Session 4

Financial Statement Analysis

Test

1. Most financial balance sheets reflect the historical cost of assets, net of depreciation since they were acquired. Assuming that this is the case, for which of the following asset classes is the balance sheet value of an asset most likely to reflect its fair market value?
   a. Land
   b. Buildings and equipment
   c. Investments in other companies' equity
   d. Accounts receivable & Inventory
   e. Intangible assets
2. The shareholders' equity in a balance sheet reflects the accountants' estimate of the value of equity in a company. Which of the following statements about shareholders' equity is always true?
   a. The shareholders' equity cannot be less than zero
   b. The shareholders' equity cannot be less than the market value of equity
   c. The shareholders equity cannot be greater than the market value of equity
   d. The shareholders' equity measures what shareholders will get if the firm is liquidated today (and debt is paid off)
   e. All of the above
   f. None of the above
3. There are several measures of income on a company's income statement. Assuming that you want to measure how much equity investors in a company are generating as a return on their investment in the company, which of the following ratios would use?
   a. Operating income after taxes/ Shareholders' Equity
   b. Operating income after taxes/ (Shareholders Equity + Debt – Cash)
   c. Net Income/ Shareholders' equity
   d. Net Income/ (Shareholders Equity + Debt – Cash)
   e. Net Income/ Market value of equity
4. You are comparing margins across steel companies and have computed two margins: a pre-tax operating margin, obtained by dividing pre-tax operating income by revenues and a net margin, calculated as net income divided by sales. In which of the following companies would you see the biggest difference between the two margins?
   a. A company with a high effective tax rate and no debt
   b. A company with a low effective tax rate and no debt
   c. A company with a high effective tax rate and lots of debt
   d. A company with a low effective tax rate and lots of debt

5. In a statement of cash flows, you try to explain the change in a cash balance. Assume that your company saw a large decline in its cash balance last year. Which of the following is not an explanation for why this might have happened?
    a. The company reported a loss for the year
    b. The company loosened its policy on granting customer credit during the year, leading to a large increase in accounts receivable
    c. Inventory increased during the course of the year
    d. Suppliers also loosened credit policies, leading to an increase in accounts payable.
    e. The company made a large cash acquisition during the year
    f. The company bought back 10% of its outstanding shares

Solutions

1. Most financial balance sheets reflect the historical cost of assets, net of depreciation since they were acquired. Assuming that this is the case, for which of the following asset classes is the balance sheet value of an asset most likely to reflect its fair market value?
    a. Land
    b. Buildings and equipment
    c. Investments in other companies' equity
    d. Accounts receivable & Inventory
    e. Intangible assets

Explanation: The divergence between book value and market value will great greater for assets that have been on your books for a long time. Inventory and accounts receivable should be constantly replenished, making it unlikely that they have been around for more than a few weeks or months. They should therefore be close to fair value.

2. The shareholders' equity in a balance sheet reflects the accountants' estimate of the value of equity in a company. Which of the following statements about shareholders' equity is always true?
    a. The shareholders' equity cannot be less than zero
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    d. The shareholders' equity measures what shareholders will get if the firm is liquidated today (and debt is paid off)
    e. All of the above
    f. None of the above

Explanation: The book value of equity can be negative for companies that have had sustained losses over long periods. It can be greater or less than the market value and often is a poor measure of liquidation value.

3. There are several measures of income on a company's income statement. Assuming that you want to measure how much equity investors in a company are generating as a return on their investment in the company, which of the following ratios would use?
    a. Operating income after taxes/ Shareholders' Equity
    b. Operating income after taxes/ (Shareholders Equity + Debt – Cash)
    c. Net Income/ Shareholders' equity
    d. Net Income/ (Shareholders Equity + Debt – Cash)
    e. Net Income/ Market value of equity

Rationale: Since you are adopting the perspective of equity investors, you want to measure equity income (net income rather than operating income) and you should be computing an accounting return (hence the use of shareholders' equity). Using market

value of equity will yield a number but it is not clear what relationship that number will have to returns earned by the company or by stockholders. (You can compute a market return to equity investors by taking the change in price and dividends paid and dividing by the stock price)

4. You are comparing margins across steel companies and have computed two margins: a pre-tax operating margin, obtained by dividing pre-tax operating income by revenues and a net margin, calculated as net income divided by sales. In which of the following companies would you see the biggest difference between the two margins?
    a. A company with a high effective tax rate and no debt
    b. A company with a low effective tax rate and no debt
    c. A company with a high effective tax rate and lots of debt
    d. A company with a low effective tax rate and lots of debt

Rationale: To get from operating income to net income, you have to subtract out interest expenses and then taxes. For companies with a lot of debt and a high tax rate, these two items will be large, creating a larger divergence between operating and net income.

5. In a statement of cash flows, you try to explain the change in a cash balance. Assume that your company saw a large decline in its cash balance last year. Which of the following is not an explanation for why this might have happened?
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    e. The company made a large cash acquisition during the year
    f. The company bought back 10% of its outstanding shares

Explanation: An increase in accounts payable is the only item that increases cash flows. All of the other choices on this list would decrease cash flows (and the cash balance).