

## Chapter 02 Financial Statements & Cash Flow

### Multiple Choice Questions

1. The financial statement showing a firm's accounting value on a particular date is the:
  - A. shareholders' equity sheet.
  - B. tax reconciliation statement.
  - C. statement of cash flows.
  - D. balance sheet.
  - E. income statement.
  
2. A current asset is:
  - A. the market value of all items currently owned by the firm.
  - B. an item that the firm expects to own within the next year.
  - C. the amount of cash on hand the firm currently shows on its balance sheet.
  - D. cash or an item currently owned by the firm that will convert to cash within the next 12 months.
  - E. an item currently owned by the firm.
  
3. The long-term debts of a firm are liabilities:
  - A. owed to the firm's shareholders.
  - B. the firm expects to incur within the next 12 months.
  - C. owed to the firm's suppliers.
  - D. that come due within the next 12 months.
  - E. that do not come due for at least 12 months.
  
4. Net working capital is defined as:
  - A. total liabilities minus shareholders' equity.
  - B. current liabilities minus shareholders' equity.
  - C. fixed assets minus long-term liabilities.
  - D. total assets minus total liabilities.
  - E. current assets minus current liabilities.

5. A(n) \_\_\_\_\_ asset is one which can be quickly converted into cash without significant loss in value.

- A. current
- B. fixed
- C. intangible
- D. liquid
- E. long-term

6. The financial statement summarizing a firm's accounting performance over a period of time is the:

- A. income statement.
- B. balance sheet.
- C. statement of cash flows.
- D. tax reconciliation statement.
- E. shareholders' equity sheet.

7. Noncash items refer to:

- A. the credit sales of a firm.
- B. the accounts payable of a firm.
- C. all accounts on the balance sheet other than cash on hand.
- D. the costs incurred for the purchase of intangible fixed assets.
- E. expenses charged against revenues that do not directly affect cash flow.

8. Your \_\_\_\_\_ tax rate is the amount of tax payable on the next taxable dollar you earn.

- A. deductible
- B. residual
- C. total
- D. average
- E. marginal

9. Your \_\_\_\_\_ tax rate measures the total taxes you pay divided by your taxable income.

- A. average
- B. marginal
- C. total
- D. deductible
- E. residual

10. \_\_\_\_\_ refers to the cash flow that results from the firm's ongoing, normal business activities.

- A. Cash flow from assets
- B. Net working capital
- C. Capital spending
- D. Cash flow from operating activities
- E. Cash flow to creditors

11. \_\_\_\_\_ refers to the changes in net capital assets.

- A. Cash flow from assets
- B. Net working capital
- C. Cash flow from investing
- D. Operating cash flow
- E. Cash flow to creditors

12. \_\_\_\_\_ refers to the difference between a firm's current assets and its current liabilities.

- A. Operating cash flow
- B. Capital spending
- C. Net working capital
- D. Cash flow from assets
- E. Cash flow to creditors

13. \_\_\_\_\_ is calculated by adding back noncash expenses to net income and adjusting for changes in current assets and liabilities.

- A. Total cash flow
- B. Capital spending
- C. Net working capital
- D. Cash flow from operations
- E. Cash flow to creditors

14. \_\_\_\_\_ refers to the firm's interest payments less any net new borrowing.

- A. Operating cash flow
- B. Capital spending
- C. Net working capital
- D. Cash flow from shareholders
- E. Cash flow to creditors

15. \_\_\_\_\_ refers to the firm's dividend payments less any net new equity raised.

- A. Operating cash flow
- B. Capital spending
- C. Net working capital
- D. Cash flow from creditors
- E. Cash flow to stockholders

16. Earnings per share is equal to:

- A. net income divided by total shareholders' equity.
- B. net income divided by the par value of the common stock.
- C. gross income multiplied by the par value of the common stock.
- D. net income divided by the total number of shares outstanding.
- E. operating income divided by the par value of the common stock.

17. Dividends per share is equal to dividends paid:

- A. multiplied by the total number of shares outstanding.
- B. divided by total shareholders' equity.
- C. divided by the total number of shares outstanding.
- D. multiplied by the par value of the common stock.
- E. divided by the par value of common stock.

18. Which of the following are included in current assets?

- I. equipment
  - II. Inventory
  - III. accounts payable
  - IV. cash
- A. II and IV only
  - B. I and III only
  - C. I, II, and IV only
  - D. III and IV only
  - E. II, III, and IV only

19. Which of the following are included in current liabilities?

- I. note payable to a supplier in eighteen months
  - II. debt payable to a mortgage company in nine months
  - III. accounts payable to suppliers
  - IV. loan payable to the bank in fourteen months
- A. I and III only
  - B. II and III only
  - C. III and IV only
  - D. II, III, and IV only
  - E. I, II, and III only

20. An increase in total assets:

- A. means that net working capital is also increasing.
- B. requires an investment in fixed assets.
- C. means that shareholders' equity must also increase.
- D. must be offset by an equal increase in liabilities and shareholders' equity.
- E. can only occur when a firm has positive net income.

21. Which one of the following accounts is generally the most liquid?

- A. Patent
- B. Accounts receivable
- C. Building
- D. Equipment
- E. Inventory

22. Which one of the following statements concerning liquidity is correct?

- A. If you sold an asset today, it is a liquid asset.
- B. Balance sheet accounts are listed in order of decreasing liquidity.
- C. If you can sell an asset next year at a price equal to its actual value, the asset is highly liquid.
- D. The less liquidity a firm has, the lower the probability the firm will encounter financial difficulties.
- E. Trademarks and patents are highly liquid.

23. Liquidity is:

- A. a measure of the use of debt in a firm's capital structure.
- B. equal to current assets minus current liabilities.
- C. equal to the market value of a firm's total assets minus its current liabilities.
- D. valuable to a firm even though liquid assets tend to be less profitable to own.
- E. generally associated with intangible assets.

24. Which of the following accounts are included in shareholders' equity?

- I. retained earnings
  - II. interest paid
  - III. long-term debt
  - IV. capital surplus
- A. I and II only
  - B. II and IV only
  - C. I and IV only
  - D. II and III only
  - E. I and III only

25. Book value:

- A. is based on historical cost.
- B. is equivalent to market value for firms with fixed assets.
- C. is more of a financial than an accounting valuation.
- D. generally tends to exceed market value when fixed assets are included.
- E. is adjusted to market value whenever the market value exceeds the stated book value.

26. When making financial decisions related to assets, you should:

- A. always consider market values.
- B. place more emphasis on book values than on market values.
- C. rely primarily on the value of assets as shown on the balance sheet.
- D. place primary emphasis on historical costs.
- E. only consider market values if they are less than book values.

27. As seen on an income statement:

- A. interest is deducted from income and increases the total taxes incurred.
- B. the tax rate is applied to the earnings before interest and taxes when the firm has both depreciation and interest expenses.
- C. depreciation is shown as an expense but does not affect the taxes payable.
- D. depreciation reduces both the pretax income and the net income.
- E. interest expense is added to earnings before interest and taxes to get pretax income.

28. The earnings per share will:

- A. decrease as the total revenue of the firm increases.
- B. increase as the number of shares outstanding increase.
- C. increase as net income increases.
- D. decrease as the costs decrease.
- E. increase as the tax rate increases.

29. Dividends per share:

- A. increase as the net income increases as long as the number of shares outstanding remains constant.
- B. decrease as the number of shares outstanding decrease, all else constant.
- C. are inversely related to the earnings per share.
- D. are based upon the dividend requirements established by Generally Accepted Accounting Procedures.
- E. are equal to the amount of net income distributed to shareholders divided by the number of shares outstanding.

30. According to Generally Accepted Accounting Principles,

- A. income is recorded based on the matching principle.
- B. costs are recorded based on the liquidity principle.
- C. income is recorded based on the realization principle.
- D. depreciation is recorded as it affects the cash flows of a firm.
- E. net income is recorded based on the realization principle.

31. According to Generally Accepted Accounting Principles, costs are:

- A. recorded as incurred.
- B. recorded when paid.
- C. matched with revenues.
- D. matched with production levels.
- E. expensed as management desires.

32. Depreciation:

- A. reduces both the net fixed assets and the costs of a firm.
- B. is a non-cash expense that is recorded on the income statement.
- C. is a non-cash expense which decreases the net operating income.
- D. decreases net fixed assets, net income, and operating cash flows.
- E. increases the net fixed assets as shown on the balance sheet.

33. When you are making a financial decision, the most relevant tax rate is the \_\_\_\_\_ rate.

- A. average
- B. fixed
- C. marginal
- D. total
- E. variable

34. An increase in which one of the following will cause the operating cash flow to increase?

- A. Change in net working capital
- B. Taxes
- C. Net working capital
- D. Costs
- E. Depreciation

35. A firm starts its year with a positive net working capital. During the year, the firm acquires more short-term debt than it does short-term assets. This means that:

- A. the ending net working capital will be negative.
- B. both accounts receivable and inventory decreased during the year.
- C. the beginning current assets were less than the beginning current liabilities.
- D. accounts payable increased and inventory decreased during the year.
- E. the ending net working capital can be positive, negative, or equal to zero.

36. The cash flow to creditors includes the cash:

- A. received by the firm when payments are paid to suppliers.
- B. outflow of the firm when new debt is acquired.
- C. outflow when interest is paid on outstanding debt.
- D. inflow when accounts payable decreases.
- E. received when long-term debt is paid off.

37. Cash flow to stockholders must be positive when:
- A. the net sale of common stock exceeds the amount of dividends paid.
  - B. no income is distributed but new shares of stock are sold.
  - C. both the cash flow to assets and the cash flow to creditors are negative.
  - D. the dividends paid exceed the net new equity raised.
  - E. both the cash flow to assets and the cash flow to creditors are positive.
38. Which equality is the basis for the balance sheet?
- A.  $\text{Fixed Assets} = \text{Stockholder's Equity} + \text{Current Assets}$
  - B.  $\text{Assets} = \text{Liabilities} + \text{Stockholder's Equity}$
  - C.  $\text{Assets} = \text{Current Long-Term Debt} + \text{Retained Earnings}$
  - D.  $\text{Fixed Assets} = \text{Liabilities} + \text{Stockholder's Equity}$
  - E. None of the above.
39. Assets are listed on the balance sheet in order of:
- A. decreasing size.
  - B. decreasing liquidity.
  - C. relative life.
  - D. increasing size.
  - E. None of the above.
40. Debt is a contractual obligation that:
- A. requires the payout of residual flows to the holders of these instruments.
  - B. requires a repayment of a stated amount and interest over the period.
  - C. allows the bondholders to sue the firm if it defaults.
  - D. Both A and B.
  - E. Both B and C.

41. The carrying value or book value of assets:
- A. is always the best measure of the company's value to an investor.
  - B. represents the true market value according to GAAP.
  - C. is always higher than the replacement cost of the assets.
  - D. is determined under GAAP and is based on the cost of the asset.
  - E. None of the above.
42. Under GAAP, a firm's assets are reported at:
- A. market value.
  - B. liquidation value.
  - C. intrinsic value.
  - D. cost.
  - E. None of the above.
43. Which of the following statements concerning the income statement is true?
- A. It measures performance over a specific period of time.
  - B. It determines after-tax income of the firm.
  - C. It includes deferred taxes.
  - D. It treats interest as an expense.
  - E. All of the above.
44. According to generally accepted accounting principles (GAAP), revenue is recognized as income when:
- A. the transaction is complete and the goods or services are delivered.
  - B. a contract is signed to perform a service or deliver a good.
  - C. payment is requested.
  - D. income taxes are paid.
  - E. All of the above.

45. Which of the following is not included in the computation of operating cash flow?

- A. Earnings before interest and taxes
- B. Interest paid
- C. Depreciation
- D. Current taxes
- E. All of the above are included.

46. Net capital spending is equal to:

- A. net additions to net working capital.
- B. total cash flow to stockholders less interest and dividends paid.
- C. net income plus depreciation.
- D. the change in total assets.
- E. the net change in fixed assets.

47. Cash flow to stockholders is defined as:

- A. interest payments.
- B. cash dividends plus repurchases of equity minus new equity financing.
- C. cash flow from financing less cash flow to creditors.
- D. repurchases of equity less cash dividends paid plus new equity sold.
- E. None of the above.

48. Free cash flow is:

- A. without cost to the firm.
- B. net income plus taxes.
- C. an increase in net working capital.
- D. cash that the firm is free to distribute to creditors and stockholders.
- E. None of the above.

49. The cash flow of the firm must be equal to:

- A. cash flow to equity plus cash flow to debtholders.
- B. cash flow to debtholders minus cash flow to equity.
- C. cash flow to governments plus cash flow to equity.
- D. cash flow to equity minus cash flow to debtholders.
- E. None of the above.

50. Which of the following are all components of the statement of cash flows?

- A. Cash flow from internal activities, cash flow from external activities, and cash flow from financing activities
- B. Cash flow from operating activities, cash flow from investing activities, and cash flow from divesting activities
- C. Cash flow from operating activities, cash flow from investing activities, and cash flow from financing activities
- D. Cash flow from brokering activities, cash flow from profitable activities, and cash flow from non-profitable activities
- E. None of the above.

51. A firm has \$300 in inventory, \$600 in fixed assets, \$200 in accounts receivables, \$100 in accounts payable, and \$50 in cash. What is the amount of the current assets?

- A. \$500
- B. \$550
- C. \$600
- D. \$1,150
- E. \$1,200

52. The total assets are \$1200, the fixed assets are \$700, long-term debt is \$600, and short-term debt is \$400. What is the amount of net working capital?

- A. \$0
- B. \$100
- C. \$200
- D. \$300
- E. \$400

53. Brad's Company has equipment with a book value of \$500 that could be sold today at a 50 percent discount. Its inventory is valued at \$400 and could be sold to a competitor for that amount. The firm has \$50 in cash and customers owe them \$300. What is the accounting value of its liquid assets?

- A. \$50
- B. \$350
- C. \$700
- D. \$750
- E. \$1,000

54. Martha's Enterprises spent \$2,400 to purchase equipment three years ago. This equipment is currently valued at \$2,000 on today's balance sheet but could actually be sold for \$2,000. Net working capital is \$300 and long-term debt is \$900. Assuming the equipment is the firm's only fixed asset, what is the book value of shareholders' equity?

- A. \$200
- B. \$800
- C. \$1,200
- D. \$1,400
- E. The answer cannot be determined from the information provided.

55. Art's Boutique has sales of \$640,000 and costs of \$480,000. Interest expense is \$40,000 and depreciation is \$60,000. The tax rate is 34%. What is the net income?

- A. \$20,400
- B. \$39,600
- C. \$50,400
- D. \$79,600
- E. \$99,600

56. Given the tax rates as shown, what is the average tax rate for a firm with taxable income of \$126,500?

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

- A. 21.38%
- B. 23.88%
- C. 25.76%
- D. 34.64%
- E. 39.00%

57. The tax rates are as shown. Your firm currently has taxable income of \$74,000. How much additional tax will you owe if you increase your taxable income by \$20,000?

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

- A. \$6,460
- B. \$6,710
- C. \$6,940
- D. \$7,160
- E. \$7,174

58. Your firm has net income of \$198 on total sales of \$1,200. Costs are \$715 and depreciation is \$145. The tax rate is 34 percent. The firm does not have interest expenses. What is the operating cash flow?

- A. \$93
- B. \$241
- C. \$340
- D. \$383
- E. \$485

59. Teddy's Pillows has beginning net fixed assets of \$600 and ending net fixed assets of \$730. Assets valued at \$400 were sold during the year. Depreciation was \$50. What is the amount of net capital spending?

- A. \$130
- B. \$150
- C. \$165
- D. \$180
- E. \$330

60. At the beginning of the year, a firm has current assets of \$360 and current liabilities of \$190. At the end of the year, the current assets are \$510 and the current liabilities are \$240. What is the change in net working capital?

- A. -\$30
- B. -\$10
- C. \$0
- D. \$10
- E. \$100

61. At the beginning of the year, long-term debt of a firm is \$270 and total debt is \$340. At the end of the year, long-term debt is \$290 and total debt is \$390. The interest paid is \$40. What is the amount of the cash flow to creditors?

- A. -\$50
- B. -\$20
- C. \$20
- D. \$50
- E. \$60

62. Pete's Boats has beginning long-term debt of \$180 and ending long-term debt of \$210. The beginning and ending total debt balances are \$340 and \$360, respectively. The interest paid is \$20. What is the amount of the cash flow to creditors?

- A. -\$10
- B. \$0
- C. \$10
- D. \$40
- E. \$50

63. Peggy Grey's Cookies has net income of \$360. The firm pays out 40 percent of the net income to its shareholders as dividends. During the year, the company sold \$80 worth of common stock. What is the cash flow to stockholders?

- A. \$64
- B. \$136
- C. \$144
- D. \$224
- E. \$296

64. Thompson's Jet Skis has operating cash flow of \$258. Depreciation is \$45 and interest paid is \$53. A net total of \$79 was paid on long-term debt. The firm spent \$210 on fixed assets and increased net working capital by \$48. What is the amount of the cash flow to stockholders?

- A. -\$104
- B. -\$26
- C. \$28
- D. \$114
- E. \$142

Nabors, Inc  
2010 Income Statement  
(\$ in millions)

Net sales	\$9,610
Less: Cost of goods sold	6,310
Less Depreciation	<u>1,370</u>
Earnings before interest and taxes	1,930
Less Interest paid	<u>630</u>
Taxable Income	\$1,300
Less Taxes	<u>455</u>
Net income	<u>\$ 845</u>

Nabors, Inc  
2009 and 2010 Balance Sheets  
(\$ in millions)

	<u>2009</u>	<u>2010</u>		<u>2009</u>	<u>2010</u>
Cash	\$ 310	\$ 405	Accounts payable	\$ 2,720	\$ 2,570
Accounts rec.	2,640	3,055	Notes payable	<u>100</u>	<u>0</u>
Inventory	<u>3,275</u>	<u>3,850</u>	Total	<u>\$ 2,820</u>	<u>\$ 2,570</u>
Total	<u>\$ 6,225</u>	<u>\$ 7,310</u>	Long-term debt	7,875	8,100
Net fixed assets	<u>10,960</u>	<u>10,670</u>	Common stock	5,000	5,250
			Retained earnings	<u>1,490</u>	<u>2,060</u>
Total assets	<u>\$17,185</u>	<u>\$17,980</u>	Total liab & equity	<u>\$17,185</u>	<u>\$17,980</u>

65. What is the change in the net working capital from 2009 to 2010?

- A. \$1,235
- B. \$1,035
- C. \$1,335
- D. \$3,405
- E. \$4,740

66. What is the amount of the non-cash expenses for 2010?

- A. \$570
- B. \$630
- C. \$845
- D. \$1,370
- E. \$2,000

67. What is the amount of the net capital spending for 2010?

- A. -\$290
- B. \$795
- C. \$1,080
- D. \$1,660
- E. \$2,165

68. What is the operating cash flow for 2010?

- A. \$845
- B. \$1,930
- C. \$2,215
- D. \$2,845
- E. \$3,060

69. What is the cash flow of the firm for 2010?

- A. \$405
- B. \$430
- C. \$1,340
- D. \$2,590
- E. \$3,100

70. What is the amount of net new borrowing for 2010?

- A. -\$225
- B. -\$25
- C. \$0
- D. \$25
- E. \$225

71. What is the cash flow to creditors for 2010?

- A. -\$405
- B. -\$225
- C. \$225
- D. \$385
- E. \$405

Knuckerdoodles, Inc.		
	<u>2009</u>	<u>2010</u>
Sales	\$ 740	\$ 785
COGS	430	460
Interest	33	35
Dividends	16	17
Depreciation	250	210
Cash	70	75
Accounts receivable	563	502
Current liabilities	390	405
Inventory	662	640
Long-term debt	340	410
Net fixed assets	1,680	1,413
Common stock	700	235
Tax rate	35%	35%

72. What is the net working capital for 2010?

- A. \$345
- B. \$405
- C. \$645
- D. \$805
- E. \$812

73. What is the change in net working capital from 2009 to 2010?

- A. -\$93
- B. -\$7
- C. \$7
- D. \$85
- E. \$97

74. What is net capital spending for 2010?

- A. -\$477
- B. -\$250
- C. -\$57
- D. \$0
- E. \$57

75. What is the operating cash flow for 2010?

- A. \$143
- B. \$297
- C. \$325
- D. \$353
- E. \$367

76. What is the cash flow of the firm for 2010?

- A. \$50
- B. \$247
- C. \$297
- D. \$447
- E. \$517

77. What is net new borrowing for 2010?

- A. -\$70
- B. -\$35
- C. 0
- D. \$35
- E. \$70

78. What is the cash flow to creditors for 2010?

- A. -\$170
- B. -\$35
- C. \$135
- D. \$170
- E. \$205

79. What is the cash flow to stockholders for 2010?

- A. \$408
- B. \$417
- C. \$452
- D. \$482
- E. \$503

	<u>2010</u>
Cost of goods sold	\$3,210
Interest	\$215
Dividends	\$160
Depreciation	\$375
Change in retained earnings	\$360
Tax rate	35%

80. What is the taxable income for 2010?

- A. \$360
- B. \$520
- C. \$640
- D. \$780
- E. \$800

81. What is the operating cash flow for 2010?

- A. \$520
- B. \$800
- C. \$1,015
- D. \$1,110
- E. \$1,390

82. What are the sales for 2010?

- A. \$4,225
- B. \$4,385
- C. \$4,600
- D. \$4,815
- E. \$5,000

83. Calculate net income based on the following information: sales are \$300; cost of goods sold is \$190, depreciation expense is \$45, interest paid is \$20, and the tax rate is 34%.

- A. \$11.90
- B. \$15.30
- C. \$29.70
- D. \$36.30
- E. \$45.00

	<u>2010</u>
Cost of goods sold	\$4,000
Interest	\$300
Dividends	\$180
Depreciation	\$450
Change in retained earnings	\$300
Tax rate	30%

84. What is the taxable income for 2010?

- A. \$380.45
- B. \$480.00
- C. \$640.52
- D. \$655.03
- E. \$685.71

85. What is the operating cash flow for 2010?

- A. \$940.52
- B. \$985.71
- C. \$1,075.50
- D. \$1,230.00
- E. \$1,354.55

86. What are the sales for 2010?

- A. \$4,000.00
- B. \$4,385.50
- C. \$5,435.71
- D. \$5,525.50
- E. \$5,680.00

87. Calculate net income based on the following information: sales are \$300; cost of goods sold is \$150, depreciation expense is \$60, interest paid is \$30, and the tax rate is 40%.

- A. \$36.00
- B. \$38.50
- C. \$40.50
- D. \$56.80
- E. \$60.00

**Essay Questions**

88. What is a liquid asset and why is it necessary for a firm to maintain a reasonable level of liquid assets?

89. Why is interest expense excluded from the operating cash flow calculation?

90. Explain why the income statement is not a good representation of cash flow.

91. Discuss the difference between book values and market values on the balance sheet and explain which is more important to the financial manager and why.

92. Note that in all of our cash flow computations to determine cash flow of the firm, we never include the addition to retained earnings. Why not? Is this an oversight?

93. Note that we added depreciation back to operating cash flow and to additions to fixed assets. Why add it back twice? Isn't this double-counting?

94. Sometimes when businesses are critically delinquent on their tax liabilities, the tax authority comes in and literally seizes the business by chasing all of the employees out of the building and changing the locks. What does this tell you about the importance of taxes relative to our discussion of cash flow? Why might a business owner want to avoid such an occurrence?

95. Interpret, in words, what cash flow of the firm represents by discussing operating cash flow, changes in net working capital, and additions to fixed assets.

96. Cash flow is generated by the firm and paid to creditors and shareholders. How are financial cash flows classified and why is estimating cash flow so important in financial analysis?

## Chapter 02 Financial Statements & Cash Flow **Answer Key**

### Multiple Choice Questions

1. The financial statement showing a firm's accounting value on a particular date is the:
- A. shareholders' equity sheet.
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  - C. statement of cash flows.
  - D.** balance sheet.
  - E. income statement.

*Difficulty level: Easy*  
*Topic: Balance Sheet*

2. A current asset is:
- A. the market value of all items currently owned by the firm.
  - B. an item that the firm expects to own within the next year.
  - C. the amount of cash on hand the firm currently shows on its balance sheet.
  - D.** cash or an item currently owned by the firm that will convert to cash within the next 12 months.
  - E. an item currently owned by the firm.

*Difficulty level: Easy*  
*Topic: Current Asset*

3. The long-term debts of a firm are liabilities:
- A. owed to the firm's shareholders.
  - B. the firm expects to incur within the next 12 months.
  - C. owed to the firm's suppliers.
  - D. that come due within the next 12 months.
  - E.** that do not come due for at least 12 months.

*Difficulty level: Easy*  
*Topic: Long-Term Debt*

4. Net working capital is defined as:
- A. total liabilities minus shareholders' equity.
  - B. current liabilities minus shareholders' equity.
  - C. fixed assets minus long-term liabilities.
  - D. total assets minus total liabilities.
  - E. current assets minus current liabilities.**

*Difficulty level: Easy*  
*Topic: Net Working Capital*

5. A(n) \_\_\_\_\_ asset is one which can be quickly converted into cash without significant loss in value.
- A. current
  - B. fixed
  - C. intangible
  - D. liquid**
  - E. long-term

*Difficulty level: Easy*  
*Topic: Liquid Assets*

6. The financial statement summarizing a firm's accounting performance over a period of time is the:
- A. income statement.**
  - B. balance sheet.
  - C. statement of cash flows.
  - D. tax reconciliation statement.
  - E. shareholders' equity sheet.

*Difficulty level: Easy*  
*Topic: Income Statement*

7. Noncash items refer to:

- A. the credit sales of a firm.
- B. the accounts payable of a firm.
- C. all accounts on the balance sheet other than cash on hand.
- D. the costs incurred for the purchase of intangible fixed assets.
- E.** expenses charged against revenues that do not directly affect cash flow.

*Difficulty level: Easy*  
*Topic: Noncash Items*

8. Your \_\_\_\_\_ tax rate is the amount of tax payable on the next taxable dollar you earn.

- A. deductible
- B. residual
- C. total
- D. average
- E.** marginal

*Difficulty level: Easy*  
*Topic: Marginal Tax Rate*

9. Your \_\_\_\_\_ tax rate measures the total taxes you pay divided by your taxable income.

- A.** average
- B. marginal
- C. total
- D. deductible
- E. residual

*Difficulty level: Easy*  
*Topic: Average Tax Rates*

Chapter 02 - Financial Statements & Cash Flow

10. \_\_\_\_\_ refers to the cash flow that results from the firm's ongoing, normal business activities.

- A. Cash flow from assets
- B. Net working capital
- C. Capital spending
- D.** Cash flow from operating activities
- E. Cash flow to creditors

*Difficulty level: Medium*

*Topic: Cash Flow From Operating Activities*

11. \_\_\_\_\_ refers to the changes in net capital assets.

- A. Cash flow from assets
- B. Net working capital
- C.** Cash flow from investing
- D. Operating cash flow
- E. Cash flow to creditors

*Difficulty level: Medium*

*Topic: Cash Flow From Investing*

12. \_\_\_\_\_ refers to the difference between a firm's current assets and its current liabilities.

- A. Operating cash flow
- B. Capital spending
- C.** Net working capital
- D. Cash flow from assets
- E. Cash flow to creditors

*Difficulty level: Easy*

*Topic: Net Working Capital*

13. \_\_\_\_\_ is calculated by adding back noncash expenses to net income and adjusting for changes in current assets and liabilities.

- A. Total cash flow
- B. Capital spending
- C. Net working capital
- D.** Cash flow from operations
- E. Cash flow to creditors

*Difficulty level: Medium*

*Topic: Cash Flow Of Operations*

14. \_\_\_\_\_ refers to the firm's interest payments less any net new borrowing.

- A. Operating cash flow
- B. Capital spending
- C. Net working capital
- D. Cash flow from shareholders
- E.** Cash flow to creditors

*Difficulty level: Easy*

*Topic: Cash Flow To Creditors*

15. \_\_\_\_\_ refers to the firm's dividend payments less any net new equity raised.

- A. Operating cash flow
- B. Capital spending
- C. Net working capital
- D. Cash flow from creditors
- E.** Cash flow to stockholders

*Difficulty level: Easy*

*Topic: Cash Flow To Stockholders*

16. Earnings per share is equal to:

- A. net income divided by total shareholders' equity.
- B. net income divided by the par value of the common stock.
- C. gross income multiplied by the par value of the common stock.
- D.** net income divided by the total number of shares outstanding.
- E. operating income divided by the par value of the common stock.

*Difficulty level: Easy*  
*Topic: Earnings Per Share*

17. Dividends per share is equal to dividends paid:

- A. multiplied by the total number of shares outstanding.
- B. divided by total shareholders' equity.
- C.** divided by the total number of shares outstanding.
- D. multiplied by the par value of the common stock.
- E. divided by the par value of common stock.

*Difficulty level: Easy*  
*Topic: Dividends Per Share*

18. Which of the following are included in current assets?

- I. equipment
- II. Inventory
- III. accounts payable
- IV. cash
- A.** II and IV only
- B. I and III only
- C. I, II, and IV only
- D. III and IV only
- E. II, III, and IV only

*Difficulty level: Medium*  
*Topic: Current Assets*

19. Which of the following are included in current liabilities?

- I. note payable to a supplier in eighteen months
  - II. debt payable to a mortgage company in nine months
  - III. accounts payable to suppliers
  - IV. loan payable to the bank in fourteen months
- A. I and III only
  - B. II and III only**
  - C. III and IV only
  - D. II, III, and IV only
  - E. I, II, and III only

*Difficulty level: Medium*  
*Topic: Current Liabilities*

20. An increase in total assets:

- A. means that net working capital is also increasing.
- B. requires an investment in fixed assets.
- C. means that shareholders' equity must also increase.
- D. must be offset by an equal increase in liabilities and shareholders' equity.**
- E. can only occur when a firm has positive net income.

*Difficulty level: Medium*  
*Topic: Balance Sheet*

21. Which one of the following accounts is generally the most liquid?

- A. Patent
- B. Accounts receivable**
- C. Building
- D. Equipment
- E. Inventory

*Difficulty level: Easy*  
*Topic: Liquidity*

22. Which one of the following statements concerning liquidity is correct?

- A. If you sold an asset today, it is a liquid asset.
- B.** Balance sheet accounts are listed in order of decreasing liquidity.
- C. If you can sell an asset next year at a price equal to its actual value, the asset is highly liquid.
- D. The less liquidity a firm has, the lower the probability the firm will encounter financial difficulties.
- E. Trademarks and patents are highly liquid.

*Difficulty level: Easy*

*Topic: Liquidity*

23. Liquidity is:

- A. a measure of the use of debt in a firm's capital structure.
- B. equal to current assets minus current liabilities.
- C. equal to the market value of a firm's total assets minus its current liabilities.
- D.** valuable to a firm even though liquid assets tend to be less profitable to own.
- E. generally associated with intangible assets.

*Difficulty level: Easy*

*Topic: Liquidity*

24. Which of the following accounts are included in shareholders' equity?

- I. retained earnings
  - II. interest paid
  - III. long-term debt
  - IV. capital surplus
- A. I and II only
  - B. II and IV only
  - C.** I and IV only
  - D. II and III only
  - E. I and III only

*Difficulty level: Medium*

*Topic: Shareholders' Equity*

25. Book value:

- A. is based on historical cost.
- B. is equivalent to market value for firms with fixed assets.
- C. is more of a financial than an accounting valuation.
- D. generally tends to exceed market value when fixed assets are included.
- E. is adjusted to market value whenever the market value exceeds the stated book value.

*Difficulty level: Easy*  
*Topic: Book Value*

26. When making financial decisions related to assets, you should:

- A. always consider market values.
- B. place more emphasis on book values than on market values.
- C. rely primarily on the value of assets as shown on the balance sheet.
- D. place primary emphasis on historical costs.
- E. only consider market values if they are less than book values.

*Difficulty level: Easy*  
*Topic: Market Value*

27. As seen on an income statement:

- A. interest is deducted from income and increases the total taxes incurred.
- B. the tax rate is applied to the earnings before interest and taxes when the firm has both depreciation and interest expenses.
- C. depreciation is shown as an expense but does not affect the taxes payable.
- D. depreciation reduces both the pretax income and the net income.
- E. interest expense is added to earnings before interest and taxes to get pretax income.

*Difficulty level: Medium*  
*Topic: Income Statement*

28. The earnings per share will:

- A. decrease as the total revenue of the firm increases.
- B. increase as the number of shares outstanding increase.
- C.** increase as net income increases.
- D. decrease as the costs decrease.
- E. increase as the tax rate increases.

*Difficulty level: Easy*  
*Topic: Income Statement*

29. Dividends per share:

- A. increase as the net income increases as long as the number of shares outstanding remains constant.
- B. decrease as the number of shares outstanding decrease, all else constant.
- C. are inversely related to the earnings per share.
- D. are based upon the dividend requirements established by Generally Accepted Accounting Procedures.
- E.** are equal to the amount of net income distributed to shareholders divided by the number of shares outstanding.

*Difficulty level: Medium*  
*Topic: Dividends Per Share*

30. According to Generally Accepted Accounting Principles,

- A. income is recorded based on the matching principle.
- B. costs are recorded based on the liquidity principle.
- C.** income is recorded based on the realization principle.
- D. depreciation is recorded as it affects the cash flows of a firm.
- E. net income is recorded based on the realization principle.

*Difficulty level: Medium*  
*Topic: Realization Principle*

31. According to Generally Accepted Accounting Principles, costs are:

- A. recorded as incurred.
- B. recorded when paid.
- C.** matched with revenues.
- D. matched with production levels.
- E. expensed as management desires.

*Difficulty level: Medium*  
*Topic: Matching Principle*

32. Depreciation:

- A. reduces both the net fixed assets and the costs of a firm.
- B.** is a non-cash expense that is recorded on the income statement.
- C. is a non-cash expense which decreases the net operating income.
- D. decreases net fixed assets, net income, and operating cash flows.
- E. increases the net fixed assets as shown on the balance sheet.

*Difficulty level: Medium*  
*Topic: Noncash Items*

33. When you are making a financial decision, the most relevant tax rate is the \_\_\_\_\_ rate.

- A. average
- B. fixed
- C.** marginal
- D. total
- E. variable

*Difficulty level: Easy*  
*Topic: Marginal Tax Rate*

34. An increase in which one of the following will cause the operating cash flow to increase?

- A. Change in net working capital
- B. Taxes
- C. Net working capital
- D. Costs
- E. Depreciation**

*Difficulty level: Medium*  
*Topic: Operating Cash Flow*

35. A firm starts its year with a positive net working capital. During the year, the firm acquires more short-term debt than it does short-term assets. This means that:

- A. the ending net working capital will be negative.
- B. both accounts receivable and inventory decreased during the year.
- C. the beginning current assets were less than the beginning current liabilities.
- D. accounts payable increased and inventory decreased during the year.
- E. the ending net working capital can be positive, negative, or equal to zero.**

*Difficulty level: Medium*  
*Topic: Change In Net Working Capital*

36. The cash flow to creditors includes the cash:

- A. received by the firm when payments are paid to suppliers.
- B. outflow of the firm when new debt is acquired.
- C. outflow when interest is paid on outstanding debt.**
- D. inflow when accounts payable decreases.
- E. received when long-term debt is paid off.

*Difficulty level: Medium*  
*Topic: Cash Flow To Creditors*

37. Cash flow to stockholders must be positive when:
- A. the net sale of common stock exceeds the amount of dividends paid.
  - B. no income is distributed but new shares of stock are sold.
  - C. both the cash flow to assets and the cash flow to creditors are negative.
  - D.** the dividends paid exceed the net new equity raised.
  - E. both the cash flow to assets and the cash flow to creditors are positive.

*Difficulty level: Medium*  
*Topic: Cash Flow To Stockholders*

38. Which equality is the basis for the balance sheet?
- A. Fixed Assets = Stockholder's Equity + Current Assets
  - B.** Assets = Liabilities + Stockholder's Equity
  - C. Assets = Current Long-Term Debt + Retained Earnings
  - D. Fixed Assets = Liabilities + Stockholder's Equity
  - E. None of the above.

*Difficulty level: Easy*  
*Topic: Balance Sheet*

39. Assets are listed on the balance sheet in order of:
- A. decreasing size.
  - B.** decreasing liquidity.
  - C. relative life.
  - D. increasing size.
  - E. None of the above.

*Difficulty level: Easy*  
*Topic: Balance Sheet*

40. Debt is a contractual obligation that:

- A. requires the payout of residual flows to the holders of these instruments.
- B. requires a repayment of a stated amount and interest over the period.
- C. allows the bondholders to sue the firm if it defaults.
- D. Both A and B.
- E.** Both B and C.

*Difficulty level: Medium*  
*Topic: Debt*

41. The carrying value or book value of assets:

- A. is always the best measure of the company's value to an investor.
- B. represents the true market value according to GAAP.
- C. is always higher than the replacement cost of the assets.
- D.** is determined under GAAP and is based on the cost of the asset.
- E. None of the above.

*Difficulty level: Medium*  
*Topic: Carrying Value*

42. Under GAAP, a firm's assets are reported at:

- A. market value.
- B. liquidation value.
- C. intrinsic value.
- D.** cost.
- E. None of the above.

*Difficulty level: Medium*  
*Topic: Gaap*

43. Which of the following statements concerning the income statement is true?

- A. It measures performance over a specific period of time.
- B. It determines after-tax income of the firm.
- C. It includes deferred taxes.
- D. It treats interest as an expense.
- E.** All of the above.

*Difficulty level: Medium*  
*Topic: Income Statement*

44. According to generally accepted accounting principles (GAAP), revenue is recognized as income when:

- A.** the transaction is complete and the goods or services are delivered.
- B. a contract is signed to perform a service or deliver a good.
- C. payment is requested.
- D. income taxes are paid.
- E. All of the above.

*Difficulty level: Medium*  
*Topic: Gaap Income Recognition*

45. Which of the following is not included in the computation of operating cash flow?

- A. Earnings before interest and taxes
- B.** Interest paid
- C. Depreciation
- D. Current taxes
- E. All of the above are included.

*Difficulty level: Medium*  
*Topic: Operating Cash Flow*

46. Net capital spending is equal to:
- A. net additions to net working capital.
  - B. total cash flow to stockholders less interest and dividends paid.
  - C. net income plus depreciation.
  - D. the change in total assets.
  - E.** the net change in fixed assets.

*Difficulty level: Medium*  
*Topic: Net Capital Spending*

47. Cash flow to stockholders is defined as:
- A. interest payments.
  - B.** cash dividends plus repurchases of equity minus new equity financing.
  - C. cash flow from financing less cash flow to creditors.
  - D. repurchases of equity less cash dividends paid plus new equity sold.
  - E. None of the above.

*Difficulty level: Medium*  
*Topic: Cash Flow To Stockholders*

48. Free cash flow is:
- A. without cost to the firm.
  - B. net income plus taxes.
  - C. an increase in net working capital.
  - D.** cash that the firm is free to distribute to creditors and stockholders.
  - E. None of the above.

*Difficulty level: Medium*  
*Topic: Free Cash Flow*

49. The cash flow of the firm must be equal to:
- A.** cash flow to equity plus cash flow to debtholders.
  - B. cash flow to debtholders minus cash flow to equity.
  - C. cash flow to governments plus cash flow to equity.
  - D. cash flow to equity minus cash flow to debtholders.
  - E. None of the above.

*Difficulty level: Medium*  
*Topic: Cash Flow*

50. Which of the following are all components of the statement of cash flows?
- A. Cash flow from internal activities, cash flow from external activities, and cash flow from financing activities
  - B. Cash flow from operating activities, cash flow from investing activities, and cash flow from divesting activities
  - C.** Cash flow from operating activities, cash flow from investing activities, and cash flow from financing activities
  - D. Cash flow from brokering activities, cash flow from profitable activities, and cash flow from non-profitable activities
  - E. None of the above.

*Difficulty level: Medium*  
*Topic: Statement Of Cash Flows*

51. A firm has \$300 in inventory, \$600 in fixed assets, \$200 in accounts receivables, \$100 in accounts payable, and \$50 in cash. What is the amount of the current assets?
- A. \$500
  - B.** \$550
  - C. \$600
  - D. \$1,150
  - E. \$1,200

$$\text{Current assets} = \$300 + \$200 + \$50 = \$550$$

*Difficulty level: Medium*  
*Topic: Current Assets*

52. The total assets are \$1200, the fixed assets are \$700, long-term debt is \$600, and short-term debt is \$400. What is the amount of net working capital?

- A. \$0
- B. \$100**
- C. \$200
- D. \$300
- E. \$400

$$\text{Net working capital} = \$1200 - \$700 - \$400 = \$100$$

*Difficulty level: Medium*  
*Topic: Net Working Capital*

53. Brad's Company has equipment with a book value of \$500 that could be sold today at a 50 percent discount. Its inventory is valued at \$400 and could be sold to a competitor for that amount. The firm has \$50 in cash and customers owe them \$300. What is the accounting value of its liquid assets?

- A. \$50
- B. \$350
- C. \$700
- D. \$750**
- E. \$1,000

$$\text{Liquid assets} = \$400 + \$50 + \$300 = \$750$$

*Difficulty level: Medium*  
*Topic: Liquidity*

54. Martha's Enterprises spent \$2,400 to purchase equipment three years ago. This equipment is currently valued at \$2,000 on today's balance sheet but could actually be sold for \$2,000. Net working capital is \$300 and long-term debt is \$900. Assuming the equipment is the firm's only fixed asset, what is the book value of shareholders' equity?

- A. \$200
- B. \$800
- C. \$1,200
- D. \$1,400**
- E. The answer cannot be determined from the information provided.

Book value of shareholders' equity = \$2,000 + \$300 - \$900 = \$1,400

*Difficulty level: Medium*  
*Topic: Book Value*

55. Art's Boutique has sales of \$640,000 and costs of \$480,000. Interest expense is \$40,000 and depreciation is \$60,000. The tax rate is 34%. What is the net income?

- A. \$20,400
- B. \$39,600**
- C. \$50,400
- D. \$79,600
- E. \$99,600

Taxable income = \$640,000 - \$480,000 - \$40,000 - \$60,000 = \$60,000; Tax = .34(\$60,000) = \$20,400; Net income = \$60,000 - \$20,400 = \$39,600

*Difficulty level: Medium*  
*Topic: Net Income*

56. Given the tax rates as shown, what is the average tax rate for a firm with taxable income of \$126,500?

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

- A. 21.38%
- B. 23.88%
- C. 25.76%**
- D. 34.64%
- E. 39.00%

Tax =  $.15(\$50,000) + .25(\$25,000) + .34(\$25,000) + .39(\$126,500 - \$100,000) = \$32,585$ ;  
 Average tax rate =  $\$32,585 \div \$126,500 = .2576 = 25.76$  percent

*Difficulty level: Medium*  
*Topic: Marginal Tax Rate*

57. The tax rates are as shown. Your firm currently has taxable income of \$74,000. How much additional tax will you owe if you increase your taxable income by \$20,000?

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

- A. \$6,460
- B. \$6,710**
- C. \$6,940
- D. \$7,160
- E. \$7,174

Additional tax =  $.25(\$1,000) + .34(\$19,000) = \$6,710$

*Difficulty level: Medium*  
*Topic: Taxes*

58. Your firm has net income of \$198 on total sales of \$1,200. Costs are \$715 and depreciation is \$145. The tax rate is 34 percent. The firm does not have interest expenses. What is the operating cash flow?

- A. \$93
- B. \$241
- C. \$340
- D.** \$383
- E. \$485

Earnings before interest and taxes =  $\$1,200 - \$715 - \$145 = \$340$ ; Tax =  $[\$198 \div (1 - .34)] - \$198 = \$102$ ; Operating cash flow =  $\$340 + \$145 - \$102 = \$383$

*Difficulty level: Medium*  
*Topic: Operating Cash Flow*

59. Teddy's Pillows has beginning net fixed assets of \$600 and ending net fixed assets of \$730. Assets valued at \$400 were sold during the year. Depreciation was \$50. What is the amount of net capital spending?

- A. \$130
- B. \$150
- C. \$165
- D.** \$180
- E. \$330

Net capital spending =  $\$530 - \$480 + \$40 = \$90$

*Difficulty level: Medium*  
*Topic: Net Capital Spending*

60. At the beginning of the year, a firm has current assets of \$360 and current liabilities of \$190. At the end of the year, the current assets are \$510 and the current liabilities are \$240. What is the change in net working capital?

- A. -\$30
- B. -\$10
- C. \$0
- D. \$10
- E.** \$100

$$\text{Change in net working capital} = (\$510 - \$240) - (\$360 - \$190) = \$100$$

*Difficulty level: Medium*

*Topic: Change In Net Working Capital*

61. At the beginning of the year, long-term debt of a firm is \$270 and total debt is \$340. At the end of the year, long-term debt is \$290 and total debt is \$390. The interest paid is \$40. What is the amount of the cash flow to creditors?

- A. -\$50
- B. -\$20
- C.** \$20
- D. \$50
- E. \$60

$$\text{Cash flow to creditors} = \$40 - (\$290 - \$270) = \$20$$

*Difficulty level: Medium*

*Topic: Cash Flow To Creditors*

62. Pete's Boats has beginning long-term debt of \$180 and ending long-term debt of \$210. The beginning and ending total debt balances are \$340 and \$360, respectively. The interest paid is \$20. What is the amount of the cash flow to creditors?

- A.** -\$10
- B. \$0
- C. \$10
- D. \$40
- E. \$50

$$\text{Cash flow to creditors} = \$20 - (\$210 - \$180) = -\$10$$

*Difficulty level: Medium*  
*Topic: Cash Flow To Creditors*

63. Peggy Grey's Cookies has net income of \$360. The firm pays out 40 percent of the net income to its shareholders as dividends. During the year, the company sold \$80 worth of common stock. What is the cash flow to stockholders?

- A.** \$64
- B. \$136
- C. \$144
- D. \$224
- E. \$296

$$\text{Cash flow to stockholders} = .40(\$360) - \$80 = \$64$$

*Difficulty level: Medium*  
*Topic: Cash Flow To Stockholders*

64. Thompson's Jet Skis has operating cash flow of \$258. Depreciation is \$45 and interest paid is \$53. A net total of \$79 was paid on long-term debt. The firm spent \$210 on fixed assets and increased net working capital by \$48. What is the amount of the cash flow to stockholders?

A. -\$104

**B.** -\$26

C. \$28

D. \$114

E. \$142

Cash flow of the firm =  $\$258 - \$48 - \$210 = \$0$ ; Cash flow to creditors =  $\$53 - (-\$79) = \$26$ ;  
Cash flow to stockholders =  $\$0 - \$26 = -\$26$

*Difficulty level: Medium*

*Topic: Cash Flow To Stockholders*

Nabors, Inc  
2010 Income Statement  
(\$ in millions)

Net sales	\$9,610
Less: Cost of goods sold	6,310
Less Depreciation	<u>1,370</u>
Earnings before interest and taxes	1,930
Less Interest paid	<u>630</u>
Taxable Income	\$1,300
Less Taxes	<u>455</u>
Net income	<u>\$ 845</u>

Nabors, Inc  
2009 and 2010 Balance Sheets  
(\$ in millions)

	<u>2009</u>	<u>2010</u>		<u>2009</u>	<u>2010</u>
Cash	\$ 310	\$ 405	Accounts payable	\$ 2,720	\$ 2,570
Accounts rec.	2,640	3,055	Notes payable	<u>100</u>	<u>0</u>
Inventory	<u>3,275</u>	<u>3,850</u>	Total	<u>\$ 2,820</u>	<u>\$ 2,570</u>
Total	<u>\$ 6,225</u>	<u>\$ 7,310</u>	Long-term debt	7,875	8,100
Net fixed assets	<u>10,960</u>	<u>10,670</u>	Common stock	5,000	5,250
			Retained earnings	<u>1,490</u>	<u>2,060</u>
Total assets	<u>\$17,185</u>	<u>\$17,980</u>	Total liab & equity	<u>\$17,185</u>	<u>\$17,980</u>

65. What is the change in the net working capital from 2009 to 2010?

- A. \$1,235
- B. \$1,035
- C. \$1,335**
- D. \$3,405
- E. \$4,740

Change in net working capital =  $(\$7,310 - \$2,570) - (\$6,225 - \$2,820) = \$1,335$

*Difficulty level: Medium*  
*Topic: Change In Net Working Capital*

66. What is the amount of the non-cash expenses for 2010?

- A. \$570
- B. \$630
- C. \$845
- D.** \$1,370
- E. \$2,000

The non-cash expense is depreciation in the amount of \$1,370.

*Difficulty level: Medium*  
*Topic: Noncash Expenses*

67. What is the amount of the net capital spending for 2010?

- A. -\$290
- B. \$795
- C.** \$1,080
- D. \$1,660
- E. \$2,165

Net capital spending =  $\$10,670 - \$10,960 + \$1,370 = \$1,080$

*Difficulty level: Medium*  
*Topic: Net Capital Spending*

68. What is the operating cash flow for 2010?

- A. \$845
- B. \$1,930
- C. \$2,215
- D.** \$2,845
- E. \$3,060

Operating cash flow =  $\$1,930 + \$1,370 - \$455 = \$2,845$

*Difficulty level: Medium*  
*Topic: Operating Cash Flow*

69. What is the cash flow of the firm for 2010?

- A. \$405
- B. \$430**
- C. \$1,340
- D. \$2,590
- E. \$3,100

Operating cash flow =  $\$1,930 + \$1,370 - \$455 = \$2,845$ ; Change in net working capital =  $(\$7,310 - \$2,570) - (\$6,225 - \$2,820) = \$1,335$ ; Net capital spending =  $\$10,670 - \$10,960 + \$1,370 = \$1,080$ ; Cash flow of the firm =  $\$2,845 - \$1,335 - \$1,080 = \$430$

*Difficulty level: Medium*  
*Topic: Cash Flow of The Firm*

70. What is the amount of net new borrowing for 2010?

- A. -\$225
- B. -\$25
- C. \$0
- D. \$25
- E. \$225**

Net new borrowing =  $\$8,100 - \$7,875 = \$225$

*Difficulty level: Medium*  
*Topic: Net New Borrowing*

71. What is the cash flow to creditors for 2010?

- A. -\$405
- B. -\$225
- C. \$225
- D. \$385
- E. \$405**

*Difficulty level: Medium*  
*Topic: Cash Flow To Creditors*

Knackerdoodles, Inc.		
	<u>2009</u>	<u>2010</u>
Sales	\$ 740	\$ 785
COGS	430	460
Interest	33	35
Dividends	16	17
Depreciation	250	210
Cash	70	75
Accounts receivable	563	502
Current liabilities	390	405
Inventory	662	640
Long-term debt	340	410
Net fixed assets	1,680	1,413
Common stock	700	235
Tax rate	35%	35%

72. What is the net working capital for 2010?

- A. \$345
- B. \$405
- C. \$645
- D. \$805
- E.** \$812

Net working capital = \$75 + \$502 + \$640 - \$405 = \$812

*Difficulty level: Medium*  
*Topic: Net Working Capital*

73. What is the change in net working capital from 2009 to 2010?

- A.** -\$93
- B. -\$7
- C. \$7
- D. \$85
- E. \$97

$$\text{Change in net working capital} = (\$75 + \$502 + \$640 - \$405) - (\$70 + \$563 + \$662 - \$390) = -\$93$$

*Difficulty level: Medium*

*Topic: Change In Net Working Capital*

74. What is net capital spending for 2010?

- A. -\$477
- B. -\$250
- C.** -\$57
- D. \$0
- E. \$57

$$\text{Net capital spending} = \$1,413 - \$1,680 + \$210 = -\$57$$

*Difficulty level: Medium*

*Topic: Net Capital Spending*

75. What is the operating cash flow for 2010?

- A. \$143
- B.** \$297
- C. \$325
- D. \$353
- E. \$367

$$\begin{aligned} \text{Earnings before interest and taxes} &= \$785 - \$460 - \$210 = \$115; \text{ Taxable income} = \$115 - \$35 \\ &= \$80; \text{ Taxes} = .35(\$80) = \$28; \text{ Operating cash flow} = \$115 + \$210 - \$28 = \$297 \end{aligned}$$

*Difficulty level: Medium*

*Topic: Operating Cash Flow*

76. What is the cash flow of the firm for 2010?

- A. \$50
- B. \$247
- C. \$297
- D. \$447**
- E. \$517

Cash flow of the firm =  $\$297 - (-\$93) - (-\$57) = \$447$  (See problems 73 and 74)

*Difficulty level: Medium*

*Topic: Cash Flow of The Firm*

77. What is net new borrowing for 2010?

- A. -\$70
- B. -\$35
- C. 0
- D. \$35
- E. \$70**

Net new borrowing =  $\$410 - \$340 = \$70$

*Difficulty level: Medium*

*Topic: Net New Borrowing*

78. What is the cash flow to creditors for 2010?

- A. -\$170
- B. -\$35**
- C. \$135
- D. \$170
- E. \$205

Cash flow to creditors =  $\$35 - (\$410 - \$340) = -\$35$

*Difficulty level: Medium*

*Topic: Cash Flow To Creditors*

79. What is the cash flow to stockholders for 2010?

- A. \$408
- B. \$417
- C. \$452
- D. \$482**
- E. \$503

Cash flow to stockholders =  $\$447 - (-\$35) = \$482$  (See problems 76 and 78); or, Cash flow to stockholders =  $\$17 - (\$235 - \$700) = \$482$

*Topic: Cash Flow To Stockholders*

	<u>2010</u>
Cost of goods sold	\$3,210
Interest	\$215
Dividends	\$160
Depreciation	\$375
Change in retained earnings	\$360
Tax rate	35%

80. What is the taxable income for 2010?

- A. \$360
- B. \$520
- C. \$640
- D. \$780
- E. \$800**

Net income =  $\$160 + \$360 = \$520$ ; Taxable income =  $\$520 \div (1 - .35) = \$800$

*Difficulty level: Medium*  
*Topic: Taxable Income*

81. What is the operating cash flow for 2010?

- A. \$520
- B. \$800
- C. \$1,015
- D.** \$1,110
- E. \$1,390

Earnings before interest and taxes = \$800 + \$215 = \$1,015 (See problem 80); Operating cash flow = \$1,015 + \$375 - (\$800 - \$520) = \$1,110 (See problem 80)

*Difficulty level: Medium*  
*Topic: Operating Cash Flow*

82. What are the sales for 2010?

- A. \$4,225
- B. \$4,385
- C.** \$4,600
- D. \$4,815
- E. \$5,000

Sales = \$1,015 + \$375 + \$3,210 = \$4,600 (see problem 81)

*Difficulty level: Medium*  
*Topic: Sales*

83. Calculate net income based on the following information: sales are \$300; cost of goods sold is \$190, depreciation expense is \$45, interest paid is \$20, and the tax rate is 34%.

- A. \$11.90
- B. \$15.30
- C.** \$29.70
- D. \$36.30
- E. \$45.00

$((\text{Sales}-\text{COGS})-\text{Depreciation}-\text{Interest})-\text{Taxes} = \text{Net Income}$   $((\$300-\$190)-\$45-\$20)-\$15.30=\$29.70$

*Difficulty level: Medium*  
*Topic: Net Income*

	<u>2010</u>
Cost of goods sold	\$4,000
Interest	\$300
Dividends	\$180
Depreciation	\$450
Change in retained earnings	\$300
Tax rate	30%

84. What is the taxable income for 2010?

- A. \$380.45
- B. \$480.00
- C. \$640.52
- D. \$655.03
- E. \$685.71**

Net income =  $\$180 + \$300 = \$480$ ; Taxable income =  $\$480 \div (1 - .30) = \$685.71$

*Difficulty level: Medium*  
*Topic: Taxable Income*

85. What is the operating cash flow for 2010?

- A. \$940.52
- B. \$985.71
- C. \$1,075.50
- D. \$1,230.00**
- E. \$1,354.55

Earnings before interest and taxes =  $\$685.71 + \$300 = \$985.71$  (See problem 84); Operating cash flow =  $\$985.71 + \$450 - (\$685.71 - \$480) = \$1,230$  (See problem 84)

*Difficulty level: Medium*  
*Topic: Operating Cash Flow*

86. What are the sales for 2010?

- A. \$4,000.00
- B. \$4,385.50
- C. \$5,435.71
- D. \$5,525.50
- E.** \$5,680.00

Sales = \$1,230 + \$450 + \$4,000 = \$5,680 (see problem 85)

*Difficulty level: Medium*  
*Topic: Sales*

87. Calculate net income based on the following information: sales are \$300; cost of goods sold is \$150, depreciation expense is \$60, interest paid is \$30, and the tax rate is 40%.

- A.** \$36.00
- B. \$38.50
- C. \$40.50
- D. \$56.80
- E. \$60.00

$((\text{Sales}-\text{COGS})-\text{Depreciation}-\text{Interest})-\text{Taxes} = \text{Net Income}$   $((\$300-\$150)-\$60-\$30)-\$24=\$36.00$

*Difficulty level: Medium*  
*Topic: Net Income*

### Essay Questions

88. What is a liquid asset and why is it necessary for a firm to maintain a reasonable level of liquid assets?

Liquid assets are those that can be sold quickly with little or no loss in value. A firm that has sufficient liquidity will be less likely to experience financial distress.

*Difficulty level: Difficult*  
*Topic: Liquid Assets*

89. Why is interest expense excluded from the operating cash flow calculation?

Operating cash flow is designed to represent the cash flow a firm generates from its day-to-day operating activities. Interest expense arises from a financing decision and thus should be considered as a cash flow to creditors.

*Difficulty level: Difficult*  
*Topic: Operating Cash Flow*

90. Explain why the income statement is not a good representation of cash flow.

Most income statements contain some noncash items, so these must be accounted for when calculating cash flows. More importantly, however, since GAAP is used to create income statements, revenues and expenses are booked when they accrue, not when their corresponding cash flows occur.

*Difficulty level: Difficult*  
*Topic: Cash Flow and Accounting Statements*

91. Discuss the difference between book values and market values on the balance sheet and explain which is more important to the financial manager and why.

The accounts on the balance sheet are generally carried at historical cost, not market values. Although the book value of current assets and current liabilities may closely approximate market values, the same cannot be said for the rest of the balance sheet accounts. Ultimately, the financial manager should focus on the firm's stock price, which is a market value measure. Hence, market values are more meaningful than book values.

*Difficulty level: Difficult*  
*Topic: Book Value and Market Value*

92. Note that in all of our cash flow computations to determine cash flow of the firm, we never include the addition to retained earnings. Why not? Is this an oversight?

The addition to retained earnings is not a cash flow. It is simply an accounting entry that reconciles the balance sheet. Any additions to retained earnings will show up as cash flow changes in other balance sheet accounts.

*Difficulty level: Difficult*

*Topic: Addition to Retained Earnings*

93. Note that we added depreciation back to operating cash flow and to additions to fixed assets. Why add it back twice? Isn't this double-counting?

In both cases, depreciation is added back because it was previously subtracted when obtaining ending balances of net income and fixed assets. Also, since depreciation is a noncash expense, we need to add it back in both instances, so there is no double counting.

*Difficulty level: Difficult*

*Topic: Depreciation and Cash Flow*

94. Sometimes when businesses are critically delinquent on their tax liabilities, the tax authority comes in and literally seizes the business by chasing all of the employees out of the building and changing the locks. What does this tell you about the importance of taxes relative to our discussion of cash flow? Why might a business owner want to avoid such an occurrence?

Taxes must be paid in cash, and in this case, they are one of the most important components of cash flow. The reputation of a business can undergo irreparable harm if word gets out that the tax authorities have confiscated the business, even if only for a couple of hours until the business owner can come up with the money to clear up the tax problem. The bottom line is if the owner can't come up with the cash, the tax authority has effectively put them out of business.

*Difficulty level: Difficult*

*Topic: Tax Liabilities and Cash Flow*

95. Interpret, in words, what cash flow of the firm represents by discussing operating cash flow, changes in net working capital, and additions to fixed assets.

Operating cash flow is the cash flow a firm generates from its day-to-day operations. In other words, it is the cash inflow generated as a result of putting the firm's assets to work. Changes in net working capital and fixed assets represent investments a firm makes in these assets. That is, a firm typically takes some of the cash flow it generates from using assets and reinvests it in new assets. Cash flow of the firm, then, is the cash flow a firm generates by employing its assets, net of any acquisitions.

*Difficulty level: Difficult*  
*Topic: Cash Flow of The Firm*

96. Cash flow is generated by the firm and paid to creditors and shareholders. How are financial cash flows classified and why is estimating cash flow so important in financial analysis?

Cash flow can be classified as cash flow from operations, cash flow from changes in fixed asset, and cash flow from changes in working capital. The estimation of cash flow is important because it is the basis for subsequent valuation techniques which allow the analyst to determine whether or not to accept a project or investment. While discussed in this chapter, students will see in more detail in later chapters how a small change in cash flows, especially early cash flows can dramatically impact the financial analysis.

*Difficulty level: Difficult*  
*Topic: Cash Flow of The Firm*