CHAPTER 2

CONCEPT REVIEW QUESTIONS

1. What roles do the IAS and SEC play?

The FASB is a nongovernmental, professional standards body that examines controversial accounting topics and then issues "rulings" that almost have the force of law, at least in terms of their impact on accounting practices. In the U.S. the FASB has developed the GAAP (Generally Accepted Accounting Principles) as the set of accounting rules for companies to comply with in the preparation of their financial statements. The Securities and Exchange Commission (SEC) is responsible for regulating publicly traded U.S. companies, as well as the nation's stock and bond markets. It monitors the compliance of publicly traded companies with the GAPP. The four key financial statements required by the SEC are (1) the balance sheet, (2) the income statement, (3) the statement of retained earnings, and (4) the statement of cash flows.

2. Are balance sheets and income statements prepared with the same purpoase in mind? How are these two statements different, and how are they related?

Balance sheets and income statements both are prepared for the purpose of providing financial information about a company at a point in time. A balance sheet provides a picture of the company's assets and liabilities, or net worth at a point in time, and sums all of the company's past earnings in the shareholder equity account. An income statement provides a picture of the company's revenues and expenses for a specified period of time. Both statements are very useful in analyzing the company's past and future.

3. Which statements are of greatest interest to creditors, and which would be of greatest interest to stockholders?

Creditors would most likely be interested in the balance sheet, which states how much in liabilities the company has, but they also would want to see an income statement, which tells the company's ability to meet its payment commitments. Shareholders will certainly be interested in the balance sheet and income statement, which will allow them to compute ratios for the company, in the statement of retained earnings which states how much their share of the company has increased or decreased and in the statement of cash flows, which describes where cash is coming into and going out of the company.

4. Why does the balance sheet have to balance?

Assets must equal liabilities.

5. How do depreciation and other noncash charges act as sources of cash inflow to the firm? Why does a depreciation allowance exist in the tax laws? For a profitable firm, is it better to depreciate an asset quickly or slowly for tax purposes? Explain.

Depreciation and other non-cash charges are sources of cash to the firm. These charges are subtracted from the firm's revenues, decreasing cash flow in order to get a correct estimate of taxes owed. They need to be added back to compute an accurate cash flow. These charges are not real cash flows – no dollars exchange hands when a company takes a depreciation expense – and are only subtracted because they reduce the company's tax bill, and taxes are a real dollar cash flow. The tax code does not allow a company to expense its capital equipment in the year it was purchased. It requires company's to charge this expense over the lifetime of the equipment, taking a percentage of the total cost each year. For a profitable firm, it is better to depreciate assets as quickly as possible. The larger the depreciation expense, the lower the taxable income and the lower the taxes owed.

6. What is *operating cash flow (OCF)?* What is *free cash flow (FCF),* and how is it related to *OCF?*

Operating cash flow is earnings before interest or taxes minus taxes and plus depreciation. Free cash flow is operating cash flow (revenues minus operating costs, depreciation and taxes, with depreciation added back in) minus change in fixed assets minus change in working capital (current assets minus operating current liabilities, accounts payable and accruals). Free cash flow takes operating cash flow and subtracts any short term and long term capital investments needed to support operating cash flow.

7. Why is the financial manager likely to have great interest in the firm's *statement of cash flows*? What type of information can be obtained from this statement?

The financial manager is very interested in the statement of cash flows because cash flows are the lifeblood of the firm. A firm that does not have sufficient cash flow to meet its obligations will soon get into financial difficulty. Cash flows are also used in valuation of the firm. The firm wants to maximize cash flows in order to maximize firm value.

8. Which of the categories and individual ratios described in this chapter would be of greatest interest to each of the following parties?

a. Existing and prospective creditors (lenders)
b. Existing and prospective shareholders
c. The firm's managementa.

a. Existing and prospective lenders would be most interested in liquidity ratios (how much in liquid assets the firm has to pay its bills) and debt ratios (how much of a commitment the firm has overall to debt).
b. Existing and prospective shareholders will be interested in most ratios. In particular, they will want to know the activity ratios (how efficiently the company is using its assets), profitability ratios and market ratios.

c. The firm's management should be interested in all ratios, identifying the firm's strengths and weaknesses and looking at how to continue the strengths and improve the weak areas.

9. How could the availability of cash inflow and cash outflow data be used to improve on the accuracy of the liquidity and debt coverage ratios presented previously? What specific ratio measures would you calculate to assess the firm's liquidity and debt coverage, using cash flow rather than financial statement data?

Cash inflow and outflow data can be used to improve liquidity ratios. For example, times interest earned is earnings before interest and taxes divided by interest. If cash flow were used instead, it could provide a more accurate measure of how much cash the firm had available to pay its interest expense. Debt ratios could be calculated using market value numbers rather than book value numbers, as the share price represents the discounted value of all future cash flows to the company.

10. Assume that a firm's total assets and sales remain constant. Would an increase in each of the ratios below be associated with a cash inflow or a cash outflow?

a. Current ratio
b. Inventory turnover
c. Average collection period
d. Average payment period
e. Debt ratio
f. Net profit margin

a. cash inflow
b. cash inflow – decrease in inventory
c. cash outflow – increase in AR
d. cash inflow – increase in AP, decrease in inventory
e. no effect on cash
f. no effect on cash

11. Use the *DuPont system* to explain why a slower-than-average inventory turnover could cause a firm with an above-average net profit margin and an average degree of financial leverage to have a below-average return on common equity.

In order to evaluate the impact of the different ratios on the company's ROE, we need to decompose the ROE by means of the DuPont system. ROE = Profit margin * Asset turnover * Equity multiplier. If the company has an above-average net profit margin and an average leverage, the only way that the company can have a below-average ROE is for its asset turnover to be lower (slower) than the industry average.

12. How can you reconcile investor expectations for a firm with an above-average M/B ratio and a below-average P/E ratio? Could the age of the firm have any effect on this ratio comparison?

Since the M/B ratio compares market and book values, it is possible that the ratio is high not so much due to high market price as due to a low book value. The M/B ratio shows how investors view the company's past and how they project it to the company's future. Therefore, a high M/B and a low P/E do not necessarily mean that there is a discrepancy in the investors' expectations. It may be explained by the fact that since investors do not expect the company to perform well in the future, they are willing to pay less for its earnings thus bringing the P/E ratio down. In the same time, however, if the company has existed for a long time it may have initially sold its shares at a low for the current period value. Therefore, a low value of common stock on the company's books combined with decreasing retained earnings, leads to a high M/B ratio due to the small denominator of the ratio.