Chapter 02
Reviewing Financial Statements

Multiple Choice Questions

1. Which financial statement reports a firm's assets, liabilities, and equity at a particular point in time?
A. Balance Sheet
B. Income Statement
C. Statement of Retained Earnings
D. Statement of Cash Flows

2. Which financial statement shows the total revenues that a firm earns and the total expenses the firm incurs to generate those revenues over a specific period of time—generally one year?
A. Balance Sheet
B. Income Statement
C. Statement of Retained Earnings
D. Statement of Cash Flows

3. Which financial statement reports the amounts of cash that the firm generated and distributed during a particular time period?
A. Balance Sheet
B. Income Statement
C. Statement of Retained Earnings
D. Statement of Cash Flows

4. Which financial statement reconciles net income earned during a given period and any cash dividends paid within that period using the change in retained earnings between the beginning and end of the period?
A. Balance Sheet
B. Income Statement
C. Statement of Retained Earnings
D. Statement of Cash Flows

5. On which of the four major financial statements would you find the common stock and paid-in surplus?
A. Balance Sheet
B. Income Statement
C. Statement of Cash Flows
D. Statement of Retained Earnings

6. On which of the four major financial statements would you find the increase in inventory?
A. Balance Sheet
B. Income Statement
C. Statement of Cash Flows
D. Statement of Retained Earnings

7. On which of the four major financial statements would you find net plant and equipment?
A. Balance Sheet
B. Income Statement
C. Statement of Cash Flows
D. Statement of Retained Earnings

8. For which of the following would one expect the book value of the asset to differ widely from its market value?
A. Cash
B. Accounts receivable
C. Inventory
D. Fixed assets

9. Common stockholders' equity divided by number of shares of common stock outstanding is the formula for calculating
A. Earnings per share (EPS)
B. Dividends per share (DPS)
C. Book value per share (BVPS)
D. Market value per share (MVPS)

10. This is the amount of additional taxes a firm must pay out for every additional dollar of taxable income it earns.
A. Average tax rate
B. Marginal tax rate
C. Progressive tax system
D. Earnings before tax

11. An equity-financed firm will
A. pay more in income taxes than a debt-financed firm.
B. pay less in income taxes than a debt-financed firm.
C. pay the same in income taxes as a debt-finance firm.
D. not pay any income taxes.

12. This is cash flow available for payments to stockholders and debt holders of a firm after the firm has made investments in assets necessary to sustain the ongoing operations of the firm.
A. Net income available to common stockholders
B. Cash flow from operations
C. Net cash flow
D. Free cash flow

13. Which of the following activities result in an increase in a firm's cash?
A. Decrease fixed assets
B. Decrease accounts payable
C. Pay dividends
D. Repurchase of common stock

14. These are cash inflows and outflows associated with buying and selling of fixed or other long-term assets.
A. Cash flows from operations
B. Cash flows from investing activities
C. Cash flows from financing activities
D. Net change in cash and cash equivalents

15. If a company reports a large amount of net income on its income statement during a year, the firm will have
A. positive cash flow.
B. negative cash flow.
C. zero cash flow.
D. Any of these scenarios are possible.

16. Free cash flow is defined as
A. Cash flows available for payments to stockholders of a firm after the firm has made payments to all others will claims against it.
B. Cash flows available for payments to stockholders and debt holders of a firm after the firm has made payments necessary to vendors.
C. Cash flows available for payments to stockholders and debt holders of a firm after the firm has made investments in assets necessary to sustain the ongoing operations of the firm.
D. Cash flows available for payments to stockholders and debt holders of a firm that would be tax-free to the recipients.

17. The Sarbanes-Oxley Act requires public companies to ensure that these individuals have considerable experience applying generally accepted accounting principles (GAAP) for financial statements.
A. External auditors
B. Internal auditors
C. Chief Financial Officers
D. Corporate boards' audit committees

18. **Balance Sheet** You are evaluating the balance sheet for Campus Corporation. From the balance sheet you find the following balances: Cash and marketable securities = $400,000, Accounts receivable = $200,000, Inventory = $100,000, Accrued wages and taxes = $10,000, Accounts payable = $300,000, and Notes payable = $600,000. What is Campus's net working capital?
A. -$210,000
B. $700,000
C. $910,000
D. $1,610,000

19. **Balance Sheet** Jack and Jill Corporation's year-end 2009 balance sheet lists current assets of $250,000, fixed assets of $800,000, current liabilities of $195,000, and long-term debt of $300,000. What is Jack and Jill's total stockholders' equity?
A. $495,000
B. $555,000
C. $1,050,000
D. There is not enough information to calculate total stockholder's equity.

20. **Income Statement** Bullseye, Inc.'s 2010 income statement lists the following income and expenses: EBIT = $900,000, Interest expense = $85,000, and Net income = $570,000. What is the 2010 Taxes reported on the income statement?
A. $245,000
B. $330,000
C. $815,000
D. There is not enough information to calculate 2010 Taxes.

21. **Income Statement** Barnyard, Inc.'s 2010 income statement lists the following income and expenses: EBIT = $500,000, Interest expense = $45,000, and Taxes = $152,000. Barnyard's has no preferred stock outstanding and 200,000 shares of common stock outstanding. What are its 2010 earnings per share?
A. $2.50
B. $2.275
C. $1.74
D. $1.515

22. **Corporate Taxes** Eccentricity, Inc. had $300,000 in 2010 taxable income. Using the tax schedule from Table 2-3, what is the company's 2010 income taxes, average tax rate, and marginal tax rate, respectively?

Table 2.3	Corporate Tax Rates as of 2012	
Taxable Income	Pay this Amount on Base Income	Plus this Percentage on Anything Over the Base
$0-$50,000	$0	15%
$50,001-$75,000	$7,500	25%
$75,001-$100,000	$13,750	34%
$100,001-$335,000	$22,250	39%
$335,001-$10,000,000	$113,900	34%
$10,000,001-$15,000,000	$3,400,000	35%
$15,000,001-$18,333,333	$5,150,000	38%
Over $18,333,333	$6,416,667	35%

A. $22,250, 7.42%, 39%
B. $78,000, 26.00%, 39%
C. $100,250, 33.42%, 39%
D. $139,250, 46.42%, 39%

23. **Corporate Taxes** Swimmy, Inc. had $400,000 in 2010 taxable income. Using the tax schedule from Table 2-3, what is the company's 2010 income taxes, average tax rate, and marginal tax rate, respectively?

Table 2.3	Corporate Tax Rates as of 2012	
Taxable Income	Pay this Amount on Base Income	Plus this Percentage on Anything Over the Base
$0-$50,000	$0	15%
$50,001-$75,000	$7,500	25%
$75,001-$100,000	$13,750	34%
$100,001-$335,000	$22,250	39%
$335,001-$10,000,000	$113,900	34%
$10,000,001-$15,000,000	$3,400,000	35%
$15,000,001-$18,333,333	$5,150,000	38%
Over $18,333,333	$6,416,667	35%

A. $22,100, 5.53%, 34%
B. $113,900, 28.48%, 34%
C. $136,000, 34.00%, 34%
D. $136,000, 39.00%, 34%

24. **Corporate Taxes** Scuba, Inc. is concerned about the taxes paid by the company in 2010. In addition to $5 million of taxable income, the firm received $80,000 of interest on state-issued bonds and $500,000 of dividends on common stock it owns in Boating Adventures, Inc. What is Scuba's tax liability, average tax rate, and marginal tax rate, respectively?
A. $1,637,100, 31.79%, 34%
B. $1,751,000, 34.00%, 34%
C. $1,870,000, 34.00%, 34%
D. $1,983,900, 36.07%, 34%

25. **Statement of Cash Flows** Paige's Properties Inc. reported 2008 net income of $5 million and depreciation of $1,500,000. The top part Paige's Properties, Inc.'s 2007 and 2008 balance sheets is listed below (in millions of dollars).

Current assets:	2007	2008	Current liabilities:	2007	2008
Cash and marketable securities	$ 10	$ 20	Accrued wages and taxes	$ 5	$ 11
Accounts receivable	20	34	Accounts payable	25	29
Inventory	10	11	Notes payable	10	25
Total	$ 40	$ 65	Total	$ 40	$ 65

What is the 2008 net cash flow from operating activities for Paige's Properties, Inc.?
A. -$13,500,000
B. $1,500,000
C. $5,000,000
D. $6,500,000

26. **Statement of Cash Flows** In 2008, Upper Crust had cash flows from investing activities of ($250,000) and cash flows from financing activities of ($150,000). The balance in the firm's cash account was $90,000 at the beginning of 2008 and $105,000 at the end of the year. What was Upper Crust's cash flow from operations for 2008?
A. $15,000
B. $105,000
C. $400,000
D. $415,000

27. **Statement of Cash Flows** In 2010, Lower Case Productions had cash flows from investing activities of +$50,000 and cash flows from financing activities of +$100,000. The balance in the firm's cash account was $80,000 at the beginning of 2010 and $65,000 at the end of the year. What was Lower Case's cash flow from operations for 2010?
A. $-15,000
B. $-150,000
C. $-165,000
D. $65,000

28. **Free Cash Flow** You are considering an investment in Crew Cut, Inc. and want to evaluate the firm's free cash flow. From the income statement, you see that Crew Cut earned an EBIT of $23 million, paid taxes of $4 million, and its depreciation expense was $8 million. Crew Cut's gross fixed assets increased by $10 million from 2007 to 2008. The firm's current assets increased by $6 million and spontaneous current liabilities increased by $4 million. What is Crew Cut's operating cash flow, investment in operating capital and free cash flow for 2008, respectively in millions?
A. $23, $10, $13
B. $23, $12, $11
C. $27, $10, $17
D. $27, $12, $15

29. **Free Cash Flow** You are considering an investment in Cruise, Inc. and want to evaluate the firm's free cash flow. From the income statement, you see that Cruise earned an EBIT of $202 million, paid taxes of $51 million, and its depreciation expense was $75 million. Cruise's gross fixed assets increased by $70 million from 2007 to 2008. The firm's current assets decreased by $10 million and spontaneous current liabilities increased by $6 million. What is Cruise's operating cash flow, investment in operating capital, and free cash flow for 2008, respectively, in millions?
A. $202, $70, $130
B. $226, $70, $156
C. $226, $54, $172
D. $226, $74, $152

30. **Free Cash Flow** Catering Corp. reported free cash flows for 2008 of $8 million and investment in operating capital of $2 million. Catering listed $1 million in depreciation expense and $2 million in taxes on its 2008 income statement. What was Catering's 2008 EBIT?
A. $7 million
B. $10 million
C. $11 million
D. $13 million

31. **Statement of Retained Earnings** TriCycle, Corp. began the year 2008 with $25 million in retained earnings. The firm earned net income of $7 million in 2008 and paid $1 million to its preferred stockholders and $3 million to its common stockholders. What is the year-end 2008 balance in retained earnings for TriCycle?
A. $25 million
B. $28 million
C. $32 million
D. $36 million

32. **Statement of Retained Earnings** Night Scapes, Corp. began the year 2008 with $10 million in retained earnings. The firm suffered a net loss of $2 million in 2008 and yet paid $2 million to its preferred stockholders and $1 million to its common stockholders. What is the year-end 2008 balance in retained earnings for Night Scapes?
A. $5 million
B. $8 million
C. $9 million
D. $15 million

33. **Statement of Retained Earnings** Use the following information to find dividends paid to common stockholders during 2008.

Balance of Retained Earnings, December 31, 2007		$ 52m.
Plus: Net Income for 2008		21m.
Less: Cash Dividends Paid		
Preferred Stock	$7m.	
Common Stock	10m.	
Total Cash Dividends Paid		17m.
Balance of Retained Earnings, December 31, 2008		$ 56m.

A. $3 million
B. $4 million
C. $10 million
D. $17 million

34. **Balance Sheet** Harvey's Hamburger Stand has total assets of $3 million of which $1 million are current assets. Cash makes up 20 percent of the current assets and accounts receivable makes up another 5 percent of current assets. Harvey's gross plant and equipment has a book value of $1.5 million and other long-term assets have a book value of $1 million. Using this information, what is the balance of inventory and the balance of depreciation on Harvey's Hamburger Stand's balance sheet?
A. $250,000, $500,000
B. $250,000, $1 million
C. $750,000, $500,000
D. $750,000, $1 million

35. **Balance Sheet** School Books, Inc. has total assets of $18 million of which $6 million are current assets. Cash makes up 10 percent of the current assets and accounts receivable makes up another 40 percent of current assets. School Books' gross plant and equipment has an original cost of $13 million and other long-term assets have a cost value of $2 million. Using this information, what are the balance of inventory and the balance of depreciation on School Books' balance sheet?
A. $3 million, $2 million
B. $3 million, $3 million
C. $2.4 million, $2 million
D. $2.4 million, $3 million

36. **Balance Sheet** Ted's Taco Shop has total assets of $5 million. Forty percent of these assets are financed with debt of which $400,000 is current liabilities. The firm has no preferred stock but the balance in common stock and paid-in surplus is $1 million. Using this information what is the balance for long-term debt and retained earnings on Ted's Taco Shop's balance sheet?
A. $400,000, $1 million
B. $1.6 million, $2 million
C. $1.6 million, $3 million
D. $2 million, $3 million

37. **Balance Sheet** Hair Etc. has total assets of $15 million. Twenty percent of these assets are financed with debt of which $1 million is current liabilities. The firm has no preferred stock but the balance in common stock and paid-in surplus is $8 million. Using this information what is the balance for long-term debt and retained earnings on Hair Etc.'s balance sheet?
A. $1 million, $8 million
B. $2 million, $4 million
C. $2 million, $8 million
D. $3 million, $4 million

38. **Market Value versus Book Value** Acme Bricks balance sheet lists net fixed assets as $40 million. The fixed assets could currently be sold for $50 million. Acme's current balance sheet shows current liabilities of $15 million and net working capital of $12 million. If all the current accounts were liquidated today, the company would receive $77 million cash after paying $15 million in liabilities. What is the book value of Acme's assets today? What is the market value of these assets?
A. $12 million, $77 million
B. $27 million, $92 million
C. $40 million, $50 million
D. $67 million, $142 million

39. **Market Value versus Book Value** Glo's Glasses balance sheet lists net fixed assets as $20 million. The fixed assets could currently be sold for $25 million. Glo's current balance sheet shows current liabilities of $7 million and net working capital of $3 million. If all the current accounts were liquidated today, the company would receive $9 million cash after paying $7 million in liabilities. What is the book value of Glo's assets today? What is the market value of these assets?
A. $10 million, $16 million
B. $10 million, $35 million
C. $30 million, $35 million
D. $30 million, $41 million

40. **Market Value versus Book Value** Rupert's Rims balance sheet lists net fixed assets as $15 million. The fixed assets could currently be sold for $17 million. Rupert's current balance sheet shows current liabilities of $5 million and net working capital of $3 million. If all the current accounts were liquidated today, the company would receive $6 million cash after paying $5 million in liabilities. What is the book value of Rupert's assets today? What is the market value of these assets?
A. $8 million, $23 million
B. $23 million, $25 million
C. $23 million, $28 million
D. $31 million, $28 million

41. **Debt versus Equity Financing** You are considering a stock investment in one of two firms (AllDebt, Inc. and AllEquity, Inc.), both of which operate in the same industry and have identical operating income of $600,000. AllDebt, Inc. finances its $1.2 million in assets with $1 million in debt (on which it pays 10 percent interest annually) and $.2 million in equity. AllEquity, Inc. finances its $1.2 million in assets with no debt and $1.2 million in equity. Both firms pay a tax rate of 30 percent on their taxable income. What are the asset funders' (the debt holders and stockholders') resulting return on assets for the two firms?
A. 29.17%, and 35%, respectively
B. 37.5%, and 35%, respectively
C. 37.5%, and 37.5%, respectively
D. 50%, and 50%, respectively

42. **Debt versus Equity Financing** You are considering a stock investment in one of two firms (AllDebt, Inc. and AllEquity, Inc.), both of which operate in the same industry and have identical operating income of $3 million. AllDebt, Inc. finances its $6 million in assets with $5 million in debt (on which it pays 5 percent interest annually) and $1 million in equity. AllEquity, Inc. finances its $6 million in assets with no debt and $6 million in equity. Both firms pay a tax rate of 40 percent on their taxable income. What are the asset funders' (the debt holders and stockholders') resulting return on assets for the two firms?
A. 27.5%, and 30%, respectively
B. 31.67%, and 30%, respectively
C. 33%, and 30%, respectively
D. 50%, and 50%, respectively

43. **Debt versus Equity Financing** You are considering a stock investment in one of two firms (AllDebt, Inc. and AllEquity, Inc.), both of which operate in the same industry and have identical operating income of $400,000. AllDebt, Inc. finances its $800,000 in assets with $600,000 in debt (on which it pays 5 percent interest annually) and $200,000 in equity. AllEquity, Inc. finances its $800,000 in assets with no debt and $800,000 in equity. Both firms pay a tax rate of 30 percent on their taxable income. What are the asset funders' (the debt holders and stockholders') resulting return on assets for the two firms?
A. 32.375%, and 35.00%,respectively
B. 36.125%, and 35.00%, respectively
C. 46.25%, and 50%, respectively
D. 50%, and 50%, respectively

44. **Income Statement** You have been given the following information for Fina's Furniture Corp.:
net sales = $25,500,000;
cost of goods sold = $10,250,000;
addition to retained earnings = $305,000;
dividends paid to preferred and common stockholders = $500,000;
interest expense = $2,000,000.
The firm's tax rate is 30 percent. What is the depreciation expense for Fina's Furniture Corp?
A. $12,100,000
B. $12,400,000
C. $14,100,000
D. $14,400,000

45. **Income Statement** You have been given the following information for Romeo's Rockers Corp.:
net sales = $5,200,000;
cost of goods sold = $2,100,000;
addition to retained earnings = $1,000,000;
dividends paid to preferred and common stockholders = $400,000;
interest expense = $200,000.
The firm's tax rate is 30 percent. What is the depreciation expense for Romeo's Rockers Corp.?
A. $900,000
B. $1,100,000
C. $1,500,000
D. $1,600,000

46. **Income Statement** You have been given the following information for Nicole's Neckties Corp.:
net sales = $2,500,000;
cost of goods sold = $1,300,000;
addition to retained earnings = $30,000;
dividends paid to preferred and common stockholders = $300,000;
interest expense = $50,000.
The firm's tax rate is 40 percent. What is the depreciation expense for Nicole's Neckties Corp.?
A. $550,000
B. $600,000
C. $650,000
D. $820,000

47. **Income Statement** You have been given the following information for Sherry's Sandwich Corp.:
net sales = $300,000;
gross profit = $100,000;
addition to retained earnings = $30,000;
dividends paid to preferred and common stockholders = $8,500;
depreciation expense = $25,000.
The firm's tax rate is 30 percent. What are the cost of goods sold and the interest expense for Sherry's Sandwich Corp.?
A. $20,000, and $200,000, respectively
B. $100,000, and $20,000, respectively
C. $200,000, and $20,000, respectively
D. $200,000, and $36,500, respectively

48. **Income Statement** You have been given the following information for Kaye's Krumpet Corp.:
net sales = $150,000;
gross profit = $100,000;
addition to retained earnings = $20,000;
dividends paid to preferred and common stockholders = $8,000;
depreciation expense = $50,000.
The firm's tax rate is 30 percent. What are the cost of goods sold and the interest expense for Kaye's Krumpet Corp.?
A. $10,000, and $50,000, respectively
B. $50,000, and $10,000, respectively
C. $50,000, and $22,000, respectively
D. $62,000, and $10,000, respectively

49. **Income Statement** You have been given the following information for Ross's Rocket Corp.:
net sales = $1,000,000;
gross profit = $400,000;
addition to retained earnings = $60,000;
dividends paid to preferred and common stockholders = $90,000;
depreciation expense = $50,000.
The firm's tax rate is 40 percent. What are the cost of goods sold and the interest expense for Ross's Rocket Corp.?
A. $100,000, and $600,000, respectively
B. $600,000, and $100,000, respectively
C. $600,000, and $200,000, respectively
D. $700,000, and $100,000, respectively

Table 2.3	Corporate Tax Rates as of 2012	
Taxable Income	Pay this Amount on Base Income	Plus this Percentage on Anything Over the Base
$0-$50,000	$0	15%
$50,001-$75,000	$7,500	25%
$75,001-$100,000	$13,750	34%
$100,001-$335,000	$22,250	39%
$335,001-$10,000,000	$113,900	34%
$10,000,001-$15,000,000	$3,400,000	35%
$15,000,001-$18,333,333	$5,150,000	38%
Over $18,333,333	$6,416,667	35%

50. **Corporate Taxes** The Carolina Corporation had a 2010 taxable income of $3,000,000 from operations after all operating costs but before

(1) interest charges of $500,000,
(2) dividends received of $75,000,
(3) dividends paid of $1,000,000, and
(4) income taxes.

Using the tax schedule in Table 2.3, what is Carolina's income tax liability?
What are Carolina's average and marginal tax rates on taxable income from operations?
A. $857,650, 28.59%, 34%, respectively
B. $875,500, 29.18%, 34%, respectively
C. $875,500, 34.00%, 34%, respectively
D. $1,020,000, 34.00%, 34%, respectively

51. **Corporate Taxes** The Ohio Corporation had a 2010 taxable income of $50,000,000 from operations after all operating costs but before

(1) interest charges of $500,000,
(2) dividends received of $45,000,
(3) dividends paid of $10,000,000, and
(4) income taxes.

Using the tax schedule in Table 2.3, what is Ohio's income tax liability?
What are Ohio's average and marginal tax rates on taxable income from operations?
A. $6,416,667, 12.83%, 35%, respectively
B. $13,829,725, 27.66%, 35%, respectively
C. $17,329,725, 34.66%, 35%, respectively
D. $17,340,750, 34.68%, 35%, respectively

52. **Corporate Taxes** The Sasnak Corporation had a 2010 taxable income of $4,450,000 from operations after all operating costs but before

(1) interest charges of $750,000,
(2) dividends received of $900,000,
(3) dividends paid of $500,000, and
(4) income taxes.

Using the tax schedule in Table 2.3, what is Sasnak's income tax liability?
What are Sasnak's average and marginal tax rates on taxable income from operations?
A. $1,349,800, 30.33%, 34%, respectively
B. $1,349,800, 34.00%, 34%, respectively
C. $1,564,000, 34.00%, 34%, respectively
D. $1,564,000, 35.15%, 34%, respectively

53. **Corporate Taxes** The AOK Corporation had a 2008 taxable income of $2,200,000 from operations after all operating costs but before

(1) interest charges of $90,000,
(2) dividends received of $750,000,
(3) dividends paid of $80,000, and
(4) income taxes.

Using the tax schedule in Table 2.3, what is AOK's income tax liability?
What are AOK's average and marginal tax rates on taxable income from operations?
A. $793,900, 34%, 34%, respectively
B. $793,900, 36.0864%, 34%, respectively
C. $972,400, 34%, 34%, respectively
D. $972,400, 44.2%, 34%, respectively

54. **Corporate Taxes** Suppose that in addition to the $5.5 million of taxable income from operations, Emily's Flowers, Inc. received $500,000 of interest on state-issued bonds and $300,000 of dividends on common stock it owns in Amy's Iris Bulbs, Inc.
Using the tax schedule in Table 2.3 what is Emily's Flowers' income tax liability?
What are Emily's Flowers' average and marginal tax rates on total taxable income?
A. $1,900,600, 34%, 34%, respectively
B. $1,972,000, 34%, 34%, respectively
C. $2,070,600, 34%, 34%, respectively
D. $2,142,000, 34%, 34%, respectively

55. **Corporate Taxes** Suppose that in addition to the $300,000 of taxable income from operations, Liam's Burgers, Inc. received $25,000 of interest on state-issued bonds and $50,000 of dividends on common stock it owns in Sodas, Inc.
Using the tax schedule in Table 2.3 what is Liam's income tax liability?
What are Liam's average and marginal tax rates on **total** taxable income?
A. $106,100, 33.68%, 39%, respectively
B. $122,850, 39.00%, 39%, respectively
C. $129,500, 34.53%, 39%, respectively
D. $139,250, 37.13%, 39%, respectively

56. **Statement of Cash Flows** Fina's Faucets, Inc. has net cash flows from operating activities for the last year of $17 million. The income statement shows that net income is $15 million and depreciation expense is $6 million. During the year, the change in inventory on the balance sheet was an increase of $4 million, change in accrued wages and taxes was an increase of $1 million and change in accounts payable was an increase of $1 million. At the beginning of the year the balance of accounts receivable was $5 million. What was the end of year balance for accounts receivable?
A. $2 million
B. $3 million
C. $7 million
D. $9 million

57. **Statement of Cash Flows** Zoe's Dog Biscuits, Inc. has net cash flows from operating activities for the last year of $226 million. The income statement shows that net income is $150 million and depreciation expense is $85 million. During the year, the change in inventory on the balance sheet was an increase of $14 million, change in accrued wages and taxes was an increase of $15 million and change in accounts payable was an increase of $10 million. At the beginning of the year the balance of accounts receivable was $45 million. What was the end of year balance for accounts receivable?
A. $20 million
B. $25 million
C. $45 million
D. $65 million

58. **Statement of Cash Flows** Nickolas's Nut Farms, Inc. has net cash flows from operating activities for the last year of $25 million. The income statement shows that net income is $15 million and depreciation expense is $6 million. During the year, the change in inventory on the balance sheet was a decrease of $4 million, change in accrued wages and taxes was a decrease of $1 million and change in accounts payable was a decrease of $1 million. At the beginning of the year the balance of accounts receivable was $5 million. What was the end of year balance for accounts receivable?
A. $2 million
B. $3 million
C. $7 million
D. $9 million

59. **Statement of Cash Flows** Crispy Corporation has net cash flow from financing activities for the last year of $20 million. The company paid $5 million in dividends last year. During the year, the change in notes payable on the balance sheet was an increase of $2 million, and change in common and preferred stock was an increase of $3 million. The end of year balance for long-term debt was $45 million. What was their beginning of year balance for long-term debt?
A. $15 million
B. $20 million
C. $25 million
D. $35 million

60. **Statement of Cash Flows** Full Moon Productions Inc. has net cash flow from financing activities for the last year of $105 million. The company paid $15 million in dividends last year. During the year, the change in notes payable on the balance sheet was an increase of $40 million, and change in common and preferred stock was an increase of $50 million. The end of year balance for long-term debt was $50 million. What was their beginning of year balance for long-term debt?
A. $5 million
B. $20 million
C. $30 million
D. $35 million

61. **Statement of Cash Flows** Café Creations Inc. has net cash flow from financing activities for the last year of $25 million. The company paid $15 million in dividends last year. During the year, the change in notes payable on the balance sheet was a decrease of $40 million, and change in common and preferred stock was an increase of $50 million. The end of year balance for long-term debt was $40 million. What was their beginning of year balance for long-term debt?
A. $10 million
B. $20 million
C. $30 million
D. $40 million

62. **Free Cash Flow** The 2010 income statement for Pete's Pumpkins shows that depreciation expense is $250 million, EBIT is $500 million, EBT is $320 million, and the tax rate is 30 percent. At the beginning of the year, the balance of gross fixed assets was $1,600 million and net operating working capital was $640 million. At the end of the year gross fixed assets was $2,000 million. Pete's free cash flow for the year was $630 million. What is their end of year balance for net operating working capital?
A. $24 million
B. $264 million
C. $654 million
D. $1,064 million

63. **Free Cash Flow** The 2010 income statement for Lou's Shoes shows that depreciation expense is $2 million, EBIT is $5 million, EBT is $3 million, and the tax rate is 40 percent. At the beginning of the year, the balance of gross fixed assets was $16 million and net operating working capital was $6 million. At the end of the year gross fixed assets was $20 million. Lou's free cash flow for the year was $4 million. What is their end of year balance for net operating working capital?
A. $1.8 million
B. $3.8 million
C. $5.8 million
D. $12.2 million

64. **Free Cash Flow** The 2010 income statement for Paige's Purses shows that depreciation expense is $10 million, EBIT is $25 million, EBT is $15 million, and the tax rate is 30 percent. At the beginning of the year, the balance of gross fixed assets was $80 million and net operating working capital was $30 million. At the end of the year gross fixed assets was $100 million. Paige's free cash flow for the year was $20 million. What is their end of year balance for net operating working capital?
A. $10.5 million
B. $14 million
C. $20.5 million
D. $30.5 million

65. **Free Cash Flow** The 2010 income statement for Betty's Barstools shows that depreciation expense is $100 million, EBIT is $400 million, and taxes are $120 million. At the end of the year, the balance of gross fixed assets was $510 million. The increase in net operating working capital during the year was $94 million. Betty's free cash flow for the year was $625 million. What was the beginning of year balance for gross fixed assets?
A. $359 million
B. $380 million
C. $849 million
D. $1,094 million

66. **Free Cash Flow** The 2010 income statement for John's Gym shows that depreciation expense is $20 million, EBIT is $80 million, and taxes are $24 million. At the end of the year, the balance of gross fixed assets was $102 million. The increase in net operating working capital during the year was $18 million. John's free cash flow for the year was $41 million. What was the beginning of year balance for gross fixed assets?
A. $43 million
B. $85 million
C. $84 million
D. $163 million

67. **Statement of Retained Earnings** Bike and Hike, Inc. started the year with a balance of retained earnings of $100 million and ended the year with retained earnings of $128 million. The company paid dividends of $9 million to the preferred stock holders and $22 million to common stock holders. What was Bike and Hike's net income for the year?
A. $28 million
B. $31 million
C. $59 million
D. $128 million

68. **Statement of Retained Earnings** Soccer Starz, Inc. started the year with a balance of retained earnings of $25 million and ended the year with retained earnings of $32 million. The company paid dividends of $2 million to the preferred stock holders and $6 million to common stock holders. What was Soccer Starz's net income for the year?
A. $7 million
B. $15 million
C. $40 million
D. $49 million

69. **Statement of Retained Earnings** Jamaican Ice Cream Corp. started the year with a balance of retained earnings of $100 million. The company reported net income for the year of $45 million, paid dividends of $2 million to the preferred stock holders and $15 million to common stock holders. What is Jamaican Ice Cream's end of year balance in retained earnings?
A. $38 million
B. $55 million
C. $128 million
D. $162 million

70. **Income Statement** Listed below is the 2008 income statement for Lamps, Inc.

Lamps, Inc.
Income Statement for Year Ending December 31, 2008
(in millions of dollars)

	2008
Net sales	$100
Less: Cost of goods sold	80
Gross profits	20
Less: Depreciation	5
Earnings before interest and taxes (EBIT)	15
Less: Interest	2
Earnings before taxes (EBT)	13
Less: Taxes	5
Net income	$ 8

The CEO of Lamps wants the company to earn a net income of $12 million in 2009. Cost of goods sold is expected to be 75 percent of net sales, depreciation expense is not expected to change, interest expense is expected to increase to $4 million, and the firm's tax rate will be 40 percent. What is the net sales needed to produce net income of $12 million?

A. $29 million
B. $112 million
C. $116 million
D. $124 million

71. **Income Statement** You have been given the following information for Halle's Holiday Store Corp. for the year 2008:
net sales = $50,000,000;
cost of goods sold = $35,000,000;
addition to retained earnings = $2,000,000;
dividends paid to preferred and common stockholders = $3,000,000;
interest expense = $3,000,000.
The firm's tax rate is 30 percent.
In 2009, net sales are expected to increase by $5 million,
cost of goods sold is expected to be 65 percent of net sales,
expensed depreciation is expected to be the same as in 2008,
interest expense is expected to be $2,500,000,
the tax rate is expected to be 30 percent of EBT, and
dividends paid to preferred and common stockholders will not change.
What is the addition to retained earnings expected in 2009?
A. $2,000,000
B. $5,325,000
C. $8,447,500
D. $10,304,643

72. **Free Cash Flow** Martha's Moving Van 4U, Inc. had free cash flow during 2008 of $1 million, EBIT of $30 million, tax expense of $8 million, and depreciation of $4 million. Using this information, what was Martha's Accounts Payable ending balance in 2008?
A. $5 million
B. $15 million
C. $35 million
D. $45 million

73. You are evaluating the balance sheet for Goodman's Bees Corporation. From the balance sheet you find the following balances: Cash and marketable securities = $200,000, Accounts receivable = $1,100,000, Inventory = $2,000,000, Accrued wages and taxes = $500,000, Accounts payable = $600,000, and Notes payable = $100,000. Calculate Goodman's Bees' net working capital.
A. $2,000,000
B. $2,100,000
C. $1,400,000
D. $1,900,000

74. Zoeckler Mowing & Landscaping's year-end 2011 balance sheet lists current assets of $350,000, fixed assets of $325,000, current liabilities of $145,000, and long-term debt of $185,000. Calculate Zoeckler's total stockholders' equity.
A. $115,000
B. $490,000
C. $345,000
D. $500,000

75. Reed's Birdie Shot, Inc.'s 2011 income statement lists the following income and expenses: EBIT = $550,000, Interest expense = $43,000, and Net income = $300,000. Calculate the 2011 Taxes reported on the income statement.
A. $85,000
B. $107,000
C. $309,000
D. $207,000

76. Reed's Birdie Shot, Inc.'s 2010 income statement lists the following income and expenses: EBIT = $555,000, Interest expense = $178,000, and Taxes = $148,000. Reed's has no preferred stock outstanding and 100,000 shares of common stock outstanding. Calculate the 2010 earnings per share.
A. $3.49
B. $2.29
C. $3.14
D. $2.79

77. Oakdale Fashions Inc. had $255,000 in 2011 taxable income. If the firm paid $82,100 in taxes, what is the firm's average tax rate?
A. 34.70%
B. 32.20%
C. 29.90%
D. 28.20%

78. Hunt Taxidermy, Inc. is concerned about the taxes paid by the company in 2011. In addition to $36.5 million of taxable income, the firm received $1,250,000 of interest on state-issued bonds and $400,000 of dividends on common stock it owns in Hunt Taxidermy, Inc. Calculate Hunt Taxidermy's taxable income.
A. $40,250,000
B. $38,150,000
C. $36,900,000
D. $36,620,000

79. Ramakrishnan Inc. reported 2008 net income of $20 million and depreciation of $1,500,000. The top part of Ramakrishnan, Inc.'s 2007 and 2008 balance sheets is listed below (in millions of dollars).

Current assets:	2007	2008	Current liabilities:	2007	2008
Cash and marketable securities	$ 15	$ 20	Accrued wages and taxes	$ 18	$ 20
Accounts receivable	75	84	Accounts payable	45	50
Inventory	110	121	Notes payable	40	45
Total	**$200**	**$225**	Total	**$103**	**$115**

Calculate the 2008 net cash flow from operating activities for Ramakrishnan, Inc.
A. $12,500,000
B. $10,500,000
C. $8,500,000
D. $7,100,000

80. In 2011, Usher Sports Shop had cash flows from investing activities of ($2,150,000) and cash flows from financing activities of ($3,219,000). The balance in the firm's cash account was $980,000 at the beginning of 2011 and $1,025,000 at the end of the year. Calculate Usher Sports Shop's cash flow from operations for 2011.
A. $6,219,000
B. $5,414,000
C. $4,970,000
D. $5,980,000

81. You are considering an investment in Fields and Struthers, Inc. and want to evaluate the firm's free cash flow. From the income statement, you see that Fields and Struthers earned an EBIT of $52 million, paid taxes of $10 million, and its depreciation expense was $5 million. Fields and Struthers' gross fixed assets increased by $38 million from 2010 to 2011. The firm's current assets increased by $20 million and spontaneous current liabilities increased by $12 million. Calculate Fields and Struthers' operating cash flow (OCF), investment in operating capital (IOC) and free cash flow (FCF) for 2011.
A. OCF = $42,000,000; IOC = $37,000,000; FCF = $5,000,000
B. OCF = $47,000,000; IOC = $37,000,000; FCF = $10,000,000
C. OCF = $42,000,000; IOC = $46,000,000; FCF = -$4,000,000
D. OCF = $47,000,000; IOC = $46,000,000; FCF = $1,000,000

82. Tater and Pepper Corp. reported free cash flows for 2010 of $20 million and investment in operating capital of $15 million. Tater and Pepper listed $8 million in depreciation expense and $12 million in taxes on its 2010 income statement. Calculate Tater and Pepper's 2010 EBIT.
A. $49,000,000
B. $42,000,000
C. $39,000,000
D. $47,000,000

83. Mr. Husker's Tuxedos, Corp. began the year 2011 with $205 million in retained earnings. The firm earned net income of $30 million in 2011 and paid $5 million to its preferred stockholders and $12 million to its common stockholders. What is the year-end 2011 balance in retained earnings for Mr. Husker's Tuxedos?
A. $193,000,000
B. $200,000,000
C. $213,000,000
D. $218,000,000

84. Brenda's Bar and Grill has total assets of $17 million of which $5 million are current assets. Cash makes up 12 percent of the current assets and accounts receivable makes up another 40 percent of current assets. Brenda's gross plant and equipment has a cost value of $12 million and other long-term assets have a cost value of $1,000,000. Using this information, what is the balance of inventory and the balance of depreciation on Brenda's Bar and Grill's balance sheet?
A. $2.4 million; $1 million
B. $3.4 million; $2 million
C. $1.4 million; $1 million
D. $0.4 million; $3 million

85. Ed's Tobacco Shop has total assets of $100 million. Fifty percent of these assets are financed with debt of which $37 million is current liabilities. The firm has no preferred stock but the balance in common stock and paid-in surplus is $32 million. Using this information what is the balance for long-term debt and retained earnings on Ed's Tobacco Shop's balance sheet?
A. $18 million; $27 million
B. $12 million; $12 million
C. $14 million; $29 million
D. $13 million; $18 million

86. Muffin's Masonry, Inc.'s balance sheet lists net fixed assets as $16 million. The fixed assets could currently be sold for $17 million. Muffin's current balance sheet shows current liabilities of $5.5 million and net working capital of $6.5 million. If all the current accounts were liquidated today, the company would receive $10.25 million cash after paying $5.5 million in liabilities. What is the book value of Muffin's Masonry's assets today? What is the market value of these assets?
A. Book Value: $28M; Market Value: $32.75M
B. Book Value: $32M; Market Value: $42.25M
C. Book Value: $32M; Market Value: $32.75M
D. Book Value: $28M; Market Value: $42.25M

87. You have been given the following information for Corky's Bedding Corp.:
Net sales = $15,250,000;
Cost of goods sold = $5,750,000;
Addition to retained earnings = $4,000,000;
Dividends paid to preferred and common stockholders = $995,000;
Interest expense = $1,150,000.
The firm's tax rate is 30 percent. Calculate the depreciation expense for Corky's Bedding Corp.
A. $1,210,000
B. $1,970,000
C. $1,520,000
D. $1,725,000

88. Dogs 4 U Corporation has net cash flow from financing activities for the last year of $10 million. The company paid $8 million in dividends last year. During the year, the change in notes payable on the balance was $9 million, and change in common and preferred stock was $0 million. The end of year balance for long-term debt was $44 million. Calculate the beginning of year balance for long-term debt.
A. $37 million
B. $34 million
C. $33 million
D. $35 million

89. The 2011 income statement for Duffy's Pest Control shows that depreciation expense is $180 million, EBIT is $420 million, EBT is $240 million, and the tax rate is 30 percent. At the beginning of the year, the balance of gross fixed assets was $1,500 million and net operating working capital was $500 million. At the end of the year gross fixed assets was $1,803 million. Duffy's free cash flow for the year was $425 million. Calculate the end of year balance for net operating working capital.
A. $403 million
B. $300 million
C. $203 million
D. $103 million

90. The CEO of Tom and Sue's wants the company to earn a net income of $3.25 million in 2010. Cost of goods sold is expected to be 60 percent of net sales, depreciation expense is $2.9 million, interest expense is expected to increase to $1.050 million, and the firm's tax rate will be 30 percent. Calculate the net sales needed to produce net income of $3.25 million.
A. $26.02 million
B. $29.36 million
C. $21.48 million
D. $28.25 million

91. All of the following would be a result of changing to the MACRS method of depreciation except _______.
A. Higher depreciation expense
B. Lower taxes in the early years of a project's life
C. Lower taxable income in the early years of a project's life
D. All of these.

92. Which of the following is NOT a source of cash?
A. The firm reduces its inventory.
B. The firm pays off some of its long-term debt.
C. The firm has positive net income.
D. The firm sells more common stock.

93. Which of the following is a use of cash?
A. The firm takes its depreciation expense.
B. The firm sells some of its fixed assets.
C. The firm issues more long-term debt.
D. The firm decreases its accrued wages and taxes.

94. Is it possible for a firm to have positive net income and yet to have cash flow problems?
A. No, this is impossible since net income increases the firm's cash.
B. Yes, this can occur when a firm is growing very rapidly.
C. Yes, this is possible if the firm window-dressed its financial statements.
D. No, this is impossible since net income and cash are highly correlated.

95. All of the following are cash flows from operations except ______________.
A. Increases or decreases in cash
B. Net Income
C. Depreciation
D. Increases or decreases in accounts payable

96. All of the following are cash flows from financing except a(n) __________.
A. Increase in accounts payable
B. Issuing stock
C. Stock repurchases
D. Paying dividends

97. Cash flows available to pay the firm's stockholders and debt holders after the firm has made the necessary working capital investments, fixed asset investments, and developed the necessary new products to sustain the firm's ongoing operations is referred to as __________________.
A. Operating cash flow
B. Net operating working capital
C. Free cash flow
D. None of these.

98. Investment in operating capital is ____________________________.
A. The change in assets plus the change in current liabilities
B. The change in gross fixed assets plus depreciation
C. The change in gross fixed assets plus the change in free cash flow
D. None of these.

99. A firm had EBIT of $1,000, paid taxes of $225, expensed depreciation at $13, and its gross fixed assets increased by $25. What was the firm's operating cash flow?
A. $763
B. $737
C. $813
D. $788

100. Which of the following is an example of a capital structure?
A. 15% current assets and 85% fixed assets
B. 10% current liabilities and 90% long-term debt
C. 20% debt and 80% equity
D. None of these.

101. Lemmon Inc. lists fixed assets of $100 on its balance sheet. The firm's fixed assets have recently been appraised at $140. The firm's balance sheet also lists current assets at $15. Current assets were appraised at $16.5. Current liabilities book and market values stand at $12 and the firm's long-term debt is $40. Calculate the market value of the firm's stockholders' equity.
A. $156.5
B. $112.50
C. $104.50
D. $144.50

102. A firm has operating income of $1,000, depreciation expense of $185 and its investment in operating capital is $400. The firm is 100% equity financed and has a 35% tax rate. What is the firm's operating cash flow?
A. $725
B. $795
C. $835
D. $965

103. All of the following are reasons that one should be cautious in interpreting financial statements except ____________.
A. Firms can take steps to over- or understate earnings at various times.
B. It is difficult to compare two firms that use different depreciation methods.
C. Financial managers have quite a bit of latitude in using accounting rules to manage their reported earnings.
D. All of these are reasons to be cautious in interpreting financial statements.

104. Which of the following statements is correct?
A. The bottom line on the statement of cash flows equals the change in the retained earnings on the balance sheet.
B. The reason the statement of cash flows is important is because cash is what pays the firm's obligations, not accounting profit.
C. If a firm has accounting profit, its cash account will always increase.
D. All of these statements are correct.

105. ABC Inc. has $100 in cash on its balance at the end of 2009. During 2010, the firm issued $450 in common stock, reduced its notes payable by $40, purchased fixed assets in the amount of $750 and had cash flows from operating activities of $315. How much cash did ABC Inc. have on its balance sheet at the end of 2010?
A. $75
B. $140
C. $225
D. -$25

106. LLV Inc. originally forecasted the following financial data for next year: Sales = $1,000, Cost of goods sold = $675 and Interest expense = $90. The firm believes that COGS will always be 67.5% of sales. Due to increased global demand, the firm is now projecting that sales will be 20% higher than the original forecast. What is the *additional* net income (as compared to the original forecast) the firm can expect assuming a 35% tax rate?
A. $59.45
B. $195.00
C. $42.25
D. $74.00

107. LLV Inc. originally forecasted the following financial data for next year: Sales = $1,000, Cost of goods sold = $710 and Interest expense = $95. The firm believes that COGS will always be 71% of sales. Due to pressure from shareholders, the firm wants to achieve a net income of $150. Assuming the interest expense will remain the same, how large must sales be to achieve this goal? Assume a 35% tax rate.
A. $1,403.82
B. $1,3009.18
C. $1,123.34
D. $1,296.51

108. A firm has sales of $690, EBIT of $300, depreciation of $40 and fixed assets increased by $265. If the firm's tax rate is 40% and there were no increases in net operating working capital, what is the firm's free cash flow?
A. $15
B. $75
C. -$45
D. -$55

109. GW Inc. had $800 million in retained earnings at the beginning of the year. During the year, the firm paid $.75 per share dividend and generated $1.92 earnings per share. The firm has 100 million shares outstanding. At the end of year, what was the level of retained earnings for GW?
A. $725 million
B. $917 million
C. $882 million
D. $807 million

Essay Questions

110. LG 5 2-21 **Statement of Cash Flows** Use the balance sheet and income statement below to construct a statement of cash flows for Betty's Bakery Corp.

Betty's Bakery Corporation
Balance Sheet as of December 31, 2007 and 2008
(in millions of dollars)

Assets	**2007**	**2008**	**Liabilities & Equity**	**2007**	**2008**
Current assets:			Current liabilities:		
Cash and marketable securities	$ 12	$ 5	Accrued wages and taxes	$ 5	$ 4
Accounts receivable	21	15	Accounts payable	18	16
Inventory	25	30	Notes payable	35	30
Total	$ 58	$ 50	Total	$ 58	$ 50
Fixed assets:			Long-term debt:	$ 40	$ 45
Gross plant and equipment	$ 60	$ 80	Stockholders' equity:		
Less: Depreciation	10	15	Preferred stock (1 million shares)	$ 1	$ 1
Net plant and equipment	$ 50	$ 65	Common stock and paid-in surplus (4 million shares)	4	4
Other long-term assets	20	25	Retained earnings	25	40
Total	$ 70	$ 90	Total	$ 30	$ 45
Total assets	$128	$140	Total liabilities and equity	$128	$140

Betty's Bakery Corporation
Income Statement for Years Ending December 31, 2007 and 2008
(in millions of dollars)

	2007	2008
Net sales	$ 33	$ 40.5
Less: Cost of goods sold	8	11
Gross profits	25	29.5
Less: Depreciation	2	2
Earnings before interest and taxes (EBIT)	23	27.5
Less: Interest	1	1.5
Earnings before taxes (EBT)	22	26
Less: Taxes	9	10
Net income	$13	$16.
Less: Preferred stock dividends	$ 1	$ 1
Net income available to common stockholders	$12	$15
Less: Common stock dividends	$ 1	$ 2
Addition to retained earnings	$11	$13
Per (common) share data:		
Earnings per share (EPS)	$6.75	$4.00
Dividends per share (DPS)	$0.25	$0.50
Book value per share (BV)	$22.00	$23.75
Market value (price) per share (MV)	$24.00	$24.25

111. When might earnings management become an ethical consideration?

112. How do taxes influence how corporate managers' and investors' structure transactions and capitalize their companies?

113. How would you explain to a friend why market value of a firm is more important to an investor than book value of the firm?

114. What are free cash flows for a firm? What does it mean when a firm's free cash flow is negative?

115. What are the costs and benefits of holding liquid securities on a firm's balance sheet?

Chapter 02 Reviewing Financial Statements Answer Key

Multiple Choice Questions

1. Which financial statement reports a firm's assets, liabilities, and equity at a particular point in time?
A. Balance Sheet
B. Income Statement
C. Statement of Retained Earnings
D. Statement of Cash Flows

AACSB: Reflective Thinking
Blooms: Understand
Difficulty: 1 Basic
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Topic: Understanding Financial Statements

2. Which financial statement shows the total revenues that a firm earns and the total expenses the firm incurs to generate those revenues over a specific period of time—generally one year?
A. Balance Sheet
B. Income Statement
C. Statement of Retained Earnings
D. Statement of Cash Flows

AACSB: Reflective Thinking
Blooms: Understand
Difficulty: 1 Basic
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Topic: Understanding Financial Statements

3. Which financial statement reports the amounts of cash that the firm generated and distributed during a particular time period?
A. Balance Sheet
B. Income Statement
C. Statement of Retained Earnings
D. Statement of Cash Flows

AACSB: Reflective Thinking
Blooms: Understand
Difficulty: 1 Basic
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Topic: Understanding Financial Statements

4. Which financial statement reconciles net income earned during a given period and any cash dividends paid within that period using the change in retained earnings between the beginning and end of the period?
A. Balance Sheet
B. Income Statement
C. Statement of Retained Earnings
D. Statement of Cash Flows

AACSB: Reflective Thinking
Blooms: Understand
Difficulty: 1 Basic
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Topic: Understanding Financial Statements

5. On which of the four major financial statements would you find the common stock and paid-in surplus?
A. Balance Sheet
B. Income Statement
C. Statement of Cash Flows
D. Statement of Retained Earnings

AACSB: Reflective Thinking
Blooms: Understand
Difficulty: 1 Basic
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Topic: Understanding Financial Statements

6. On which of the four major financial statements would you find the increase in inventory?
A. Balance Sheet
B. Income Statement
C. Statement of Cash Flows
D. Statement of Retained Earnings

AACSB: Reflective Thinking
Blooms: Understand
Difficulty: 1 Basic
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Topic: Understanding Financial Statements

7. On which of the four major financial statements would you find net plant and equipment?
A. Balance Sheet
B. Income Statement
C. Statement of Cash Flows
D. Statement of Retained Earnings

AACSB: Reflective Thinking
Blooms: Understand
Difficulty: 1 Basic
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Topic: Understanding Financial Statements

8. For which of the following would one expect the book value of the asset to differ widely from its market value?
A. Cash
B. Accounts receivable
C. Inventory
D. Fixed assets

AACSB: Reflective Thinking
Blooms: Understand
Difficulty: 1 Basic
Learning Objective: 02-02 Differentiate between book (or accounting) value and market value.
Topic: Book vs. Market Value

9. Common stockholders' equity divided by number of shares of common stock outstanding is the formula for calculating
A. Earnings per share (EPS)
B. Dividends per share (DPS)
C. Book value per share (BVPS)
D. Market value per share (MVPS)

AACSB: Reflective Thinking
Blooms: Understand
Difficulty: 1 Basic
Learning Objective: 02-02 Differentiate between book (or accounting) value and market value.
Topic: Book vs. Market Value

10. This is the amount of additional taxes a firm must pay out for every additional dollar of taxable income it earns.
A. Average tax rate
B. Marginal tax rate
C. Progressive tax system
D. Earnings before tax

AACSB: Reflective Thinking
Blooms: Understand
Difficulty: 1 Basic
Learning Objective: 02-03 Explain how taxes influence corporate managers' and investors' decisions.
Topic: Taxes

11. An equity-financed firm will
A. pay more in income taxes than a debt-financed firm.
B. pay less in income taxes than a debt-financed firm.
C. pay the same in income taxes as a debt-finance firm.
D. not pay any income taxes.

AACSB: Reflective Thinking
Blooms: Understand
Difficulty: 2 Intermediate
Learning Objective: 02-03 Explain how taxes influence corporate managers' and investors' decisions.
Topic: Taxes

12. This is cash flow available for payments to stockholders and debt holders of a firm after the firm has made investments in assets necessary to sustain the ongoing operations of the firm.
A. Net income available to common stockholders
B. Cash flow from operations
C. Net cash flow
D. Free cash flow

AACSB: Reflective Thinking
Blooms: Understand
Difficulty: 1 Basic
Learning Objective: 02-05 Demonstrate how to use a firm's financial statements to calculate its cash flows.
Topic: Calculating Cash Flows

13. Which of the following activities result in an increase in a firm's cash?
A. Decrease fixed assets
B. Decrease accounts payable
C. Pay dividends
D. Repurchase of common stock

AACSB: Reflective Thinking
Blooms: Understand
Difficulty: 2 Intermediate
Learning Objective: 02-05 Demonstrate how to use a firm's financial statements to calculate its cash flows.
Topic: Calculating Cash Flows

14. These are cash inflows and outflows associated with buying and selling of fixed or other long-term assets.
A. Cash flows from operations
B. Cash flows from investing activities
C. Cash flows from financing activities
D. Net change in cash and cash equivalents

AACSB: Reflective Thinking
Blooms: Understand
Difficulty: 1 Basic
Learning Objective: 02-05 Demonstrate how to use a firm's financial statements to calculate its cash flows.
Topic: Calculating Cash Flows

15. If a company reports a large amount of net income on its income statement during a year, the firm will have
A. positive cash flow.
B. negative cash flow.
C. zero cash flow.
D. Any of these scenarios are possible.

AACSB: Reflective Thinking
Blooms: Understand
Difficulty: 2 Intermediate
Learning Objective: 02-05 Demonstrate how to use a firm's financial statements to calculate its cash flows.
Topic: Calculating Cash Flows

16. Free cash flow is defined as
A. Cash flows available for payments to stockholders of a firm after the firm has made payments to all others will claims against it.
B. Cash flows available for payments to stockholders and debt holders of a firm after the firm has made payments necessary to vendors.
C. Cash flows available for payments to stockholders and debt holders of a firm after the firm has made investments in assets necessary to sustain the ongoing operations of the firm.
D. Cash flows available for payments to stockholders and debt holders of a firm that would be tax-free to the recipients.

AACSB: Reflective Thinking
Blooms: Understand
Difficulty: 2 Intermediate
Learning Objective: 02-05 Demonstrate how to use a firm's financial statements to calculate its cash flows.
Topic: Calculating Cash Flows

17. The Sarbanes-Oxley Act requires public companies to ensure that these individuals have considerable experience applying generally accepted accounting principles (GAAP) for financial statements.
A. External auditors
B. Internal auditors
C. Chief Financial Officers
D. Corporate boards' audit committees

AACSB: Reflective Thinking
Blooms: Understand
Difficulty: 2 Intermediate
Learning Objective: 02-06 Observe cautions that should be taken when examining financial statements.
Topic: Financial Statement Cautions

18. **Balance Sheet** You are evaluating the balance sheet for Campus Corporation. From the balance sheet you find the following balances: Cash and marketable securities = $400,000, Accounts receivable = $200,000, Inventory = $100,000, Accrued wages and taxes = $10,000, Accounts payable = $300,000, and Notes payable = $600,000. What is Campus's net working capital?

A. -$210,000
B. $700,000
C. $910,000
D. $1,610,000

net working capital = current assets - current liabilities.

Cypress's current assets =

Cash and marketable securities	=	$400,000
Accounts receivable	=	$200,000
Inventory	=	$100,000
Total current assets		$700,000

and current liabilities =

Accrued wages and taxes	=	$ 10,000
Accounts payable	=	$300,000
Notes payable	=	$600,000
Total current liabilities		$910,000

So the firm's net working capital was -$210,000 ($700,000 - $910,000).

AACSB: Analytical
Blooms: Apply
Difficulty: 1 Basic
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Topic: Understanding Financial Statements

19. **Balance Sheet** Jack and Jill Corporation's year-end 2009 balance sheet lists current assets of $250,000, fixed assets of $800,000, current liabilities of $195,000, and long-term debt of $300,000. What is Jack and Jill's total stockholders' equity?
A. $495,000
B. $555,000
C. $1,050,000
D. There is not enough information to calculate total stockholder's equity.

Recall the balance sheet identity in Equation 2-1: Assets = Liabilities + Equity. Rearranging this equation: Equity = Assets - Liabilities. Thus, the balance sheets would appear as follows:

	Book value		Book value
Assets		**Liabilities and Equity**	
Current assets	$ 250,000	Current liabilities	$ 195,000
Fixed assets	800,000	Long-term debt	300,000
		Stockholders' equity	555,000
Total	$1,050,000	Total	$1,050,000

AACSB: Analytical
Blooms: Apply
Difficulty: 1 Basic
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Topic: Understanding Financial Statements

20. **Income Statement** Bullseye, Inc.'s 2010 income statement lists the following income and expenses: EBIT = $900,000, Interest expense = $85,000, and Net income = $570,000. What is the 2010 Taxes reported on the income statement?

A. $245,000
B. $330,000
C. $815,000
D. There is not enough information to calculate 2010 Taxes.

Using the setup of an Income Statement in Table 2.2:

EBIT	$900,000
Interest expense	-85,000
EBT	815,000
Taxes	-245,000
Net income	$570,000

AACSB: Analytical
Blooms: Apply
Difficulty: 1 Basic
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Topic: Understanding Financial Statements

21. **Income Statement** Barnyard, Inc.'s 2010 income statement lists the following income and expenses: EBIT = $500,000, Interest expense = $45,000, and Taxes = $152,000. Barnyard's has no preferred stock outstanding and 200,000 shares of common stock outstanding. What are its 2010 earnings per share?
A. $2.50
B. $2.275
C. $1.74
D. $1.515

Using the setup of an Income Statement in Table 2.2:

EBIT	$500,000
Interest expense	-45,000
EBT	455,000
Taxes	-152,000
Net income	$303,000

Thus,

$$\text{Earnings per share (EPS)} = \frac{\$303{,}000}{200{,}000} = \$1.515 \text{ per share}$$

AACSB: Analytical
Blooms: Apply
Difficulty: 1 Basic
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Topic: Understanding Financial Statements

22. **Corporate Taxes** Eccentricity, Inc. had $300,000 in 2010 taxable income. Using the tax schedule from Table 2-3, what is the company's 2010 income taxes, average tax rate, and marginal tax rate, respectively?

Table 2.3	Corporate Tax Rates as of 2012	
Taxable Income	Pay this Amount on Base Income	Plus this Percentage on Anything Over the Base
$0-$50,000	$0	15%
$50,001-$75,000	$7,500	25%
$75,001-$100,000	$13,750	34%
$100,001-$335,000	$22,250	39%
$335,001-$10,000,000	$113,900	34%
$10,000,001-$15,000,000	$3,400,000	35%
$15,000,001-$18,333,333	$5,150,000	38%
Over $18,333,333	$6,416,667	35%

A. $22,250, 7.42%, 39%
B. $78,000, 26.00%, 39%
C. $100,250, 33.42%, 39%
D. $139,250, 46.42%, 39%

From Table 2.3, the $300,000 of taxable income puts Eccentricity in the 39 percent marginal tax bracket. Thus,
Tax liability = Tax on base amount + Tax rate (amount over base): = $22,250 + .39 ($300,000 - $100,000) = $100,250
Note that the base amount is the maximum dollar value listed in the previous tax bracket. The *average* tax rate for Eccentricity Inc. comes to:

$$\text{Average tax rate} = \frac{\$100{,}250}{\$300{,}000}$$

$$= 33.4167\%$$

If Eccentricity earned $1 more of taxable income, it would pay 39 cents (its tax rate of 39 percent) more in taxes. Thus, the firm's marginal tax rate is 39 percent.

AACSB: Analytical
Blooms: Apply
Difficulty: 1 Basic
Learning Objective: 02-03 Explain how taxes influence corporate managers' and investors' decisions.
Topic: Taxes

23. **Corporate Taxes** Swimmy, Inc. had $400,000 in 2010 taxable income. Using the tax schedule from Table 2-3, what is the company's 2010 income taxes, average tax rate, and marginal tax rate, respectively?

Table 2.3	Corporate Tax Rates as of 2012	
Taxable Income	Pay this Amount on Base Income	Plus this Percentage on Anything Over the Base
$0-$50,000	$0	15%
$50,001-$75,000	$7,500	25%
$75,001-$100,000	$13,750	34%
$100,001-$335,000	$22,250	39%
$335,001-$10,000,000	$113,900	34%
$10,000,001-$15,000,000	$3,400,000	35%
$15,000,001-$18,333,333	$5,150,000	38%
Over $18,333,333	$6,416,667	35%

A. $22,100, 5.53%, 34%
B. $113,900, 28.48%, 34%
C. $136,000, 34.00%, 34%
D. $136,000, 39.00%, 34%

From Table 2.3, the $400,000 of taxable income puts Swimmy in the 34 percent marginal tax bracket. Thus, Tax liability = Tax on base amount + Tax rate (amount over base): = $113,900 + .34 ($400,000 - $335,000) = $136,000
Note that the base amount is the maximum dollar value listed in the previous tax bracket. The *average* tax rate for Swimmy Inc. comes to:

$$\text{Average tax rate} = \frac{\$136{,}000}{\$400{,}000}$$

$$= 34\%$$

If Swimmy earned $1 more of taxable income, it would pay 34 cents (its tax rate of 34 percent) more in taxes. Thus, the firm's marginal tax rate is 34 percent.

AACSB: Analytical
Blooms: Apply
Difficulty: 1 Basic
Learning Objective: 02-03 Explain how taxes influence corporate managers' and investors' decisions.
Topic: Taxes

24. **Corporate Taxes** Scuba, Inc. is concerned about the taxes paid by the company in 2010. In addition to $5 million of taxable income, the firm received $80,000 of interest on state-issued bonds and $500,000 of dividends on common stock it owns in Boating Adventures, Inc. What is Scuba's tax liability, average tax rate, and marginal tax rate, respectively?
A. $1,637,100, 31.79%, 34%
B. $1,751,000, 34.00%, 34%
C. $1,870,000, 34.00%, 34%
D. $1,983,900, 36.07%, 34%

In this case, interest on the state-issued bonds is not taxable and should not be included in taxable income. Further, the first 70 percent of the dividends received from Boating Adventures is not taxable. Thus, only 30 percent of the dividends received are taxed, so:
Taxable income = $5,000,000 + (.3)$500,000 = $5,150,000
Now Scuba's tax liability will be: Tax liability = $113,900 + .34 ($5,150,000 - $335,000) = $1,751,000
The $500,000 of dividend income increased Scuba's tax liability by $51,000 (= (.3) x $500,000 x (.34)). Scuba's resulting average tax rate is now: Average tax rage = $1,751,000/$5,150,000 = 34.00%
Finally, if Scuba earned $1 more of taxable income, it would still pay 34 cents (based upon its marginal tax rate of 34 percent) more in taxes.

AACSB: Analytical
Blooms: Apply
Difficulty: 1 Basic
Learning Objective: 02-03 Explain how taxes influence corporate managers' and investors' decisions.
Topic: Taxes

25. **Statement of Cash Flows** Paige's Properties Inc. reported 2008 net income of $5 million and depreciation of $1,500,000. The top part Paige's Properties, Inc.'s 2007 and 2008 balance sheets is listed below (in millions of dollars).

Current assets:	2007	2008	Current liabilities:	2007	2008
Cash and marketable securities	$ 10	$ 20	Accrued wages and taxes	$ 5	$ 11
Accounts receivable	20	34	Accounts payable	25	29
Inventory	10	11	Notes payable	10	25
Total	$ 40	$ 65	Total	$ 40	$ 65

What is the 2008 net cash flow from operating activities for Paige's Properties, Inc.?
A. -$13,500,000
B. $1,500,000
C. $5,000,000
D. $6,500,000

Cash Flows from Operating Activities	
Net income	$ 5,000,000
Additions (sources of cash):	
Depreciation	1,500,000
Increase accrued wages and taxes	6,000,000
Increase in accounts payable	4,000,000
Subtractions (uses of cash):	
Increase in accounts receivable	-14,000,000
Increase in inventory	- 1,000,000
Net cash flow from operating activities:	$ 1,500,000

AACSB: Analytical
Blooms: Apply
Difficulty: 1 Basic
Learning Objective: 02-04 Differentiate between accounting income and cash flows.
Topic: Accounting Income and Cash Flows

26. **Statement of Cash Flows** In 2008, Upper Crust had cash flows from investing activities of ($250,000) and cash flows from financing activities of ($150,000). The balance in the firm's cash account was $90,000 at the beginning of 2008 and $105,000 at the end of the year. What was Upper Crust's cash flow from operations for 2008?

A. $15,000
B. $105,000
C. $400,000
<u>D.</u> $415,000

Net change in cash and marketable securities = $105,000 - $90,000 = $15,000

Cash Flows from Operating Activities	= $415,000
Cash Flows from Investing Activities	= - 250,000
Cash Flows from Financing Activities	= - <u>150,000</u>
Net Change in Cash and Marketable Securities	= $ 15,000

AACSB: Analytical
Blooms: Apply
Difficulty: 1 Basic
Learning Objective: 02-04 Differentiate between accounting income and cash flows.
Topic: Accounting Income and Cash Flows

27. **Statement of Cash Flows** In 2010, Lower Case Productions had cash flows from investing activities of +$50,000 and cash flows from financing activities of +$100,000. The balance in the firm's cash account was $80,000 at the beginning of 2010 and $65,000 at the end of the year. What was Lower Case's cash flow from operations for 2010?

A. $-15,000
B. $-150,000
C. $-165,000
D. $65,000

Net change in cash and marketable securities = $65,000 - $80,000 = $-15,000

Cash Flows from Operating Activities	= $-165,000
Cash Flows from Investing Activities	= +50,000
Cash Flows from Financing Activities	= + 100,000
Net Change in Cash and Marketable Securities	= $ -15,000

AACSB: Analytical
Blooms: Apply
Difficulty: 1 Basic
Learning Objective: 02-04 Differentiate between accounting income and cash flows.
Topic: Accounting Income and Cash Flows

28. **Free Cash Flow** You are considering an investment in Crew Cut, Inc. and want to evaluate the firm's free cash flow. From the income statement, you see that Crew Cut earned an EBIT of $23 million, paid taxes of $4 million, and its depreciation expense was $8 million. Crew Cut's gross fixed assets increased by $10 million from 2007 to 2008. The firm's current assets increased by $6 million and spontaneous current liabilities increased by $4 million. What is Crew Cut's operating cash flow, investment in operating capital and free cash flow for 2008, respectively in millions?

A. $23, $10, $13
B. $23, $12, $11
C. $27, $10, $17
D. $27, $12, $15

Crew Cut's operating cash flow was:

$$\text{OCF} = \text{EBIT} - \text{Taxes} + \text{Depreciation}$$
$$= (\$23\text{m.} - \$4\text{m} + \$8\text{m}) = \$27\text{m}$$

Investment in operating capital for 2008 was:

$$\text{IOC} = \Delta\text{Gross fixed assets} + \Delta\text{Net operating working capital}$$
$$= \$10\text{m.} + (\$6\text{m.} - \$4\text{m.}) = \$12\text{ m.}$$

Accordingly, Crew Cut's free cash flow for 2008 was:

$$\text{FCF} = \text{Operating cash flow} - \text{Investment in operating capital}$$
$$= \$27\text{m.} - \$12\text{m.} = \$15\text{m.}$$

In other words, in 2008, Crew Cut had cash flows of $15 million available to pay its stockholders and debt holders.

AACSB: Analytical
Blooms: Apply
Difficulty: 1 Basic
Learning Objective: 02-05 Demonstrate how to use a firm's financial statements to calculate its cash flows.
Topic: Calculating Cash Flows

29. **Free Cash Flow** You are considering an investment in Cruise, Inc. and want to evaluate the firm's free cash flow. From the income statement, you see that Cruise earned an EBIT of $202 million, paid taxes of $51 million, and its depreciation expense was $75 million. Cruise's gross fixed assets increased by $70 million from 2007 to 2008. The firm's current assets decreased by $10 million and spontaneous current liabilities increased by $6 million. What is Cruise's operating cash flow, investment in operating capital, and free cash flow for 2008, respectively, in millions?

A. $202, $70, $130
B. $226, $70, $156
C. $226, $54, $172
D. $226, $74, $152

Cruise's operating cash flow was:

$$\text{OCF} = \text{EBIT} - \text{Taxes} + \text{Depreciation}$$
$$= (\$202\text{m.} - \$51\text{m} + \$75\text{m}) = \$226\text{m}$$

Investment in operating capital for 2008 was:

$$\text{IOC} = \Delta\text{Gross fixed assets} + \Delta\text{Net operating working capital}$$
$$= \$70\text{m.} + (\$\text{-}10\text{m.} - \$6\text{m.}) = \$54\text{m.}$$

Accordingly, Cruise's free cash flow for 2008 was:

$$\text{FCF} = \text{Operating cash flow} - \text{Investment in operating capital}$$
$$= \$226\text{m.} - \$54\text{m.} = \$172\text{m.}$$

In other words, in 2008, Cruise had cash flows of $172 million available to pay its stockholders and debt holders.

AACSB: Analytical
Blooms: Apply
Difficulty: 1 Basic
Learning Objective: 02-05 Demonstrate how to use a firm's financial statements to calculate its cash flows.
Topic: Calculating Cash Flows

30. **Free Cash Flow** Catering Corp. reported free cash flows for 2008 of $8 million and investment in operating capital of $2 million. Catering listed $1 million in depreciation expense and $2 million in taxes on its 2008 income statement. What was Catering's 2008 EBIT?
A. $7 million
B. $10 million
C. $11 million
D. $13 million

Catering's free cash flow for 2008 was:

FCF = Operating cash flow – Investment in operating capital

$8m. = Operating cash flow - $2m.

So, operating cash flow = $8m. + $2m. = $10m.

Catering's operating cash flow was:

OCF = EBIT – Taxes + Depreciation

$10m. = (EBIT – $2m. + $1m.)

So, EBIT = $10m. + $2m. - $1m. = $11m.

AACSB: Analytical
Blooms: Apply
Difficulty: 1 Basic
Learning Objective: 02-05 Demonstrate how to use a firm's financial statements to calculate its cash flows.
Topic: Calculating Cash Flows

31. **Statement of Retained Earnings** TriCycle, Corp. began the year 2008 with $25 million in retained earnings. The firm earned net income of $7 million in 2008 and paid $1 million to its preferred stockholders and $3 million to its common stockholders. What is the year-end 2008 balance in retained earnings for TriCycle?

A. $25 million

B. $28 million

C. $32 million

D. $36 million

The statement of retained earnings for 2008 is as follows:

		2008
Balance of Retained Earnings, December 31, 2007		$25m.
Plus: Net Income for 2008		7m.
Less: Cash Dividends Paid		
Preferred Stock	$1m.	
Common Stock	3m.	
Total Cash Dividends Paid		4m.
Balance of Retained Earnings, December 31, 2008		$ 28m.

AACSB: Analytical
Blooms: Apply
Difficulty: 1 Basic
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Topic: Understanding Financial Statements

32. **Statement of Retained Earnings** Night Scapes, Corp. began the year 2008 with $10 million in retained earnings. The firm suffered a net loss of $2 million in 2008 and yet paid $2 million to its preferred stockholders and $1 million to its common stockholders. What is the year-end 2008 balance in retained earnings for Night Scapes?

A. $5 million
B. $8 million
C. $9 million
D. $15 million

The statement of retained earnings for 2008 is as follows:

		2008
Balance of Retained Earnings, December 31, 2007		$10m.
Less: Net Loss for 2008		2 m.
Less: Cash Dividends Paid		
Preferred Stock	$2m.	
Common Stock	1m.	
Total Cash Dividends Paid		3m.
Balance of Retained Earnings, December 31, 2008		$ 5m.

AACSB: Analytical
Blooms: Apply
Difficulty: 1 Basic
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Topic: Understanding Financial Statements

33. **Statement of Retained Earnings** Use the following information to find dividends paid to common stockholders during 2008.

Balance of Retained Earnings, December 31, 2007		$ 52m.
Plus: Net Income for 2008		21m.
Less: Cash Dividends Paid		
Preferred Stock	$7m.	
Common Stock	10m.	
Total Cash Dividends Paid		17m.
Balance of Retained Earnings, December 31, 2008		$ 56m.

A. $3 million
B. $4 million
C. $10 million
D. $17 million

Total Cash Dividends Paid = $56m. - $21m. - $52m. = -$17m. Thus, common stock dividends paid = $17m. - $7m = $10m.

AACSB: Analytical
Blooms: Apply
Difficulty: 1 Basic
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Topic: Understanding Financial Statements

34. **Balance Sheet** Harvey's Hamburger Stand has total assets of $3 million of which $1 million are current assets. Cash makes up 20 percent of the current assets and accounts receivable makes up another 5 percent of current assets. Harvey's gross plant and equipment has a book value of $1.5 million and other long-term assets have a book value of $1 million. Using this information, what is the balance of inventory and the balance of depreciation on Harvey's Hamburger Stand's balance sheet?

A. $250,000, $500,000
B. $250,000, $1 million
C. $750,000, $500,000
D. $750,000, $1 million

Current assets:			
Cash and marketable Securities (.2 x $1)		$ 0.20	
Accounts receivable (.05 x $1)		0.05	
Inventory	step 1.	.75	($ 1- $0.2 - $0.05)
Total		$ 1.0	
Fixed assets:			
Gross plant and equipment		$ 1.5	
Less: Depreciation	step 4.	0.5	($1.5- $1.0)
Net plant and equipment	step 3.	$1.0	($2.0 - $1.0)
Other long-term assets		1.0	
Total	step 2.	$ 2.0	($3.0 - $1.0)
Total assets		$ 3.0	

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Topic: Understanding Financial Statements

35. **Balance Sheet** School Books, Inc. has total assets of $18 million of which $6 million are current assets. Cash makes up 10 percent of the current assets and accounts receivable makes up another 40 percent of current assets. School Books' gross plant and equipment has an original cost of $13 million and other long-term assets have a cost value of $2 million. Using this information, what are the balance of inventory and the balance of depreciation on School Books' balance sheet?

A. $3 million, $2 million
<u>B.</u> $3 million, $3 million
C. $2.4 million, $2 million
D. $2.4 million, $3 million

Current assets:			
Cash and marketable Securities (.10 x $6)		$ 0.6	
Accounts receivable (.40 x $6)		2.4	
Inventory	step 1.	3.0	($ 6- $0.6 - $3.0)
Total		$ 6.0	
Fixed assets:			
Gross plant and equipment		$ 13.0	
Less: Depreciation	step 4.	3.0	($13- $10)
Net plant and equipment	step 3.	$10.0	($12 - $2)
Other long-term assets		2.0	
Total	step 2.	$12.0	($18 - $6)
Total assets		$ 18.0	

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Topic: Understanding Financial Statements

36. **Balance Sheet** Ted's Taco Shop has total assets of $5 million. Forty percent of these assets are financed with debt of which $400,000 is current liabilities. The firm has no preferred stock but the balance in common stock and paid-in surplus is $1 million. Using this information what is the balance for long-term debt and retained earnings on Ted's Taco Shop's balance sheet?

A. $400,000, $1 million
B. $1.6 million, $2 million
C. $1.6 million, $3 million
D. $2 million, $3 million

Total current liabilities		$ .4
Long-term debt:	step 3.	$1.6 (= $2 - $.4)
Total debt:	step 2.	$2 (= .4 x $5)
Stockholders' equity:		
Preferred stock		$ 0
Common stock and paid-in surplus (2 million shares)		1
Retained earnings	step 5.	2 (= $3 - $1)
Total	step 4	$ 3 (= $5 - $2)
Total liabilities and equity	step 1.	$5 (= Total Assets)

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Topic: Understanding Financial Statements

37. **Balance Sheet** Hair Etc. has total assets of $15 million. Twenty percent of these assets are financed with debt of which $1 million is current liabilities. The firm has no preferred stock but the balance in common stock and paid-in surplus is $8 million. Using this information what is the balance for long-term debt and retained earnings on Hair Etc.'s balance sheet?
A. $1 million, $8 million
B. $2 million, $4 million
C. $2 million, $8 million
D. $3 million, $4 million

Total current liabilities		$ 1	
Long-term debt:	step 3.	$ 2	(= $3 - $1)
Total debt:	step 2.	$ 3	(= .2 x $15 m)
Stockholders' equity:			
Preferred stock		$ 0	
Common stock and paid-in surplus (2 million shares)		8	
Retained earnings	step 5.	4	(= $12 - $8)
Total	step 4	$12	(= $15 - $3)
Total liabilities and equity	step 1.	$15	(= Total Assets)

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Topic: Understanding Financial Statements

38. **Market Value versus Book Value** Acme Bricks balance sheet lists net fixed assets as $40 million. The fixed assets could currently be sold for $50 million. Acme's current balance sheet shows current liabilities of $15 million and net working capital of $12 million. If all the current accounts were liquidated today, the company would receive $77 million cash after paying $15 million in liabilities. What is the book value of Acme's assets today? What is the market value of these assets?
A. $12 million, $77 million
B. $27 million, $92 million
C. $40 million, $50 million
D. $67 million, $142 million

		Book value		Market value
Assets				
Current assets	step 1.	$27m.	step 3.	$92m.
Fixed assets		40m.		50m.
Total	step 2.	$67m.		$142m.

Step 1. Net working capital (book value) = Current assets (book value) - Current liabilities (book value)
= $12m. = Current assets (book value) - $15m. => Current assets (book value) = $12m. + $15m. = $27m.
Step 2. Total assets (book value) = $27m. + $40m. = $67m.
Step 3. Net working capital (market value) = Current assets (market value) - Current liabilities (market value)
= $77m. = Current assets (market value) - $15m. => Current assets (market value) = $77m. + $15m. = $92m.
Step 4. Total assets (market value) = $92m. + $50m. = $142m.

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-02 Differentiate between book (or accounting) value and market value.
Topic: Book vs. Market Value

39. **Market Value versus Book Value** Glo's Glasses balance sheet lists net fixed assets as $20 million. The fixed assets could currently be sold for $25 million. Glo's current balance sheet shows current liabilities of $7 million and net working capital of $3 million. If all the current accounts were liquidated today, the company would receive $9 million cash after paying $7 million in liabilities. What is the book value of Glo's assets today? What is the market value of these assets?
A. $10 million, $16 million
B. $10 million, $35 million
C. $30 million, $35 million
D. $30 million, $41 million

		Book value		Market value
Assets				
Current assets	step 1.	$10m.	step 3.	$16m.
Fixed assets		20m.		25m.
Total	step 2.	$30m.		$41m.

Step 1. Net working capital (book value) = Current assets (book value) - Current liabilities (book value)
= $3 m. = Current assets (book value) - $7m. => Current assets (book value) = $3m. + $7m. = $10m.
Step 2. Total assets (book value) = $10m. + $20m. = $30m.
Step 3. Net working capital (market value) = Current assets (market value) - Current liabilities (market value)
= $9m. = Current assets (market value) - $7m. => Current assets (market value) = $9m. + $7m. = $16m.
Step 4. Total assets (market value) = $16m. + $25m. = $41m.

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-02 Differentiate between book (or accounting) value and market value.
Topic: Book vs. Market Value

40. **Market Value versus Book Value** Rupert's Rims balance sheet lists net fixed assets as \$15 million. The fixed assets could currently be sold for \$17 million. Rupert's current balance sheet shows current liabilities of \$5 million and net working capital of \$3 million. If all the current accounts were liquidated today, the company would receive \$6 million cash after paying \$5 million in liabilities. What is the book value of Rupert's assets today? What is the market value of these assets?
A. \$8 million, \$23 million
B. \$23 million, \$25 million
C. \$23 million, \$28 million
D. \$31 million, \$28 million

		Book value		Market value
Assets				
Current assets	step 1.	\$ 8m.	step 3.	\$11m.
Fixed assets		15m.		17m.
Total	step 2.	\$23m.		\$28m.

Step 1. Net working capital (book value) = Current assets (book value) - Current liabilities (book value)
= \$3 m. = Current assets (book value) - \$5m. => Current assets (book value) = \$3m. + \$5m. = \$8m.
Step 2. Total assets (book value) = \$8m. + \$15m. = \$23m.
Step 3. Net working capital (market value) = Current assets (market value) - Current liabilities (market value)
= \$6m. = Current assets (market value) - \$5m. => Current assets (market value) = \$6m. + \$5m. = \$11m.
Step 4. Total assets (market value) = \$11m. + \$17m. = \$28m.

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-02 Differentiate between book (or accounting) value and market value.
Topic: Book vs. Market Value

41. **Debt versus Equity Financing** You are considering a stock investment in one of two firms (AllDebt, Inc. and AllEquity, Inc.), both of which operate in the same industry and have identical operating income of $600,000. AllDebt, Inc. finances its $1.2 million in assets with $1 million in debt (on which it pays 10 percent interest annually) and $.2 million in equity. AllEquity, Inc. finances its $1.2 million in assets with no debt and $1.2 million in equity. Both firms pay a tax rate of 30 percent on their taxable income. What are the asset funders' (the debt holders and stockholders') resulting return on assets for the two firms?

A. 29.17%, and 35%, respectively
B. 37.5%, and 35%, respectively
C. 37.5%, and 37.5%, respectively
D. 50%, and 50%, respectively

		AllDebt	AllEquity
Operating income		$ .6m.	$.6m.
Less: Interest	($1m. x .1)	.1m.	0m.
Taxable income		.5m.	.6m.
Less: Taxes (30%)		.15m.	.18m.
Net income		$.35m.	$.42m.
Income available for asset funders (= operating income - taxes)		$.45m.	$.42m.

Return on assets funders' investment $.45m/$1.2m = 37.50%
$.42m/$1.2m = 35.00%

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Topic: Understanding Financial Statements

42. **Debt versus Equity Financing** You are considering a stock investment in one of two firms (AllDebt, Inc. and AllEquity, Inc.), both of which operate in the same industry and have identical operating income of $3 million. AllDebt, Inc. finances its $6 million in assets with $5 million in debt (on which it pays 5 percent interest annually) and $1 million in equity. AllEquity, Inc. finances its $6 million in assets with no debt and $6 million in equity. Both firms pay a tax rate of 40 percent on their taxable income. What are the asset funders' (the debt holders and stockholders') resulting return on assets for the two firms?

A. 27.5%, and 30%, respectively
B. 31.67%, and 30%, respectively
C. 33%, and 30%, respectively
D. 50%, and 50%, respectively

		AllDebt	AllEquity
Operating income		$ 3m.	$ 3m.
Less: Interest	($5m. x .05)	.25m.	0m.
Taxable income		2.75m.	3m.
Less: Taxes (40%)		1.1m.	1.2m.
Net income		$1.65m.	$1.8m.
Income available for asset funders (= operating income - taxes)		$ 1.9m.	$1.8m.

Return on assets funders' investment $1.9m/$6m = 31.67%
$1.8m/$6m = 30.00%

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Topic: Understanding Financial Statements

43. **Debt versus Equity Financing** You are considering a stock investment in one of two firms (AllDebt, Inc. and AllEquity, Inc.), both of which operate in the same industry and have identical operating income of $400,000. AllDebt, Inc. finances its $800,000 in assets with $600,000 in debt (on which it pays 5 percent interest annually) and $200,000 in equity. AllEquity, Inc. finances its $800,000 in assets with no debt and $800,000 in equity. Both firms pay a tax rate of 30 percent on their taxable income. What are the asset funders' (the debt holders and stockholders') resulting return on assets for the two firms?

A. 32.375%, and 35.00%,respectively
B. 36.125%, and 35.00%, respectively
C. 46.25%, and 50%, respectively
D. 50%, and 50%, respectively

		AllDebt	AllEquity
Operating income		$ .4m.	$ .4m.
Less: Interest	($.6m. x .05)	.03m.	0m.
Taxable income		.37m.	.4m.
Less: Taxes (30%)		.111m.	.12m.
Net income		$.259m.	$.28m.
Income available for asset funders		$.289m.	$.28m.
(= operating income - taxes)			

Return on assets funders' investment $.289m/$.8m = 36.125%
$.28m/$.8m = 35.00%

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Topic: Understanding Financial Statements

44. **Income Statement** You have been given the following information for Fina's Furniture Corp.:
net sales = $25,500,000;
cost of goods sold = $10,250,000;
addition to retained earnings = $305,000;
dividends paid to preferred and common stockholders = $500,000;
interest expense = $2,000,000.
The firm's tax rate is 30 percent. What is the depreciation expense for Fina's Furniture Corp?

A. $12,100,000
B. $12,400,000
C. $14,100,000
D. $14,400,000

Net sales (all credit)		$25,500,000
Less: Cost of goods sold		10,250,000
Gross profits	step 4.	$15,250,000
Less: Depreciation	step 5.	$12,100,000
Earnings before interest and taxes (EBIT)	step 3.	$ 3,150,000
Less: Interest		2,000,000
Earnings before taxes (EBT)	step 2.	$1,150,000
Less: Taxes		
Net income	step 1.	$ 805,000
Less: Common and preferred stock dividends		$ 500,000
Addition to retained earnings		$ 305,000

Step 1. Net income = Common and preferred stock dividends + Addition to retained earnings =
$500,000 + $305,000 = $805,000
Step 2. EBT (1 - tax rate) = Net income => EBT = Net income/(1 - tax rate) = $805,000/(1 - .3) = $1,150,000
Step 3. EBIT - Interest = EBT => EBIT = EBT + Interest = $1,150,000 + $2,000,000 = $3,150,000
Step 4. Gross profits = Net sales - Cost of goods sold = $25,500,000 - 10,250,000 = $15,250,000
Step 5. Gross profits - Depreciation = EBIT => Depreciation = Gross profits - EBIT = $15,250,000 - $3,150,000 = $12,100,000

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Topic: Understanding Financial Statements

45. **Income Statement** You have been given the following information for Romeo's Rockers Corp.:
net sales = $5,200,000;
cost of goods sold = $2,100,000;
addition to retained earnings = $1,000,000;
dividends paid to preferred and common stockholders = $400,000;
interest expense = $200,000.
The firm's tax rate is 30 percent. What is the depreciation expense for Romeo's Rockers Corp.?
A. $900,000
B. $1,100,000
C. $1,500,000
D. $1,600,000

Net sales (all credit)		$5,200,000
Less: Cost of goods sold		2,100,000
Gross profits	step 4.	$3,100,000
Less: Depreciation	step 5.	$ 900,000
Earnings before interest and taxes (EBIT)	step 3.	$2,200,000
Less: Interest		200,000
Earnings before taxes (EBT)	step 2.	$2,000,000
Less: Taxes		
Net income	step 1.	$1,400,000
Less: Common and preferred stock dividends		$ 400,000
Addition to retained earnings		$1,000,000

Step 1. Net income = Common and preferred stock dividends + Addition to retained earnings =
$400,000 + $1,000,000 = $1,400,000
Step 2. EBT (1 - tax rate) = Net income => EBT = Net income/(1 - tax rate) = $1,400,000/(1 - .3) = $2,000,000
Step 3. EBIT - Interest = EBT => EBIT = EBT + Interest = $2,000,000 + $200,000 = $2,200,000
Step 4. Gross profits = Net sales - Cost of goods sold = $5,200,000 - 2,100,000 = $3,100,000
Step 5. Gross profits - Depreciation = EBIT => Depreciation = Gross profits - EBIT = $3,100,000 - $2,200,000 = $900,000

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Topic: Understanding Financial Statements

46. **Income Statement** You have been given the following information for Nicole's Neckties Corp.:
net sales = $2,500,000;
cost of goods sold = $1,300,000;
addition to retained earnings = $30,000;
dividends paid to preferred and common stockholders = $300,000;
interest expense = $50,000.
The firm's tax rate is 40 percent. What is the depreciation expense for Nicole's Neckties Corp.?
A. $550,000
B. $600,000
C. $650,000
D. $820,000

Net sales (all credit)		$ 2,500,000
Less: Cost of goods sold		1,300,000
Gross profits	step 4.	$ 1,200,000
Less: Depreciation	step 5.	$ 600,000
Earnings before interest and taxes (EBIT)	step 3.	$ 600,000
Less: Interest		50,000
Earnings before taxes (EBT)	step 2.	$ 550,000
Less: Taxes		
Net income	step 1.	$ 330,000
Less: Common and preferred stock dividends		$ 300,000
Addition to retained earnings		$ 30,000

Step 1. Net income = Common and preferred stock dividends + Addition to retained earnings = $300,000 + $30,000 = $330,000
Step 2. EBT (1 - tax rate) = Net income => EBT = Net income/(1 - tax rate) = $330,000/(1 - .4) = $550,000
Step 3. EBIT - Interest = EBT => EBIT = EBT + Interest = $550,000 + $50,000 = $600,000
Step 4. Gross profits = Net sales - Cost of goods sold = $2,500,000 - 1,300,000 = $1,200,000
Step 5. Gross profits - Depreciation = EBIT => Depreciation = Gross profits - EBIT = $1,200,000 - $600,000 = $600,000

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Topic: Understanding Financial Statements

47. **Income Statement** You have been given the following information for Sherry's Sandwich Corp.:
net sales = $300,000;
gross profit = $100,000;
addition to retained earnings = $30,000;
dividends paid to preferred and common stockholders = $8,500;
depreciation expense = $25,000.
The firm's tax rate is 30 percent. What are the cost of goods sold and the interest expense for Sherry's Sandwich Corp.?
A. $20,000, and $200,000, respectively
B. $100,000, and $20,000, respectively
C. $200,000, and $20,000, respectively
D. $200,000, and $36,500, respectively

Net sales (all credit)		$300,000
Less: Cost of goods sold	step 3.	200,000
Gross profits		$100,000
Less: Depreciation		$ 25,000
Earnings before interest and taxes (EBIT)	step 4.	$ 75,000
Less: Interest	step 5.	20,000
Earnings before taxes (EBT)	step 2.	$ 55,000
Less: Taxes		
Net income	step 1.	$ 38,500
Less: Common and preferred stock dividends		$ 8,500
Addition to retained earnings		$30,000

Step 1. Net income = Common and preferred stock dividends + Addition to retained earnings = \$8,500 + \$30,000 = \$38,500
Step 2. EBT (1 - tax rate) = Net income => EBT = Net income/(1 - tax rate) = \$38,500/(1 - .3) = \$55,000
Step 3. Gross profits = Net sales - Cost of goods sold =>Net Sales - Gross Profit = Cost of Goods Sold \$300,000 - 100,000 = \$200,000
Step 4. Gross profits - Depreciation = EBIT = \$100,000 - \$25,000 = \$75,000
Step 5. EBIT - Interest = EBT => Interest = EBIT - EBT = \$75,000 - \$55,000 = \$20,000

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Topic: Understanding Financial Statements

48. **Income Statement** You have been given the following information for Kaye's Krumpet Corp.:
net sales = $150,000;
gross profit = $100,000;
addition to retained earnings = $20,000;
dividends paid to preferred and common stockholders = $8,000;
depreciation expense = $50,000.
The firm's tax rate is 30 percent. What are the cost of goods sold and the interest expense for Kaye's Krumpet Corp.?
A. $10,000, and $50,000, respectively
B. $50,000, and $10,000, respectively
C. $50,000, and $22,000, respectively
D. $62,000, and $10,000, respectively

Net sales (all credit)		$150,000
Less: Cost of goods sold	step 3.	50,000
Gross profits		$100,000
Less: Depreciation		$50,000
Earnings before interest and taxes (EBIT)	step 4.	$ 50,000
Less: Interest	step 5.	10,000
Earnings before taxes (EBT)	step 2.	$ 40,000
Less: Taxes		
Net income	step 1.	$ 28,000
Less: Common and preferred stock dividends		$ 8,000
Addition to retained earnings		$20,000

Step 1. Net income = Common and preferred stock dividends + Addition to retained earnings = $8,000 + $20,000 = $28,000
Step 2. EBT (1 - tax rate) = Net income => EBT = Net income/(1 - tax rate) = $28,000/(1 - .3) = $40,000
Step 3. Gross profits = Net sales - Cost of goods sold =>Net Sales - Gross Profit = Cost of Goods Sold $150,000 - 50,000 = $50,000
Step 4. Gross profits - Depreciation = EBIT = $100,000 - $50,000 = $50,000
Step 5. EBIT - Interest = EBT => Interest = EBIT - EBT = $50,000 - $40,000 = $10,000

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Topic: Understanding Financial Statements

49. **Income Statement** You have been given the following information for Ross's Rocket Corp.:
net sales = $1,000,000;
gross profit = $400,000;
addition to retained earnings = $60,000;
dividends paid to preferred and common stockholders = $90,000;
depreciation expense = $50,000.
The firm's tax rate is 40 percent. What are the cost of goods sold and the interest expense for Ross's Rocket Corp.?
A. $100,000, and $600,000, respectively
B. $600,000, and $100,000, respectively
C. $600,000, and $200,000, respectively
D. $700,000, and $100,000, respectively

Step 1. Net income = Common and preferred stock dividends + Addition to retained earnings =
$90,000 + $60,000 = $150,000
Step 2. EBT (1 - tax rate) = Net income => EBT = Net income/(1 - tax rate) = $150,000/(1 - .4) = $250,000
Step 3. Gross profits = Net sales - Cost of goods sold =>Net Sales - Gross Profit = Cost of Goods Sold $1,000,000 - 400,000 = $600,000
Step 4. Gross profits - Depreciation = EBIT = $400,000 - $50,000 = $350,000
Step 5. EBIT - Interest = EBT => Interest = EBIT - EBT = $350,000 - $250,000 = $100,000

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Topic: Understanding Financial Statements

50. **Corporate Taxes** The Carolina Corporation had a 2010 taxable income of $3,000,000 from operations after all operating costs but before

(1) interest charges of $500,000,
(2) dividends received of $75,000,
(3) dividends paid of $1,000,000, and
(4) income taxes.

Using the tax schedule in Table 2.3, what is Carolina's income tax liability?
What are Carolina's average and marginal tax rates on taxable income from operations?
A. $857,650, 28.59%, 34%, respectively
B. $875,500, 29.18%, 34%, respectively
C. $875,500, 34.00%, 34%, respectively
D. $1,020,000, 34.00%, 34%, respectively

The first 70 percent of the dividends received by Carolina Corp. is not taxable. Thus, only 30 percent of the dividends received are taxed, so:
Taxable income = $3,000,000 - $500,000 + (.3)$75,000 = $2,522,500
Now Carolina's Corp.'s tax liability will be:
Tax liability = $113,900 + .34 ($2,522,500 - $335,000) = $857,650
Carolina Corp.'s resulting average tax rate is now:
Average tax rate = $857650/$3,000,000 = 28.59%
Finally, if Carolina Corp earned $1 more of taxable income, it would still pay 34 cents (based upon its marginal tax rate of 34 percent) more in taxes.

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-03 Explain how taxes influence corporate managers' and investors' decisions.
Topic: Taxes

51. **Corporate Taxes** The Ohio Corporation had a 2010 taxable income of $50,000,000 from operations after all operating costs but before

(1) interest charges of $500,000,
(2) dividends received of $45,000,
(3) dividends paid of $10,000,000, and
(4) income taxes.

Using the tax schedule in Table 2.3, what is Ohio's income tax liability?
What are Ohio's average and marginal tax rates on taxable income from operations?
A. $6,416,667, 12.83%, 35%, respectively
B. $13,829,725, 27.66%, 35%, respectively
C. $17,329,725, 34.66%, 35%, respectively
D. $17,340,750, 34.68%, 35%, respectively

The first 70 percent of the dividends received by Ohio Corp. is not taxable. Thus, only 30 percent of the dividends received are taxed, so:
Taxable income = $50,000,000 - $500,000 + (.3)$45,000 = $49,513,500
Now Ohio's Corp.'s tax liability will be:
Tax liability = $6,416,667 + .35 ($49,513,500 - $18,333,333) = $17,329,725
Ohio Corp.'s resulting average tax rate is now:
Average tax rate = $17,329,725.45/$50,000,000 = 34.66%
Finally, if Ohio Corp earned $1 more of taxable income, it would still pay 35 cents (based upon its marginal tax rate of 35 percent) more in taxes.

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-03 Explain how taxes influence corporate managers' and investors' decisions.
Topic: Taxes

52. **Corporate Taxes** The Sasnak Corporation had a 2010 taxable income of $4,450,000 from operations after all operating costs but before

(1) interest charges of $750,000,
(2) dividends received of $900,000,
(3) dividends paid of $500,000, and
(4) income taxes.

Using the tax schedule in Table 2.3, what is Sasnak's income tax liability?
What are Sasnak's average and marginal tax rates on taxable income from operations?
A. $1,349,800, 30.33%, 34%, respectively
B. $1,349,800, 34.00%, 34%, respectively
C. $1,564,000, 34.00%, 34%, respectively
D. $1,564,000, 35.15%, 34%, respectively

The first 70 percent of the dividends received by Sasnak Corp. is not taxable. Thus, only 30 percent of the dividends received are taxed, so:
Taxable income = $4,450,000 - $750,000 + (.3)$900,000 = $3,970,000
Now Sasnak's Corp.'s tax liability will be:
Tax liability = $113,900 + .34 ($3,970,000 - $335,000) = $1,349,800
Sasnak Corp.'s resulting average tax rate is now:
Average tax rate = $1,349,800/$4,450,000 = 30.33%
Finally, if Sasnak Corp. earned $1 more of taxable income, it would still pay 34 cents (based upon its marginal tax rate of 34 percent) more in taxes.

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-03 Explain how taxes influence corporate managers' and investors' decisions.
Topic: Taxes

53. **Corporate Taxes** The AOK Corporation had a 2008 taxable income of $2,200,000 from operations after all operating costs but before

(1) interest charges of $90,000,
(2) dividends received of $750,000,
(3) dividends paid of $80,000, and
(4) income taxes.

Using the tax schedule in Table 2.3, what is AOK's income tax liability?
What are AOK's average and marginal tax rates on taxable income from operations?
A. $793,900, 34%, 34%, respectively
B. $793,900, 36.0864%, 34%, respectively
C. $972,400, 34%, 34%, respectively
D. $972,400, 44.2%, 34%, respectively

The first 70 percent of the dividends received by AOK Corp. is not taxable. Thus, only 30 percent of the dividends received are taxed, so:
Taxable income = $2,200,000 - $90,000 + (.3)$750,000 = $2,335,000
Now AOK's Corp.'s tax liability will be:
Tax liability = $113,900 + .34 ($2,335,000 - $335,000) = $793,900
AOK Corp.'s resulting average tax rate is now:
Average tax rate = $793,900/$2,200,000 = 36.0864%
Finally, if AOK Corp. earned $1 more of taxable income, it would still pay 34 cents (based upon its marginal tax rate of 34 percent) more in taxes.

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-03 Explain how taxes influence corporate managers' and investors' decisions.
Topic: Taxes

54. **Corporate Taxes** Suppose that in addition to the $5.5 million of taxable income from operations, Emily's Flowers, Inc. received $500,000 of interest on state-issued bonds and $300,000 of dividends on common stock it owns in Amy's Iris Bulbs, Inc.
Using the tax schedule in Table 2.3 what is Emily's Flowers' income tax liability?
What are Emily's Flowers' average and marginal tax rates on total taxable income?
A. $1,900,600, 34%, 34%, respectively
B. $1,972,000, 34%, 34%, respectively
C. $2,070,600, 34%, 34%, respectively
D. $2,142,000, 34%, 34%, respectively

Interest on the state-issued bonds is not taxable and should not be included in taxable income. Further, the first 70 percent of the dividends received from Amy's is not taxable. Thus, only 30 percent of the dividends received are taxed, so:
Taxable income = $5,500,000 + (.3)$300,000 = $5,590,000
Now Emily's tax liability will be:
Tax liability = $113,900 + .34 ($5,590,000 - $335,000) = $1,900,600
Emily's resulting average tax rate is now:
Average tax rate = $1,900,600/$5,590,000 = 34%
Finally, if Emily earned $1 more of taxable income, it would still pay 34 cents (based upon its marginal tax rate of 34 percent) more in taxes.

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-03 Explain how taxes influence corporate managers' and investors' decisions.
Topic: Taxes

55. **Corporate Taxes** Suppose that in addition to the $300,000 of taxable income from operations, Liam's Burgers, Inc. received $25,000 of interest on state-issued bonds and $50,000 of dividends on common stock it owns in Sodas, Inc.
Using the tax schedule in Table 2.3 what is Liam's income tax liability?
What are Liam's average and marginal tax rates on **total** taxable income?
A. $106,100, 33.68%, 39%, respectively
B. $122,850, 39.00%, 39%, respectively
C. $129,500, 34.53%, 39%, respectively
D. $139,250, 37.13%, 39%, respectively

Interest on the state-issued bonds is not taxable and should not be included in taxable income. Further, the first 70 percent of the dividends received from Soda's is not taxable. Thus, only 30 percent of the dividends received are taxed, so:
Taxable income = $300,000 + (.3)$50,000 = $315,000
Now Liam's tax liability will be:
Tax liability = $22,250 + .39 ($315,000 - $100,000) = $106,100
Liam's resulting average tax rate is now:
Average tax rate = $106,100/$315,000 = 33.68%
Finally, if Liam earned $1 more of taxable income, it would still pay 39 cents (based upon its marginal tax rate of 39 percent) more in taxes.

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-03 Explain how taxes influence corporate managers' and investors' decisions.
Topic: Taxes

56. **Statement of Cash Flows** Fina's Faucets, Inc. has net cash flows from operating activities for the last year of $17 million. The income statement shows that net income is $15 million and depreciation expense is $6 million. During the year, the change in inventory on the balance sheet was an increase of $4 million, change in accrued wages and taxes was an increase of $1 million and change in accounts payable was an increase of $1 million. At the beginning of the year the balance of accounts receivable was $5 million. What was the end of year balance for accounts receivable?

A. $2 million
B. $3 million
C. $7 million
D. $9 million

Thus, end of year balance of accounts receivable = $5m. + $2m. = $7m.

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-05 Demonstrate how to use a firm's financial statements to calculate its cash flows.
Topic: Calculating Cash Flows

57. **Statement of Cash Flows** Zoe's Dog Biscuits, Inc. has net cash flows from operating activities for the last year of $226 million. The income statement shows that net income is $150 million and depreciation expense is $85 million. During the year, the change in inventory on the balance sheet was an increase of $14 million, change in accrued wages and taxes was an increase of $15 million and change in accounts payable was an increase of $10 million. At the beginning of the year the balance of accounts receivable was $45 million. What was the end of year balance for accounts receivable?

A. $20 million
B. $25 million
C. $45 million
D. $65 million

Thus, end of year balance of accounts receivable = $45m. + $20m. = $65m.

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-05 Demonstrate how to use a firm's financial statements to calculate its cash flows.
Topic: Calculating Cash Flows

58. **Statement of Cash Flows** Nickolas's Nut Farms, Inc. has net cash flows from operating activities for the last year of $25 million. The income statement shows that net income is $15 million and depreciation expense is $6 million. During the year, the change in inventory on the balance sheet was a decrease of $4 million, change in accrued wages and taxes was a decrease of $1 million and change in accounts payable was a decrease of $1 million. At the beginning of the year the balance of accounts receivable was $5 million. What was the end of year balance for accounts receivable?

A. $2 million
B. $3 million
C. $7 million
D. $9 million

Thus, end of year balance of accounts receivable = $5m. - $2m. = $3m.

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-05 Demonstrate how to use a firm's financial statements to calculate its cash flows.
Topic: Calculating Cash Flows

59. **Statement of Cash Flows** Crispy Corporation has net cash flow from financing activities for the last year of $20 million. The company paid $5 million in dividends last year. During the year, the change in notes payable on the balance sheet was an increase of $2 million, and change in common and preferred stock was an increase of $3 million. The end of year balance for long-term debt was $45 million. What was their beginning of year balance for long-term debt?

A. $15 million
B. $20 million
C. $25 million
D. $35 million

Thus, beginning of year balance for long-term debt = $45 - $20m = $25m.

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-05 Demonstrate how to use a firm's financial statements to calculate its cash flows.
Topic: Calculating Cash Flows

60. **Statement of Cash Flows** Full Moon Productions Inc. has net cash flow from financing activities for the last year of $105 million. The company paid $15 million in dividends last year. During the year, the change in notes payable on the balance sheet was an increase of $40 million, and change in common and preferred stock was an increase of $50 million. The end of year balance for long-term debt was $50 million. What was their beginning of year balance for long-term debt?

A. $5 million
B. $20 million
C. $30 million
D. $35 million

Thus, beginning of year balance for long-term debt = $50 - $30m = $20m.

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-05 Demonstrate how to use a firm's financial statements to calculate its cash flows.
Topic: Calculating Cash Flows

61. **Statement of Cash Flows** Café Creations Inc. has net cash flow from financing activities for the last year of $25 million. The company paid $15 million in dividends last year. During the year, the change in notes payable on the balance sheet was a decrease of $40 million, and change in common and preferred stock was an increase of $50 million. The end of year balance for long-term debt was $40 million. What was their beginning of year balance for long-term debt?

A. $10 million
B. $20 million
C. $30 million
D. $40 million

Thus, beginning of year balance for long-term debt = $40 - $30m = $10m.

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-05 Demonstrate how to use a firm's financial statements to calculate its cash flows.
Topic: Calculating Cash Flows

62. **Free Cash Flow** The 2010 income statement for Pete's Pumpkins shows that depreciation expense is $250 million, EBIT is $500 million, EBT is $320 million, and the tax rate is 30 percent. At the beginning of the year, the balance of gross fixed assets was $1,600 million and net operating working capital was $640 million. At the end of the year gross fixed assets was $2,000 million. Pete's free cash flow for the year was $630 million. What is their end of year balance for net operating working capital?

A. $24 million
B. $264 million
C. $654 million
D. $1,064 million

Taxes = $320m. x (.3) = $96m. => Pete's operating cash flow was: OCF = EBIT - Taxes + Depreciation = ($500m. - $96m. + $250m.) = $654m.
Pete's free cash flow for 2010 was: FCF = Operating cash flow - Investment in operating capital $630m. = $654m. - Investment in operating capital => Investment in operating capital = $654m. - $630m. = $24m.
Accordingly, investment in operating capital for 2010 was: IOC = ΔGross fixed assets + ΔNet operating working capital $24m. = ($2,000m. - $1,600m.) + (Ending net operating working capital - $640m.) => Ending net operating working capital = $24m. - ($2,000m. - $1,600m.) + $640 m. = $264m.

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-05 Demonstrate how to use a firm's financial statements to calculate its cash flows.
Topic: Calculating Cash Flows

63. **Free Cash Flow** The 2010 income statement for Lou's Shoes shows that depreciation expense is $2 million, EBIT is $5 million, EBT is $3 million, and the tax rate is 40 percent. At the beginning of the year, the balance of gross fixed assets was $16 million and net operating working capital was $6 million. At the end of the year gross fixed assets was $20 million. Lou's free cash flow for the year was $4 million. What is their end of year balance for net operating working capital?

A. $1.8 million
B. $3.8 million
C. $5.8 million
D. $12.2 million

Taxes = $3m. x (.4) = $1.2m. =>
Lou's operating cash flow was:
OCF = EBIT - Taxes + Depreciation
= ($5m. - $1.2m. + $2m.) = $5.8m.
Lou's free cash flow for 2010 was:
FCF = Operating cash flow - Investment in operating capital
$4m. = $5.8m. - Investment in operating capital
=> Investment in operating capital = $5.8m. - $4m. = $1.8m.
Accordingly, investment in operating capital for 2010 was:
IOC = ΔGross fixed assets + ΔNet operating working capital
$1.8m. = ($20m. - $16m.) + (Ending net operating working capital - $6m.)
=> Ending net operating working capital = $1.8m. - ($20m. - $16m.) + $6m. = $3.8m.

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-05 Demonstrate how to use a firm's financial statements to calculate its cash flows.
Topic: Calculating Cash Flows

64. **Free Cash Flow** The 2010 income statement for Paige's Purses shows that depreciation expense is $10 million, EBIT is $25 million, EBT is $15 million, and the tax rate is 30 percent. At the beginning of the year, the balance of gross fixed assets was $80 million and net operating working capital was $30 million. At the end of the year gross fixed assets was $100 million. Paige's free cash flow for the year was $20 million. What is their end of year balance for net operating working capital?

A. $10.5 million
B. $14 million
C. $20.5 million
D. $30.5 million

Taxes = $15m. x (.3) = $4.5m. =>
Paige's operating cash flow was:
OCF = EBIT - Taxes + Depreciation
= ($25m. - $4.5m. + $10m.) = $30.5m.
Paige's free cash flow for 2010 was:
FCF = Operating cash flow - Investment in operating capital
$20m. = $30.5m. - Investment in operating capital
=> Investment in operating capital = $30.5m. - $20m. =$10.5m.
Accordingly, investment in operating capital for 2010 was:
IOC = ΔGross fixed assets + ΔNet operating working capital
$10.5m. = ($100m. - $80m.) + (Ending net operating working capital - $30m.)
=> Ending net operating working capital = $10.5m. - ($100m. - $80m.) + 30m. = $20.5m.

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-05 Demonstrate how to use a firm's financial statements to calculate its cash flows.
Topic: Calculating Cash Flows

65. **Free Cash Flow** The 2010 income statement for Betty's Barstools shows that depreciation expense is \$100 million, EBIT is \$400 million, and taxes are \$120 million. At the end of the year, the balance of gross fixed assets was \$510 million. The increase in net operating working capital during the year was \$94 million. Betty's free cash flow for the year was \$625 million. What was the beginning of year balance for gross fixed assets?
A. \$359 million
B. \$380 million
C. \$849 million
D. \$1,094 million

Betty's operating cash flow was:
OCF = EBIT - Taxes + Depreciation
= (\$400m. - \$120m + \$100m) = \$380m.
Betty's free cash flow for 2010 was:
FCF = Operating cash flow - Investment in operating capital
\$625m. = \$380m. - Investment in operating capital
= > Investment in operating capital = \$380m. - \$625m. = \$-245m.
Accordingly, investment in operating capital for 2010 was:
IOC = ΔGross fixed assets + ΔNet operating working capital
\$-245m. = (\$510m. - Beginning of year gross fixed assets) + \$94m.
=> Beginning of year gross fixed assets = 510m. - (\$-245m). + \$94m. = \$849m.

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-05 Demonstrate how to use a firm's financial statements to calculate its cash flows.
Topic: Calculating Cash Flows

66. **Free Cash Flow** The 2010 income statement for John's Gym shows that depreciation expense is $20 million, EBIT is $80 million, and taxes are $24 million. At the end of the year, the balance of gross fixed assets was $102 million. The increase in net operating working capital during the year was $18 million. John's free cash flow for the year was $41 million. What was the beginning of year balance for gross fixed assets?

A. $43 million
B. $85 million
C. $84 million
D. $163 million

John's operating cash flow was:
OCF = EBIT - Taxes + Depreciation
= ($80m. - $24m + $20m) = $76m.
John's free cash flow for 2010 was:
FCF = Operating cash flow - Investment in operating capital
$41m. = $76m. - Investment in operating capital
= > Investment in operating capital = $76m. - $41m. = $35m.
Accordingly, investment in operating capital for 2010 was:
IOC = ΔGross fixed assets + ΔNet operating working capital
$35m. = ($102m. - Beginning of year gross fixed assets) + $18m.
=> Beginning of year gross fixed assets = 102m. - $35m + $18m. = $85m.

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-05 Demonstrate how to use a firm's financial statements to calculate its cash flows.
Topic: Calculating Cash Flows

67. **Statement of Retained Earnings** Bike and Hike, Inc. started the year with a balance of retained earnings of $100 million and ended the year with retained earnings of $128 million. The company paid dividends of $9 million to the preferred stock holders and $22 million to common stock holders. What was Bike and Hike's net income for the year?

A. $28 million
B. $31 million
C. $59 million
D. $128 million

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Topic: Understanding Financial Statements

68. **Statement of Retained Earnings** Soccer Starz, Inc. started the year with a balance of retained earnings of $25 million and ended the year with retained earnings of $32 million. The company paid dividends of $2 million to the preferred stock holders and $6 million to common stock holders. What was Soccer Starz's net income for the year?
A. $7 million
B. $15 million
C. $40 million
D. $49 million

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Topic: Understanding Financial Statements

69. **Statement of Retained Earnings** Jamaican Ice Cream Corp. started the year with a balance of retained earnings of $100 million. The company reported net income for the year of $45 million, paid dividends of $2 million to the preferred stock holders and $15 million to common stock holders. What is Jamaican Ice Cream's end of year balance in retained earnings?

A. $38 million
B. $55 million
<u>C.</u> $128 million
D. $162 million

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Topic: Understanding Financial Statements

70. **Income Statement** Listed below is the 2008 income statement for Lamps, Inc.

The CEO of Lamps wants the company to earn a net income of $12 million in 2009. Cost of goods sold is expected to be 75 percent of net sales, depreciation expense is not expected to change, interest expense is expected to increase to $4 million, and the firm's tax rate will be 40 percent. What is the net sales needed to produce net income of $12 million?

A. $29 million
B. $112 million
C. $116 million
D. $124 million

Step 1. EBT (1 - t) = Net income = $12m = EBT (1 - .4) => EBT = $12m./(1 - .4) = $20m.
Step 2. EBIT = EBT + Interest = $20m. + $4m. = $24m.
Step 3. Gross profits = EBIT + Depreciation = $24m. + $5m. = $29m
Step 4. Net sales = Gross profits/(1 - Cost of goods sold percent) = $29m./(1. - .75) = $116m.
Step 5. Cost of goods sold = Sales - Gross profits = $116m. - $29 = $87m.

AACSB: Analytical
Blooms: Apply
Difficulty: 3 Advanced
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Topic: Understanding Financial Statements

71. **Income Statement** You have been given the following information for Halle's Holiday Store Corp. for the year 2008:
net sales = $50,000,000;
cost of goods sold = $35,000,000;
addition to retained earnings = $2,000,000;
dividends paid to preferred and common stockholders = $3,000,000;
interest expense = $3,000,000.
The firm's tax rate is 30 percent.
In 2009, net sales are expected to increase by $5 million,
cost of goods sold is expected to be 65 percent of net sales,
expensed depreciation is expected to be the same as in 2008,
interest expense is expected to be $2,500,000,
the tax rate is expected to be 30 percent of EBT, and
dividends paid to preferred and common stockholders will not change.
What is the addition to retained earnings expected in 2009?
A. $2,000,000
B. $5,325,000
C. $8,447,500
D. $10,304,643

AACSB: Analytical
Blooms: Apply
Difficulty: 3 Advanced
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Topic: Understanding Financial Statements

72. **Free Cash Flow** Martha's Moving Van 4U, Inc. had free cash flow during 2008 of $1 million, EBIT of $30 million, tax expense of $8 million, and depreciation of $4 million. Using this information, what was Martha's Accounts Payable ending balance in 2008?
A. $5 million
B. $15 million
C. $35 million
D. $45 million

Martha's operating cash flow for 2011 was:
OCF = EBIT - Taxes + Depreciation = ($30m. - $8m. + $4m.) = $26m.
Martha's free cash flow was:
FCF = Operating cash flow - Investment in operating capital
$1m. = $26m. - Investment in operating capital
So, Investment in operating capital = $26m. - $1m. = $25m.
IOC = ΔGross fixed assets + ΔNet operating working capital
$25m. = ($40m. - $30m.) + ΔNet operating working capital
=> ΔNet operating working capital = $25m. - ($40m. - $30m.) = $15m.
ΔNet operating working capital = $15m. = ΔCurrent assets - ΔCurrent liabilities
$15m. = ($130m. - $110m.) - ΔCurrent liabilities
=> ΔCurrent liabilities = ($130m. - $110m.) - $15m. = $5m.
=> 2011 Current liabilities = $85m. + $5m. = $90m.
and 2011 Current liabilities = Accrued wages and taxes + Accounts payable + Notes payable
$90m. = $20m. + Accounts payable + $35m.
=> Accounts payable = $908m. - $20m. - $35m. = $35m.

Martha's Moving Van 4U, Inc.
Balance Sheet as of December 31, 2007 and 2008
(in millions of dollars)

	2007	2008		2007	2008
Assets			**Liabilities & Equity**		
Current assets:			Current liabilities :		
Cash and marketable securities	$ 10	$ 15	Accrued wages and taxes	$ 10	$20
Accounts receivable	20	25	Accounts payable	40	$35m.
Inventory	80	90	Notes payable	30	35
Total	$110	$130	Total	$ 85	$90m.
Fixed assets:			Long-term debt:	$ 20	$25
Gross plant and equipment	$ 30	$40	Stockholders' equity:		
Less: Depreciation	10	12	Preferred stock (5 million shares)	$ 5	$ 5
Net plant and equipment	$ 20	$28	Common stock and paid-in surplus (20 million shares)	10	10
Other long-term assets	30	30	Retained earnings	40	58
Total	$ 50	$58	Total	$55	$73
Total assets	$160	$188	Total liabilities and equity	$160	$188

AACSB: Analytical
Blooms: Apply
Difficulty: 3 Advanced
Learning Objective: 02-05 Demonstrate how to use a firm's financial statements to calculate its cash flows.
Topic: Calculating Cash Flows

73. You are evaluating the balance sheet for Goodman's Bees Corporation. From the balance sheet you find the following balances: Cash and marketable securities = $200,000, Accounts receivable = $1,100,000, Inventory = $2,000,000, Accrued wages and taxes = $500,000, Accounts payable = $600,000, and Notes payable = $100,000. Calculate Goodman's Bees' net working capital.
A. $2,000,000
B. $2,100,000
C. $1,400,000
D. $1,900,000

(.2M + 1.1M + 2.0M) - (.5M + .6M + .1M) = 2.1M

AACSB: Analytical
Blooms: Apply
Difficulty: 1 Basic
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Source: 2 - 1
Topic: Understanding Financial Statements

74. Zoeckler Mowing & Landscaping's year-end 2011 balance sheet lists current assets of $350,000, fixed assets of $325,000, current liabilities of $145,000, and long-term debt of $185,000. Calculate Zoeckler's total stockholders' equity.
A. $115,000
B. $490,000
C. $345,000
D. $500,000

[.350 + .325] - [.145 + .185] = .345M

AACSB: Analytical
Blooms: Apply
Difficulty: 1 Basic
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Source: 2 - 2
Topic: Understanding Financial Statements

75. Reed's Birdie Shot, Inc.'s 2011 income statement lists the following income and expenses: EBIT = $550,000, Interest expense = $43,000, and Net income = $300,000. Calculate the 2011 Taxes reported on the income statement.
A. $85,000
B. $107,000
C. $309,000
D. $207,000

[.550M - .043M] - .3M = .207M

AACSB: Analytical
Blooms: Apply
Difficulty: 1 Basic
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Source: 2 - 3
Topic: Understanding Financial Statements

76. Reed's Birdie Shot, Inc.'s 2010 income statement lists the following income and expenses: EBIT = $555,000, Interest expense = $178,000, and Taxes = $148,000. Reed's has no preferred stock outstanding and 100,000 shares of common stock outstanding. Calculate the 2010 earnings per share.
A. $3.49
B. $2.29
C. $3.14
D. $2.79

[.555M - .178M - .148M]/.1M = $2.29

AACSB: Analytical
Blooms: Apply
Difficulty: 1 Basic
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Source: 2 - 4
Topic: Understanding Financial Statements

77. Oakdale Fashions Inc. had $255,000 in 2011 taxable income. If the firm paid $82,100 in taxes, what is the firm's average tax rate?
A. 34.70%
B. 32.20%
C. 29.90%
D. 28.20%

82100/255000 = 32.20%

AACSB: Analytical
Blooms: Apply
Difficulty: 1 Basic
Learning Objective: 02-03 Explain how taxes influence corporate managers' and investors' decisions.
Source: 2 - 5
Topic: Taxes

78. Hunt Taxidermy, Inc. is concerned about the taxes paid by the company in 2011. In addition to $36.5 million of taxable income, the firm received $1,250,000 of interest on state-issued bonds and $400,000 of dividends on common stock it owns in Hunt Taxidermy, Inc. Calculate Hunt Taxidermy's taxable income.
A. $40,250,000
B. $38,150,000
C. $36,900,000
D. $36,620,000

$36.5M + (.3).4M = 36.620M

AACSB: Analytical
Blooms: Apply
Difficulty: 1 Basic
Learning Objective: 02-03 Explain how taxes influence corporate managers' and investors' decisions.
Source: 2 - 6
Topic: Taxes

79. Ramakrishnan Inc. reported 2008 net income of $20 million and depreciation of $1,500,000. The top part of Ramakrishnan, Inc.'s 2007 and 2008 balance sheets is listed below (in millions of dollars).

Current assets:	2007	2008	Current liabilities:	2007	2008
Cash and marketable securities	$ 15	$ 20	Accrued wages and taxes	$ 18	$ 20
Accounts receivable	75	84	Accounts payable	45	50
Inventory	110	121	Notes payable	40	45
Total	**$200**	**$225**	Total	**$103**	**$115**

Calculate the 2008 net cash flow from operating activities for Ramakrishnan, Inc.

A. $12,500,000
B. $10,500,000
C. $8,500,000
D. $7,100,000

20 + [1.5 + 2 + 5] - [9 + 11] = $8.5M

AACSB: Analytical
Blooms: Apply
Difficulty: 1 Basic
Learning Objective: 02-04 Differentiate between accounting income and cash flows.
Source: 2 - 7
Topic: Accounting Income and Cash Flows

80. In 2011, Usher Sports Shop had cash flows from investing activities of ($2,150,000) and cash flows from financing activities of ($3,219,000). The balance in the firm's cash account was $980,000 at the beginning of 2011 and $1,025,000 at the end of the year. Calculate Usher Sports Shop's cash flow from operations for 2011.
A. $6,219,000
B. $5,414,000
C. $4,970,000
D. $5,980,000

[1,025,000 - 980,000] = X - 2,150,000 - 3,219,000; = > X = Cash flow from operations = $5,414,000

AACSB: Analytical
Blooms: Apply
Difficulty: 1 Basic
Learning Objective: 02-04 Differentiate between accounting income and cash flows.
Source: 2 - 8
Topic: Accounting Income and Cash Flows

81. You are considering an investment in Fields and Struthers, Inc. and want to evaluate the firm's free cash flow. From the income statement, you see that Fields and Struthers earned an EBIT of $52 million, paid taxes of $10 million, and its depreciation expense was $5 million. Fields and Struthers' gross fixed assets increased by $38 million from 2010 to 2011. The firm's current assets increased by $20 million and spontaneous current liabilities increased by $12 million. Calculate Fields and Struthers' operating cash flow (OCF), investment in operating capital (IOC) and free cash flow (FCF) for 2011.
A. OCF = $42,000,000; IOC = $37,000,000; FCF = $5,000,000
B. OCF = $47,000,000; IOC = $37,000,000; FCF = $10,000,000
C. OCF = $42,000,000; IOC = $46,000,000; FCF = -$4,000,000
D. OCF = $47,000,000; IOC = $46,000,000; FCF = $1,000,000

OCF = EBIT - Taxes + Depreciation = ($52M - $10M + $5M) = $47M
Investment in operating capital: ΔGross fixed assets + ΔNet operating working capital = $38M + ($20M - $12M) = $46M Accordingly, Fields and Struthers' free cash flow for 2008 was: FCF = Operating cash flow - Investment in operating capital = $47M - $46M = $1M

AACSB: Analytical
Blooms: Apply
Difficulty: 1 Basic
Learning Objective: 02-05 Demonstrate how to use a firm's financial statements to calculate its cash flows.
Source: 2 - 9
Topic: Calculating Cash Flows

82. Tater and Pepper Corp. reported free cash flows for 2010 of $20 million and investment in operating capital of $15 million. Tater and Pepper listed $8 million in depreciation expense and $12 million in taxes on its 2010 income statement. Calculate Tater and Pepper's 2010 EBIT.
A. $49,000,000
B. $42,000,000
C. $39,000,000
D. $47,000,000

FCF = Operating cash flow - Investment in operating capital; $20M = X - $15M; X = $35M
OCF = EBIT - Taxes + Depreciation; $35M = (EBIT - $12M + $8M); EBIT = $39M

AACSB: Analytical
Blooms: Apply
Difficulty: 1 Basic
Learning Objective: 02-05 Demonstrate how to use a firm's financial statements to calculate its cash flows.
Source: 2 - 10
Topic: Calculating Cash Flows

83. Mr. Husker's Tuxedos, Corp. began the year 2011 with $205 million in retained earnings. The firm earned net income of $30 million in 2011 and paid $5 million to its preferred stockholders and $12 million to its common stockholders. What is the year-end 2011 balance in retained earnings for Mr. Husker's Tuxedos?
A. $193,000,000
B. $200,000,000
C. $213,000,000
D. $218,000,000

$205M + $30M - $5m - $12M = $218M

AACSB: Analytical
Blooms: Apply
Difficulty: 1 Basic
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Source: 2 - 11
Topic: Understanding Financial Statements

84. Brenda's Bar and Grill has total assets of $17 million of which $5 million are current assets. Cash makes up 12 percent of the current assets and accounts receivable makes up another 40 percent of current assets. Brenda's gross plant and equipment has a cost value of $12 million and other long-term assets have a cost value of $1,000,000. Using this information, what is the balance of inventory and the balance of depreciation on Brenda's Bar and Grill's balance sheet?

A. $2.4 million; $1 million
B. $3.4 million; $2 million
C. $1.4 million; $1 million
D. $0.4 million; $3 million

Step 1: Find Inventory: CA = 5 = Cash + A/R + Inv = .12 * 5 + .40 * 5 + Inv; = > Inv = $2.4M; Step 2: Find Depreciation Expense: TA = CA + FA - Accumulated Depreciation.; 17 = 5 + (12 + 1) - Accumulated Depreciation.; = > Accumulated Depreciation = $1M

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Source: 2 - 13
Topic: Understanding Financial Statements

85. Ed's Tobacco Shop has total assets of $100 million. Fifty percent of these assets are financed with debt of which $37 million is current liabilities. The firm has no preferred stock but the balance in common stock and paid-in surplus is $32 million. Using this information what is the balance for long-term debt and retained earnings on Ed's Tobacco Shop's balance sheet?

A. $18 million; $27 million
B. $12 million; $12 million
C. $14 million; $29 million
D. $13 million; $18 million

Step1: Find long-term debt: TL = CL + long-term debt = .5 * 100 = 50 = 37 + long-term debt; long-term debt = $13 million; Step2: Find RE: Total equity = .5 * 100 = 50 = CS + P - I-S + RE = 32 + RE; RE = $18 million

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Source: 2 - 14
Topic: Understanding Financial Statements

86. Muffin's Masonry, Inc.'s balance sheet lists net fixed assets as $16 million. The fixed assets could currently be sold for $17 million. Muffin's current balance sheet shows current liabilities of $5.5 million and net working capital of $6.5 million. If all the current accounts were liquidated today, the company would receive $10.25 million cash after paying $5.5 million in liabilities. What is the book value of Muffin's Masonry's assets today? What is the market value of these assets?

A. Book Value: $28M; Market Value: $32.75M
B. Book Value: $32M; Market Value: $42.25M
C. Book Value: $32M; Market Value: $32.75M
D. Book Value: $28M; Market Value: $42.25M

Step 1. Find CA (book value): = CA - CL = NWC; = > CA (book value) = 6.5M + 5.5M = $12M
Step 2. Find TA (book value): TA = Net FA + CA = $16M + $12M. = $28M.
Step 3.Find CA (market value): NWC (market) + CL = $10.25 + $5.5M = $15.75M
Step 4. Find TA (market value): Net FA + CA = $17M + $15.75M = $32.75M

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-02 Differentiate between book (or accounting) value and market value.
Source: 2 - 15
Topic: Book vs. Market Value

87. You have been given the following information for Corky's Bedding Corp.:
Net sales = $15,250,000;
Cost of goods sold = $5,750,000;
Addition to retained earnings = $4,000,000;
Dividends paid to preferred and common stockholders = $995,000;
Interest expense = $1,150,000.
The firm's tax rate is 30 percent. Calculate the depreciation expense for Corky's Bedding Corp.

A. $1,210,000
B. $1,970,000
C. $1,520,000
D. $1,725,000

Step 1: NI = Dividends + Addition to RE = 4M + .995M = $4.995M
Step 2: NI = EBT (1 - tax rate) = > EBT = NI/(1 - tax rate) = $4.995M/(1 - .30) = $7.14M
Step 3: EBIT - Interest = EBT = > EBIT = $7.14M + $1.15M = $8.29M
Step 4: Gross profits = Net sales - COGS = $15.25M - $5.75M = $9.5M
Step 5: Gross profits - Depreciation = EBIT = > Depreciation = $9.5M - $8.29M = $1.21M

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Source: 2 - 17
Topic: Understanding Financial Statements

88. Dogs 4 U Corporation has net cash flow from financing activities for the last year of $10 million. The company paid $8 million in dividends last year. During the year, the change in notes payable on the balance was $9 million, and change in common and preferred stock was $0 million. The end of year balance for long-term debt was $44 million. Calculate the beginning of year balance for long-term debt.
A. $37 million
B. $34 million
C. $33 million
D. $35 million

$10 = $9 - $8 - $0 + Change in long-term debt; = > change in long-term debt = $9 = Ending Bal - Change in long-term debt; = > Beg balance of long-term debt = $35

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-05 Demonstrate how to use a firm's financial statements to calculate its cash flows.
Source: 2 - 24
Topic: Calculating Cash Flows

89. The 2011 income statement for Duffy's Pest Control shows that depreciation expense is $180 million, EBIT is $420 million, EBT is $240 million, and the tax rate is 30 percent. At the beginning of the year, the balance of gross fixed assets was $1,500 million and net operating working capital was $500 million. At the end of the year gross fixed assets was $1,803 million. Duffy's free cash flow for the year was $425 million. Calculate the end of year balance for net operating working capital.
A. $403 million
B. $300 million
C. $203 million
D. $103 million

Step 1: Find OCF: OCF = $420 - ($240 * .3) + $180 = $528; Step 2: Find Investment in operating capital: FCF = $425 = $528 - Investment in Op Cap; Investment in operating capital = $103; Step 3: Find Ending level of net op. working cap: $103 = ($1803 - $1500) + (Ending net op. working capital - $500); Ending net op. working capital = $300

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-05 Demonstrate how to use a firm's financial statements to calculate its cash flows.
Source: 2 - 25
Topic: Calculating Cash Flows

90. The CEO of Tom and Sue's wants the company to earn a net income of $3.25 million in 2010. Cost of goods sold is expected to be 60 percent of net sales, depreciation expense is $2.9 million, interest expense is expected to increase to $1.050 million, and the firm's tax rate will be 30 percent. Calculate the net sales needed to produce net income of $3.25 million.
A. $26.02 million
B. $29.36 million
C. $21.48 million
D. $28.25 million

Work backwards (up) the income statement: EBT = 3.25/1 - .3 = $4.64M; EBIT = $4.64M + $1.05M = $5.69M; Gross Profits = $5.69M + $2.9 = $8.59M; Net sales = $8.59/(1 - .6) = $21.475M

AACSB: Analytical
Blooms: Apply
Difficulty: 3 Advanced
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Source: 2 - 29
Topic: Understanding Financial Statements

91. All of the following would be a result of changing to the MACRS method of depreciation except _______.
A. Higher depreciation expense
B. Lower taxes in the early years of a project's life
C. Lower taxable income in the early years of a project's life
D. All of these.

AACSB: Analytical
Blooms: Understand
Difficulty: 1 Basic
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Source: NEW
Topic: Understanding Financial Statements

92. Which of the following is NOT a source of cash?
A. The firm reduces its inventory.
B. The firm pays off some of its long-term debt.
C. The firm has positive net income.
D. The firm sells more common stock.

AACSB: Analytical
Blooms: Analyze
Difficulty: 2 Intermediate
Learning Objective: 02-05 Demonstrate how to use a firm's financial statements to calculate its cash flows.
Source: NEW
Topic: Calculating Cash Flows

93. Which of the following is a use of cash?
A. The firm takes its depreciation expense.
B. The firm sells some of its fixed assets.
C. The firm issues more long-term debt.
D. The firm decreases its accrued wages and taxes.

AACSB: Analytical
Blooms: Analyze
Difficulty: 2 Intermediate
Learning Objective: 02-05 Demonstrate how to use a firm's financial statements to calculate its cash flows.
Source: NEW
Topic: Calculating Cash Flows

94. Is it possible for a firm to have positive net income and yet to have cash flow problems?
A. No, this is impossible since net income increases the firm's cash.
B. Yes, this can occur when a firm is growing very rapidly.
C. Yes, this is possible if the firm window-dressed its financial statements.
D. No, this is impossible since net income and cash are highly correlated.

AACSB: Analytical
Blooms: Understand
Difficulty: 1 Basic
Learning Objective: 02-04 Differentiate between accounting income and cash flows.
Source: NEW
Topic: Accounting Income and Cash Flows

95. All of the following are cash flows from operations except _____________.
A. Increases or decreases in cash
B. Net Income
C. Depreciation
D. Increases or decreases in accounts payable

AACSB: Analytical
Blooms: Understand
Difficulty: 2 Intermediate
Learning Objective: 02-05 Demonstrate how to use a firm's financial statements to calculate its cash flows.
Source: NEW
Topic: Calculating Cash Flows

96. All of the following are cash flows from financing except a(n) _________.
A. Increase in accounts payable
B. Issuing stock
C. Stock repurchases
D. Paying dividends

AACSB: Analytical
Blooms: Understand
Difficulty: 2 Intermediate
Learning Objective: 02-05 Demonstrate how to use a firm's financial statements to calculate its cash flows.
Source: NEW
Topic: Calculating Cash Flows

97. Cash flows available to pay the firm's stockholders and debt holders after the firm has made the necessary working capital investments, fixed asset investments, and developed the necessary new products to sustain the firm's ongoing operations is referred to as _________________.
A. Operating cash flow
B. Net operating working capital
C. Free cash flow
D. None of these.

AACSB: Analytical
Blooms: Understand
Difficulty: 2 Intermediate
Learning Objective: 02-05 Demonstrate how to use a firm's financial statements to calculate its cash flows.
Source: NEW
Topic: Calculating Cash Flows

98. Investment in operating capital is ___________________________.
A. The change in assets plus the change in current liabilities
B. The change in gross fixed assets plus depreciation
C. The change in gross fixed assets plus the change in free cash flow
D. None of these.

AACSB: Analytical
Blooms: Understand
Difficulty: 2 Intermediate
Learning Objective: 02-05 Demonstrate how to use a firm's financial statements to calculate its cash flows.
Source: NEW
Topic: Calculating Cash Flows

99. A firm had EBIT of $1,000, paid taxes of $225, expensed depreciation at $13, and its gross fixed assets increased by $25. What was the firm's operating cash flow?
A. $763
B. $737
C. $813
D. $788

$1,000 - $225 + $13 = $788

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-05 Demonstrate how to use a firm's financial statements to calculate its cash flows.
Source: NEW
Topic: Calculating Cash Flows

100. Which of the following is an example of a capital structure?
A. 15% current assets and 85% fixed assets
B. 10% current liabilities and 90% long-term debt
C. 20% debt and 80% equity
D. None of these.

AACSB: Analytical
Blooms: Understand
Difficulty: 2 Intermediate
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Source: NEW
Topic: Understanding Financial Statements

101. Lemmon Inc. lists fixed assets of $100 on its balance sheet. The firm's fixed assets have recently been appraised at $140. The firm's balance sheet also lists current assets at $15. Current assets were appraised at $16.5. Current liabilities book and market values stand at $12 and the firm's long-term debt is $40. Calculate the market value of the firm's stockholders' equity.
A. $156.5
B. $112.50
C. $104.50
D. $144.50

[$140 + $16.5] - $12 - $40 = $104.5

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Source: NEW
Topic: Understanding Financial Statements

102. A firm has operating income of $1,000, depreciation expense of $185 and its investment in operating capital is $400. The firm is 100% equity financed and has a 35% tax rate. What is the firm's operating cash flow?
A. $725
B. $795
C. $835
D. $965

[$1000 - $350 + $185] = $835

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-02 Differentiate between book (or accounting) value and market value.
Source: NEW
Topic: Book vs. Market Value

103. All of the following are reasons that one should be cautious in interpreting financial statements except ____________.

A. Firms can take steps to over- or understate earnings at various times.

B. It is difficult to compare two firms that use different depreciation methods.

C. Financial managers have quite a bit of latitude in using accounting rules to manage their reported earnings.

D. All of these are reasons to be cautious in interpreting financial statements.

AACSB: Analytical
Blooms: Understand
Difficulty: 2 Intermediate
Learning Objective: 02-06 Observe cautions that should be taken when examining financial statements.
Source: NEW
Topic: Financial Statement Cautions

104. Which of the following statements is correct?

A. The bottom line on the statement of cash flows equals the change in the retained earnings on the balance sheet.

B. The reason the statement of cash flows is important is because cash is what pays the firm's obligations, not accounting profit.

C. If a firm has accounting profit, its cash account will always increase.

D. All of these statements are correct.

AACSB: Analytical
Blooms: Understand
Difficulty: 2 Intermediate
Learning Objective: 02-04 Differentiate between accounting income and cash flows.
Source: NEW
Topic: Accounting Income and Cash Flows

105. ABC Inc. has $100 in cash on its balance at the end of 2009. During 2010, the firm issued $450 in common stock, reduced its notes payable by $40, purchased fixed assets in the amount of $750 and had cash flows from operating activities of $315. How much cash did ABC Inc. have on its balance sheet at the end of 2010?

A. $75
B. $140
C. $225
D. -$25

100 + 315 - 40 - 750 + 450 = $75

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-03 Explain how taxes influence corporate managers' and investors' decisions.
Source: NEW
Topic: Taxes

106. LLV Inc. originally forecasted the following financial data for next year: Sales = $1,000, Cost of goods sold = $675 and Interest expense = $90. The firm believes that COGS will always be 67.5% of sales. Due to increased global demand, the firm is now projecting that sales will be 20% higher than the original forecast. What is the *additional* net income (as compared to the original forecast) the firm can expect assuming a 35% tax rate?

A. $59.45
B. $195.00
C. $42.25
D. $74.00

Step 1: Original forecasted NI = [(1,000 - 675) - 90](1 - .35) = 152.75; Step 2: NI under increase in sales = [(1,200 - (.675 * 1,200) - 90](1 - .35) = 195; Additional NI = 195 - 152.75 = 42.25

AACSB: Analytical
Blooms: Apply
Difficulty: 3 Advanced
Learning Objective: 02-02 Differentiate between book (or accounting) value and market value.
Source: NEW
Topic: Book vs. Market Value

107. LLV Inc. originally forecasted the following financial data for next year: Sales = $1,000, Cost of goods sold = $710 and Interest expense = $95. The firm believes that COGS will always be 71% of sales. Due to pressure from shareholders, the firm wants to achieve a net income of $150. Assuming the interest expense will remain the same, how large must sales be to achieve this goal? Assume a 35% tax rate.
A. $1,403.82
B. $1,3009.18
C. $1,123.34
D. $1,296.51

150/(1 - .35) = EBT = 230.77; EBT + Int Exp = EBIT = 325.77; EBIT/(1 - .71) = Sales = 1,123.34

AACSB: Analytical
Blooms: Apply
Difficulty: 3 Advanced
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Source: NEW
Topic: Understanding Financial Statements

108. A firm has sales of $690, EBIT of $300, depreciation of $40 and fixed assets increased by $265. If the firm's tax rate is 40% and there were no increases in net operating working capital, what is the firm's free cash flow?
A. $15
B. $75
C. -$45
D. -$55

[300 - (300 * .4) + 40] -265 = FCF = -$45

AACSB: Analytical
Blooms: Apply
Difficulty: 2 Intermediate
Learning Objective: 02-05 Demonstrate how to use a firm's financial statements to calculate its cash flows.
Source: NEW
Topic: Calculating Cash Flows

109. GW Inc. had $800 million in retained earnings at the beginning of the year. During the year, the firm paid $.75 per share dividend and generated $1.92 earnings per share. The firm has 100 million shares outstanding. At the end of year, what was the level of retained earnings for GW?

A. $725 million
B. $917 million
C. $882 million
D. $807 million

800M + [1.92 * 100M] - [0.75 * 100M] = $917M

AACSB: Analytical
Blooms: Apply
Difficulty: 3 Advanced
Learning Objective: 02-05 Demonstrate how to use a firm's financial statements to calculate its cash flows.
Source: NEW
Topic: Calculating Cash Flows

Essay Questions

110. LG 5 2-21 **Statement of Cash Flows** Use the balance sheet and income statement below to construct a statement of cash flows for Betty's Bakery Corp.

Betty's Bakery Corporation
Balance Sheet as of December 31, 2007 and 2008
(in millions of dollars)

Assets	**2007**	**2008**	**Liabilities & Equity**	**2007**	**2008**
Current assets:			Current liabilities:		
Cash and marketable securities	$ 12	$ 5	Accrued wages and taxes	$ 5	$ 4
Accounts receivable	21	15	Accounts payable	18	16
Inventory	25	30	Notes payable	35	30
Total	$ 58	$ 50	Total	$ 58	$ 50
Fixed assets:			Long-term debt:	$ 40	$ 45
Gross plant and equipment	$ 60	$ 80	Stockholders' equity:		
Less: Depreciation	10	15	Preferred stock (1 million shares)	$ 1	$ 1
Net plant and equipment	$ 50	$ 65	Common stock and paid-in surplus (4 million shares)	4	4
Other long-term assets	20	25	Retained earnings	25	40
Total	$ 70	$ 90	Total	$ 30	$ 45
Total assets	$128	$140	Total liabilities and equity	$128	$140

Betty's Bakery Corporation
Income Statement for Years Ending December 31, 2007 and 2008
(in millions of dollars)

	2007	2008
Net sales	$ 33	$ 40.5
Less: Cost of goods sold	8	11
Gross profits	25	29.5
Less: Depreciation	2	2
Earnings before interest and taxes (EBIT)	23	27.5
Less: Interest	1	1.5
Earnings before taxes (EBT)	22	26
Less: Taxes	9	10
Net income	$13	$16.
Less: Preferred stock dividends	$ 1	$ 1
Net income available to common stockholders	$12	$15
Less: Common stock dividends	$ 1	$ 2
Addition to retained earnings	$11	$13
Per (common) share data:		
Earnings per share (EPS)	$6.75	$4.00
Dividends per share (DPS)	$0.25	$0.50
Book value per share (BV)	$22.00	$23.75
Market value (price) per share (MV)	$24.00	$24.25

Statement of Cash Flows for Year Ending December 31, 2008
(in millions of dollars)

	2008
A. Cash Flows from Operating Activities	
Net income	$ 16
Additions (sources of cash):	
Depreciation	2
Decrease in accounts receivable	6
Subtractions (uses of cash):	
Decrease accrued wages and taxes	-1
Decrease in accounts payable	-2
Increase in inventory	-5
Net cash flow from operating activities:	$ 16
B. Cash Flows from Investing Activities	
Subtractions:	
Increase fixed assets	-$20
Increase in other long-term assets	0
Net cash flow from investing activities:	-$20
C. Cash Flows from Financing Activities	
Additions:	
Increase in long-term debt	$ 5
Increase in common and preferred stock	0
Subtractions:	
Decrease in notes payable	-5
Pay preferred stock dividends	-1
Pay common stock dividends	-2
Net cash flow from financing activities:	$-3
D. Net Change in Cash and Marketable Securities	**-$7**

AACSB: Analytical
Blooms: Apply
Difficulty: 3 Advanced
Learning Objective: 02-05 Demonstrate how to use a firm's financial statements to calculate its cash flows.
Topic: Calculating Cash Flows

111. When might earnings management become an ethical consideration?

Managers and financial analysts have recognized for years that firms use considerable latitude in using accounting rules to manage their reported earnings in a wide variety of contexts. Indeed, within the GAAP framework, firms can "smooth" earnings. That is, firms often take steps to over- or understate earnings at various times. Managers may choose to smooth earnings to show investors that firm assets are growing steadily. Similarly, one firm may be using straight line depreciation for its fixed assets, while another is using a modified accelerated cost recovery method (MACRS), which causes depreciation to accrue quickly. If the firm uses MACRS accounting methods, they write fixed asset values down quickly; assets will thus have lower book value than if the firm used straight line depreciation methods. This process of controlling a firm's earnings is called earnings management.
Ethical considerations:
Earnings management could become an ethical issue if managers started applying GAAP inconsistently throughout accounting periods in order to "manage" the financial reports given to outsiders and/or insiders. One example could be the smoothing mentioned above.

AACSB: Ethics
Blooms: Create
Blooms: Evaluate
Difficulty: 2 Intermediate
Learning Objective: 02-06 Observe cautions that should be taken when examining financial statements.
Topic: Financial Statement Cautions

112. How do taxes influence how corporate managers' and investors' structure transactions and capitalize their companies?

Many firms pay out much of their earnings in taxes. The focus on this chapter has been income taxes, but there are other taxes that a company must pay, too. Many companies will look for transactions with tax advantages. One such example would be to finance their company with debt versus equity. Interest payments are deductible from income taxes, whereas dividend payments are not.

AACSB: Reflective Thinking
Blooms: Create
Blooms: Evaluate
Difficulty: 2 Intermediate
Learning Objective: 02-03 Explain how taxes influence corporate managers' and investors' decisions.
Topic: Taxes

113. How would you explain to a friend why market value of a firm is more important to an investor than book value of the firm?

What assets can be sold (market value) for might differ than the historical costs that are reflected on the balance sheet. What the equity can be sold for (market value or price per share) might differ from the balances reflected in the stockholder equity section of the balance sheet. Financial managers and investors are often more concerned with the value of physical and financial assets in the market place and find those numbers more relevant than what is reported on the balance sheet.
Feed back: NOTE: (was an end of chapter question with a new twist)

AACSB: Reflective Thinking
Blooms: Understand
Difficulty: 2 Intermediate
Learning Objective: 02-02 Differentiate between book (or accounting) value and market value.
Topic: Book vs. Market Value

114. What are free cash flows for a firm? What does it mean when a firm's free cash flow is negative?

Free cash flows are the cash flows available to pay the firm's stockholders and debt holders after the firm has made the necessary working capital investments, fixed asset investments, and developed the necessary new products to sustain the firm's ongoing operations. If free cash flow is negative, the firm's operations produce no cash flows available for investors.

AACSB: Analytical
Blooms: Understand
Difficulty: 2 Intermediate
Learning Objective: 02-05 Demonstrate how to use a firm's financial statements to calculate its cash flows.
Source: NEW
Topic: Calculating Cash Flows

115. What are the costs and benefits of holding liquid securities on a firm's balance sheet?

The more liquid assets a firm holds, the less likely the firm will be to experience financial distress. However, liquid assets generate no profits for a firm. For example, cash is the most liquid of all assets, but it earns no return for the firm. In contrast, fixed assets are illiquid, but provide the means to generate revenue. Thus, managers must consider the trade-off between the advantages of liquidity on the balance sheet and the disadvantages of having money sit idle rather than generating profits.

AACSB: Analytical
Blooms: Understand
Difficulty: 1 Basic
Learning Objective: 02-01 Recall the major financial statements that firms must prepare and provide.
Source: NEW
Topic: Understanding Financial Statements