suit brought against the firm by its employees and is expected to have to pay a large amount of damages

Answer: D

Difficulty: Moderate

Learning Objective: 2.7 Identify management discussion and analysis and the statement of changes in equity

Topic 2.7: Other financial statement information

AACSB: Ethical Understanding and Reasoning Abilities

98) The notes to the financial statements would be LEAST likely to be used for which of the following purposes?

A) to show how the value of assets listed in the financial statements were arrived at

B) to provide information regarding the context in which these financial numbers were generated



C) to disclose the financial implications of any off-balance sheet transactions

D) to explain the method of accounting that was used in the preparation of the financial statements

Answer: C

Difficulty: Basic

Learning Objective: 2.7 identify management discussion and analysis and the statement of changes in equity

Topic 2.7: Other financial statement information

AACSB: Analytical Thinking

Write the word or phrase that best completes each statement or answers the question.

99) What is the need for the notes to the financial statements when the firm's operations are already documented in the financial statements?

Answer: Not all actions of the firm can be directly converted to an entry on the financial statements. For example, the firm may be involved in off-balance sheet transactions, which have to be reported through notes to the financial statements.

Difficulty: Basic

Learning Objective: 2.7 Identify management discussion and analysis and the statement of changes in equity

Topic 2.7: Other financial statement information

AACSB: Application of Knowledge

Write 'True' if the statement is correct and 'False' if the statement is incorrect.

100) Use of the A-IFRS and auditors has not eliminated the danger of inadvertent or deliberate fraud in financial statements.

Answer: True

Difficulty: Basic

Learning Objective: 2.8 Analyse the role of accounting manipulation in corporate failures, such as the Enron and HIH Insurance bankruptcies

Topic 2.8: Financial Reporting in practice

AACSB: Ethical Understanding and Reasoning Abilities

Choose the one alternative that best completes the statement or answers the question.

101) One way Enron manipulated its financial statements was to sell assets at inflated prices to other firms, while promising to buy back those assets at a later date. The incoming cash was recorded as revenue, but the promise to buy back the assets was not disclosed. Which of the following is one of the ways that such a transaction is deceptive?

A) The cash raised should have been recorded as short-term loans.

B) The assets should have been listed on the balance sheet as long-term assets.

C) Cash raised by selling assets should not be recorded as revenue.



D) The off-balance sheet promises to repurchase assets should have been disclosed in management discussion and analysis (MD&A) or notes to the financial statement.

Answer: D

Difficulty: Moderate

Learning Objective: 2.8 Analyse the role of accounting

manipulation in corporate failures, such as the Enron and HIH Insurance bankruptcies

Topic 2.8: Financial Reporting in practice

AACSB: Ethical Understanding and Reasoning Abilities

102) Which of the following is likely to have contributed to the failure of HIH Insurance?

A) unsupervised delegated authority

B) rapid expansion

C) fraudulent reporting

D) All of the above contributed to the failure of HIH.

Answer: D

Difficulty: Basic

Learning Objective: 2.8 Analyse the role of accounting manipulation in corporate failures, such as the Enron and HIH Insurance bankruptcies

Topic 2.8: Financial Reporting in practice

AACSB: Ethical Understanding and Reasoning Abilities

103) Together, CLERP 9 and the ASX Good Governance Principles have clarified

A) board composition, director remuneration, and auditor remuneration.

B) the role of auditor, auditor rotation, and auditor remuneration.

C) risk disclosure, insider trading, and board composition.

D) directors' share trading, auditor rotation, and board composition.

Answer: D

Difficulty: Basic

Learning Objective: 2.8 Analyse the role of accounting manipulation in corporate failures, such as the Enron and HIH Insurance bankruptcies

Topic 2.8: Financial Reporting in practice

AACSB: Application of Knowledge

104) Which of the following is the main lesson that analysts and investors should take from the cases of Enron and HIH?

A) The usefulness of financial statements to investors is entirely dependent on the ethics of those constructing them.

B) The information in financial statements should be viewed extremely critically.

C) It is not possible to effectively evaluate a company unless all the financial statements are fully and correctly prepared.

D) Readers of even fraudulent financial statements can spot signs of a firm's financial health if those



statements are read fully and with care.

Answer: D

Difficulty: Basic

Learning Objective: 2.8 Analyse the role of accounting manipulation in corporate failures, such as the Enron and HIH Insurance bankruptcies

Topic 2.8: Financial Reporting in practice

AACSB: Ethical Understanding and Reasoning Abilities

Write the word or phrase that best completes each statement or answers the question.

105) What role do external auditors play in the firm's financial reporting process?

Answer: As the name implies, external auditors act as third party monitors to the firms' financial reporting process.

Difficulty: Basic

Learning Objective: 2.8 Analyse the role of accounting manipulation in corporate failures, such as the Enron and HIH Insurance bankruptcies

Topic 2.8: Financial Reporting in practice

AACSB: Ethical Understanding and Reasoning Abilities

106) Discuss the intention of the ASX Principles of Good Corporate Governance.

Answer: The Corporate Governance Principles and Recommendations articulate the core principles underlying effective corporate governance that should be adopted by all listed firms. They were developed with the intention of promoting investor confidence.

Difficulty: Basic

Learning Objective: 2.8 Analyse the role of accounting manipulation in corporate failures, such as the Enron and HIH Insurance bankruptcies

Topic 2.8: Financial Reporting in practice

AACSB: Ethical Understanding and Reasoning Abilities

107) State the names of some of the firms discussed in the chapter that had inaccurate reporting in their financial statements.

Answer: Examples of some firms that had practiced inaccurate reporting are Enron and HIH.

Difficulty: Basic

Learning Objective: 2.8 Analyse the role of accounting manipulation in corporate failures, such as the Enron and HIH Insurance bankruptcies

Topic 2.8: Financial Reporting in practice

AACSB: Ethical Understanding and Reasoning Abilities

108) Is it possible to learn the true financial health of a corporation like HIH where the financial



statements are deceptive?

Answer: Generally speaking, if an informed reader makes a detailed study of the entire contents of a financial statement, it is possible to identify warning signs that the health of the business may not be good.

Difficulty: Basic

Learning Objective: 2.8 Analyse the role of accounting manipulation in corporate failures, such as the Enron and HIH Insurance bankruptcies

Topic 2.8: Financial Reporting in practice

AACSB: Reflective Thinking Skills