

Module 1

Framework for Analysis and Valuation

Learning Objectives – Coverage by question		
	True/False	Multiple Choice
LO1 – Explain and assess the four main business activities.		
LO2 – Identify and discuss the users and suppliers of financial statement information.	1-4	1, 2
LO3 – Review the four financial statements.	5-10	3-19
LO4 – Assess business operations within the context of a competitive environment.	11-13	20-25
LO5 –Apply basic profitability analysis.	14	26, 27
LO6 – Describe the financial statement forecasting process.		
LO7 – Explain the role of financial information in business valuation.	15	28-30
LO8 – Access and analyze financial datasets.		

These questions are available to assign in *myBusinessCourse*.

Module 1: Framework for Analysis and Valuation

True/False

Topic: Users of Financial Statement Information

LO: 2

1. Shareholders demand financial information primarily to assess profitability and risk whereas bankers demand information primarily to assess cash flows to repay loan interest and principal.

Answer: True

Rationale: While both shareholders and bankers are interested in all the information companies provide, shareholders care about more about a company's profitability and bankers care more about solvency and creditworthiness.

Topic: Publicly Available Financial Reports

LO: 2

2. Publicly traded companies are required to provide quarterly financial reports directly to the public.

Answer: False

Rationale: Companies provide electronic versions of quarterly financial statements to the SEC, which posts them to the Internet for the public to access them.

Topic: Users of Financial Statement Information

LO: 2

3. Publicly traded companies provide financial information primarily to satisfy the SEC and the tax authorities (that is, the Internal Revenue Service).

Answer: False

Rationale: Demand for information extends to many users; the regulators such as the SEC and the IRS are only one class of users.

Topic: SEC Filings

LO: 2

4. Publicly traded companies must provide to the Securities Exchange Commission annual audited financial statements (10-K reports) and quarterly audited financial statements (10-Q reports).

Answer: False

Rationale: Quarterly reports do not need to be audited.

Topic: Balance Sheet

LO: 3

5. If a company reports retained earnings of \$175.3 million on its balance sheet, it must also report \$175.3 million in cash.

Answer: False

Rationale: The accounting equation requires total assets to equal total liabilities plus stockholders' equity. That does not imply, however, that liability and equity accounts relate directly to specific assets.

Topic: Balance Sheet

LO: 3

6. A balance sheet shows a company's position over a period of time, whereas an income statement, statement of stockholders' equity, and statement of cash flows show its position at a point in time.

Answer: False

Rationale: The statement is reversed: A balance sheet shows a company's position at a point in time, whereas an income statement, statement of equity, and statement of cash flows show its position over a period of time.

Topic: Accounting Equation

LO: 3

7. Assets must always equal liabilities plus equity.

Answer: True

Rationale: The accounting equation is $\text{Assets} = \text{Liabilities} + \text{Equity}$. This relation must always hold.

Topic: Income Statement

LO: 3

8. The income statement reports net income which is defined as the company's profit after all expenses and dividends have been paid.

Answer: False

Rationale: The statement contains two errors. First, net income does not include any dividends during the period; these are a distribution of profits and not part of its calculation. Second, the income statement is prepared on an accrual basis and thus includes expenses incurred (as opposed to paid).

Topic: Statement of Cash Flows

LO: 3

9. A statement of cash flows reports on cash flows for operating, investing and financing activities at a point in time.

Answer: False

Rationale: A statement of cash flows reports on cash flows for operating, investing, and financing activities over a period of time.

Topic: Statement of Stockholders' Equity

LO: 3

10. An increase in common stock would be reflected in the statement of stockholders' equity.

Answer: True

Rationale: The statement of stockholders' equity reports on changes in the accounts that make up stockholders' equity. This includes contributed capital, retained earnings, and other equity.

Topic: Return on Assets

LO: 4

11. Return on Assets (ROA) measures the profit the company makes on each dollar of total assets it uses.

Answer: True

Rationale: Return on Assets is a profitability metric that measures how much profit the company made for each dollar of assets the company holds on average during the year.

Topic: Return on Assets

LO: 4

12. Return on Assets (ROA) = (Net Income / Sales) × Asset Turnover

Answer: True

Rationale: Return on Assets = Net Income / Average Assets. This is the disaggregation of the ROA into its components

Topic: Asset Turnover

LO: 4

13. Consider two companies (A and B) with equal profit margins of 18%. Company A has an asset turnover of 1.2 and Company B has an asset turnover of 1.5. If all else is equal, Company B with its' higher asset turnover, is less profitable because it requires more revenue to turn its assets over.

Answer: False

Rationale: Asset turnover is an efficiency metric. The higher the turnover, the more efficient the company is with its assets and thus, the more profitable. Algebraically, $ROA = PM \times AT$. Company A above is less profitable: $18\% \times 1.2 = 21.6\%$ whereas Company B's ROA is $18\% \times 1.5 = 27.0\%$.

Topic: Financial Accounting and Business Analysis

LO: 5

14. Financial statements are influenced by five important forces that determine a company's competitive intensity: (A) industry competition, (B) buyer power, (C) supplier power, (D) product substitutes, and (E) threat of entry.

Answer: True

Rationale: By systematically considering these five business forces, we can gain better insights from financial statements.

Topic: Audit Report

LO: 7

15. A "clean" audit report asserts—among other things—that (a) the auditor has prepared all necessary financial statements and (b) management has expressed its opinion that they are prepared in conformity with GAAP.

Answer: False

Rationale: The statement is reversed: A "clean" audit report asserts—among other things—that (a) management has prepared all necessary financial statements and (b) the auditor has expressed its opinion that they are prepared in conformity with GAAP.

Multiple Choice

Topic: Users of Financial Statement Information

LO: 2

1. Which of the following groups would likely *not* be interested in the financial statements of a large public company such as Procter & Gamble?
 - A) Shareholders
 - B) Employees
 - C) Competitors
 - D) Taxing agencies
 - E) None of these are correct

Answer: E

Rationale: All of these parties would use the financial statements, albeit in different ways and for different purposes.

Topic: Users of Financial Statement Information

LO: 2

2. The SEC adopted Regulation FD, to curb public companies' practice of:
 - A) Routinely filing extensions for annual reports (Form 10-K)
 - B) Selectively disclosing information
 - C) Reporting pro forma (non-GAAP) numbers
 - D) Hiring auditors for non-audit services such as consulting engagements
 - E) None of these are correct

Answer: B

Rationale: Reg FD reads as follows: "Whenever an issuer discloses any material nonpublic information regarding that issuer, the issuer shall make public disclosure of that information . . . simultaneously, in the case of an intentional disclosure; and . . . promptly, in the case of a non-intentional disclosure."

Topic: Components of the Balance Sheet

LO: 3

3. A list of assets, liabilities and equity can be found on which of the following?
 - A) Balance Sheet
 - B) Income Statement
 - C) Statement of Assets and Liabilities
 - D) Statement of Cash Flows
 - E) Statement of Stockholders' Equity

Answer: A

Rationale: A balance sheet lists amounts for assets, liabilities and equity at a point in time.

Topic: Balance Sheet

LO: 3

4. Which of the following items would *not* be found on a balance sheet? (Select all that apply)
- A) Stockholders' Equity
 - B) Property, plant and equipment
 - C) Nonowner financing
 - D) Cash
 - E) Dividends

Answer: E

Rationale: The balance sheet reports assets (including cash and property, plant and equipment), liabilities (including nonowner financing) and equity. Dividends are reported on statement of stockholders' equity.

Topic: Profit and Cash Flow

LO: 3

5. A company's net cash flow will equal its net income ...
- A) Almost always
 - B) Rarely
 - C) Occasionally
 - D) Only when the company has no investing cash flow for the period
 - E) Only when the company has no investing or financing cash flow for the period

Answer: B

Rationale: Net income reflects the company's revenue minus expenses for the given period. Net cash flow represents the amount of money received (spent) on operating, investing and financing activities for the given period. These values are rarely the same.

Topic: Financial Statement Information

LO: 3

6. Which of the following statements are correct (*select all that apply*)?
- A) A balance sheet reports on investing and financing activities.
 - B) An income statement reports on financing activities.
 - C) The statement of equity reports on changes in the accounts that make up equity.
 - D) The statement of cash flows reports on cash flows from operating, investing, and financing activities over a period of time.
 - E) A balance sheet reports on a company's assets and liabilities over a period of time.

Answer: A, C, and D

Rationale: Statement (B) is incorrect—the statement of cash flows reports on financing activities that are reflected on the balance sheet. Statement (E) is incorrect—the balance sheet reports on a company's assets and liabilities at a point in time.

Topic: Balance Sheet—Numerical calculations required

LO: 3

7. Kelty Company's year-end financial statements reported the following (in millions):

Total assets	\$41,278
Total liabilities	29,465
Total shareholders' equity	11,813
Dividends	205
Net income (loss)	3,160
Retained earnings, Jan. 1	11,425

What did Kelty Company report for retained earnings at December 31?

- A) \$14,380 million
- B) \$14,768 million
- C) \$14,790million
- D) \$14,585 million
- E) There is not enough information to determine the answer.

Answer: A

Rationale:

(in millions)

Retained earnings, Jan. 1	\$11,425
Net income	3,160
Dividends	<u>(205)</u>
Retained earnings, Dec. 31	\$14,380

Topic: Balance Sheet—Numerical calculations required

LO: 3

8. United Company's year-end balance sheet reported the following (in millions)

Total Assets	\$100,228
Total Liabilities	78,713
Contributed Capital	8,933

What was United Company's total liabilities and stockholders' equity at December 31?

- A) \$ 87,646 million
- B) \$ 91,295 million
- C) \$100,228 million
- D) \$ 21,515 million

Answer: C

Rationale: Assets = Liabilities + Stockholders Equity.

Assets = \$100,228 so this is the total of liabilities and equity combined.