QUESTIONS:

1. Which of the following is not one of the three basic financial statements required by Generally Accepted Accounting Principles (GAAP)?
   A. Income Statement
   B. Statement of Retained Earnings
   C. Statement of Cash Flows
   D. Balance Sheet

2. Which of the following would not be classified as a current asset?
   A. Marketable securities
   B. Investments
   C. Prepaid expenses
   D. Inventory

3. An item that may be converted to cash within one year or one operating cycle of the firm is classified as a
   A. current liability.
   B. long-term asset.
   C. current asset.
   D. long-term liability.

4. Which of the following is not a primary source of capital to the firm?
   A. assets
   B. common stock
   C. preferred stock
   D. bonds

5. The residual income of the firm belongs to
A. creditors.
B. preferred shareholders.
C. common shareholders.
D. bondholders.

6. The best indication of the operational efficiency of management is

A. net income.
B. earnings per share.
C. earnings before interest and taxes (EBIT).
D. gross profit.

7. Which account represents the cumulative earnings of the firm since its formation, minus dividends paid?

A. Share price
B. Common stock
C. Retained earnings
D. Accumulated amortization

8. A firm has $3,500,000 in its common stock account and $2,500,000 in its retained earnings account. The firm issued 100,000 shares of common stock. What was the original issue price if only one stock issue has ever been sold?

A. $35 per share
B. $25 per share
C. $60 per share
D. Not enough information to tell

9. A firm has $2,000,000 in its common stock account and $20,000,000 in its retained earnings account. The firm issued 500,000 shares of common stock. What are accumulated earnings per share?

A. $4 per share
B. $44 per share
C. $40 per share
D. $5 per share

10. The major limitation of financial statements is

A. in their complexity.
B. in their lack of comparability.
C. in their use of historical cost accounting.
D. in their lack of detail.

11. Inflation has its major impact on balance sheets in which of the following areas?

A. Inventory and accounts payable
B. Plant and equipment and long-term debt
C. Plant and equipment and inventory
D. Interest expense and earnings per share

12. "Inventory profits" are most likely to occur in an inflationary economy under which of the following inventory cost assumptions?

A. Weighted average
B. LIFO
C. FIFO
D. Lower of cost or market

13. The orientation of book value per share is __________, while the orientation of market value per share is __________.

A. short term; long term
B. future; historical
C. historical; future
D. long term; short term

14. A firm with earnings per share of $5 and a price-earnings ratio of 15 will have a share price of

A. $20.00
B. $75.00
C. $3.00
D. the market assigns a stock price independent of EPS and the P/E ratio.

15. Earnings per share is

A. operating profit divided by number of shares outstanding.
B. net income divided by number of shares outstanding.
C. net income divided by shareholders' equity.
D. net income minus preferred dividends divided by number of shares outstanding.

16. Which of the following is an outflow of cash?

A. profitable operations
B. the sale of equipment
C. the sale of the company's common stock
D. the payment of cash dividends

17. Which of the following is an inflow of cash?

A. funds spent in normal business operations
B. the purchase of a new factory
C. the sale of the firm's bonds
D. the retirement of the firm's bonds
18. Amortization is a source of cash inflow because

- A. it is a tax-deductible noncash expense.
- B. it supplies cash for future asset purchases.
- C. it is a tax-deductible cash expense.
- D. it is a taxable expense.

19. Assuming a tax rate of 35%, amortization expenses of $400,000 will

- A. reduce income by $140,000.
- B. reduce taxes by $140,000.
- C. reduce taxes by $400,000.
- D. have no effect on income or taxes, since amortization is not a cash expense.

20. Assuming a tax rate of 30%, the after tax cost of interest expense of $200,000 is

- A. $60,000.
- B. $140,000.
- C. $200,000.
- D. $120,000.

21. Gross profit is equal to

- A. sales minus cost of goods sold.
- B. sales minus (selling and administrative expenses).
- C. sales minus (cost of goods sold and selling and administrative expenses).
- D. sales minus (cost of goods sold and amortization expense).

22. The firm's price-earnings (P/E) ratio is influenced by its

- A. capital structure.
- B. earnings volatility.
- C. sales, profit margins, and earnings.
- D. all of the other answers are correct

23. Total shareholders' equity consists of

- A. preferred stock and common stock.
- B. common stock and retained earnings.
- C. common stock and contributed surplus.
- D. preferred stock, common stock, contributed surplus, and retained earnings.

24. The current cost method of inflation-adjusted accounting statements

- A. is sometimes referred to as replacement cost accounting.
- B. affects inventory and plant and equipment values the most.
- C. lowers historical profits through adjustments to amortization expense and inventory costs.
- D. all of the other answers are correct
25. An inflation-adjusted accounting statement
A. lets management know if cash flow from internal operations is large enough to make necessary equipment replacements.
B. provides no new information to financial managers.
C. helps make common stock prices more predictable.
D. eliminates the effects of inflation from decision making.

26. The Glorious VanderBuilt Denim Slacks Company has taxable income of $100,000. Assuming a 34% tax rate, what is the tax payable?
A. $34,000
B. $66,000
C. $100,000
D. $12,250

27. Book value of a firm
A. is usually the same as the firm's market value.
B. is based on current asset costs.
C. is the same as net worth.
D. two of the above

28. A statement of cash flows allows a financial analyst to determine
A. whether a cash dividend is affordable.
B. how increases in asset accounts have been financed.
C. whether long-term assets are being financed with long-term or short-term financing.
D. all of the other answers are correct

29. A firm has $200,000 in current assets, $400,000 in long-term assets, $80,000 in current liabilities, and $200,000 in long-term liabilities. What is its net working capital?
A. $120,000
B. $320,000
C. $520,000
D. None of the other answers are correct

30. A firm has current assets of $25,000, long term assets of $100,000, long term liabilities of $50,000, and $50,000 in shareholders' equity. What is its net working capital?
A. zero
B. $50,000
C. $100,000 D. $25,000

31. Assuming a tax rate of 40%, the after tax cost of a $200,000 dividend payment is
A. $200,000.
B. $70,000.
C. $130,000.
D. None of the other answers are correct

32. Which of the following would not be included in the balance sheet investment account?

A. shares of other corporations
B. long term government bonds
C. marketable securities
D. investments in other corporations

33. Which of the following is not true of current cost accounting?

A. The book value of equipment is near replacement value.
B. The book value of the common stock equals market value.
C. Dividends and income are adjusted for inflation.
D. All the above are always true.

34. The primary disadvantage of accrual accounting is that

A. it does not match revenues and expenses in the period in which they are incurred.
B. it does not appropriately measure accounting profit.
C. it does not recognize the actual exchange of cash.
D. it does not adequately show the actual cash flow position of the firm.

35. The statement of cash flows does not include which of the following sections?

A. cash flows from operating activities
B. cash flows from sales activities
C. cash flows from investing activities
D. cash flows from financing activities

36. Which of the following would represent a use of funds and, indirectly, a reduction in cash balances?

A. an increase in inventories
B. a decrease in marketable securities
C. an increase in accounts payable
D. the sale of new bonds by the firm

37. Which of the following would represent a source of funds and, indirectly, an increase in cash balances?

A. a reduction in accounts receivable
B. the repurchase of shares of the firm's stock
C. a decrease in net income
D. a reduction in notes payable

38. A firm's purchase of plant and equipment would be considered a
A. use of cash for financing activities.
B. use of cash for operating activities.
C. source of cash for investment activities.
D. use of cash for investment activities.

39. Reinvested funds from retained earnings theoretically belong to
A. bondholders.
B. common shareholders.
C. employees.
D. all of the other answers are correct

40. Asset accounts on the balance sheet are listed in the order of
A. liquidity.
B. profitability.
C. size.
D. importance.

41. An increase in investments in long-term securities will
A. increase cash flow from investing activities.
B. decrease cash flow from investing activities.
C. increase cash flow from financing activities.
D. decrease cash flow from financing activities.

42. Free cash flow is equal to cash flow from operating activities
A. plus capital expenditures, minus dividends.
B. plus capital expenditures, plus dividends.
C. plus dividends, minus capital expenditures.
D. minus capital expenditures, minus dividends.

43. In the last decade, free cash flow has been associated with special financial activities such as
A. leveraged buyouts.
B. RRSPs.
C. stock options.
D. golden parachutes.

44. Preferred stock dividends __________ earnings available to common shareholders.
A. increase
B. decrease
C. do not effect
D. not enough information to tell

45. Increasing interest expense will have what effect on EBIT?
A. increase it
B. decrease it
C. no effect
D. not enough information to tell

46. When a firm's earnings are falling more rapidly than its stock price, its P/E ratio will
   A. remain the same.
   B. go up.
   C. go down.
   D. could go either up or down

47. Net worth is equal to shareholders' equity
   A. plus dividends.
   B. minus preferred stock.
   C. plus preferred stock.
   D. minus liabilities

48. Book value is the same as
   A. shareholders' equity.
   B. capital assets minus long-term debt.
   C. net worth.
   D. current assets minus current debt

49. Amortization tends to
   A. increase cash flow and decrease income.
   B. decrease cash flow and increase income.
   C. affect only cash flow.
   D. affect only income.

50. Accrual based accounting results in income and cash flow being
   A. the same.
   B. different.
   C. equal except for amortization.
   D. equal except for dividends

51. The P/E ratio is determined by
   A. net worth divided by earnings.
   B. market capitalization divided by earnings.
   C. net worth per share divided by earnings per share.
   D. market value per share divided by earnings per share

52. A balance sheet valuation measure is
   A. earnings per share.
B. the P/E ratio.
C. the dividend yield.
D. market value to book value

53. Preferred share dividends ________ earnings available to common shareholders.

A. increase
B. decrease
C. due not effect
D. not enough information to tell

54. When a firm's earnings are falling more rapidly than its share price, its P/E ratio will

A. remain the same.
B. go up.
C. go down.
D. could go either up or down.

55. Which of the following is not subtracted to arrive at operating income?

A. interest expense.
B. cost of goods sold.
C. amortization.
D. selling and administration expense.

56. Given the following what is free cash flow?

<table>
<thead>
<tr>
<th>Cash flow from operations</th>
<th>$175,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital expenditures</td>
<td>$35,000</td>
</tr>
<tr>
<td>Dividends</td>
<td>$25,000</td>
</tr>
</tbody>
</table>

A. $115,000.
B. $235,000.
C. $150,000. D. $140,000

57. All of the following would be included in Cash Flows from Investing, except:

A. Investments in Plant
B. Merchandise Purchases
C. Purchases of Investments
D. Sale of Long-Term Investments

58. An item that may be converted to cash within one year or one operating cycle of the firm is classified as a

A. current liability.
B. long-term asset.
C. current asset.
59. The residual income of the firm belongs to
A. creditors.
B. preferred shareholders.
C. common shareholders.
D. Canada Revenue Agency.

60. A firm has $7,500,000 in its common stock account and $2,500,000 in its retained earnings account. The firm issued 100,000 shares of common stock. What was the original issue price if only one stock issue has ever been sold?
A. $75 per share
B. $25 per share
C. $100 per share
D. Not enough information to tell

61. Assuming a tax rate of 35%, amortization expenses of $800,000 will
A. reduce income by $280,000.
B. reduce taxes by $280,000.
C. reduce taxes by $800,000.
D. have no effect on income or taxes, since amortization is not a cash expense.

62. Assuming a tax rate of 30%, the after tax cost of interest expense of $400,000 is
A. $120,000.
B. $280,000.
C. $400,000.
D. $240,000.

63. The income statement is the primary financial statement for measuring the profitability of a firm over a period of time.

True    False

64. The income statement measures the increase in the assets of a firm over a period of time. True    False

65. Accounting income is based on verifiably completed transactions.

True    False

66. Asset accounts are listed in order of their liquidity.

True    False
67. Book value per share and market value per share are usually the same dollar amount. True    False

68. Book value per share is of greater concern to the financial manager than market value per share. True    False

69. Book value is equal to net worth. True    False

70. Equity is a measure of the monetary contributions that have been made directly or indirectly on behalf of the shareholders of the company. True    False

71. Shareholders' equity is equal to liabilities plus assets. True    False
72. Shareholders' equity is equal to assets minus liabilities. 
True    False

73. Shareholders' equity minus preferred stock is the same thing as what is sometimes called net worth or book value. 
True    False

74. The statement of cash flows helps measure how the changes in a balance sheet are financed between two time periods. 
True    False

75. An increase in an asset represents a source of funds. 
True    False

76. Accumulated amortization shows up in the income statement. 
True    False

77. The change in accumulated amortization should always be equal to the amortization expense charged in the income statement. 
True    False

78. Net working capital is the difference between current assets and current liabilities. True    False

79. Amortization is an accounting entry and does not involve a cash expense. True    False

80. An advantage of the net working capital approach over the cash approach is that it looks at the changes of every account of the statement of cash flows. 
True    False

81. Cash flow is equal to earnings before taxes minus amortization. 
True    False

82. The corporate tax rate is 25% on the first $200,000 of income and 50% on any amount over $200,000. 
True    False

83. Interest expense is deductible before taxes and therefore has an after tax cost equal to the interest paid times (1-tax rate). 
True    False

84. Preferred stock dividends are paid out before income taxes. 
True    False
85. Total assets of a firm are financed with liabilities and shareholders' equity. True  False

86. Retained earnings shown on the balance sheet represents available cash on hand generated from prior year’s earnings but not paid out in dividends. True  False

87. Current cost accounting adjusts financial statements by using the consumer price index. True  False

88. An increase in a liability account represents a source of funds. True  False

89. The statement of cash flows includes the effects of dividends paid and amortization expense. True  False

90. The net working capital approach to funds flow analysis looks at the difference between total assets and total liabilities. True  False

91. The marginal corporate tax rate for incomes over $1,000,000 is 50%. True  False

92. Preferred stock is excluded from shareholders’ equity because it is a hybrid security and does not have full voting rights. True  False

93. Current cost accounting undervalues plant and equipment because it does not adjust for inflation. True  False

94. The investments account includes marketable securities. True  False

95. The investments account represents a commitment of funds of at least one year. True  False

96. A $125,000 credit sale could be a part of a firm's cash flow from operations if paid off within a firm's fiscal year. True  False

97. An increase in accounts receivable represents a reduction in cash flows from operations. True  False

98. An increase in accounts payable represents a reduction in cash flows from operations. True  False
99. The purchase of a new factory would reduce the cash flows from investing activities. True  False

100. The sale of corporate bonds held by the firm as a long-term investment would increase cash flows from investing activities. True  False

101. Paying dividends to common shareholders will not affect cash flows from financing activities. True  False

102. It is not possible for a company with a high profit margin to have a low operating profit. True  False

103. Operating profit is essentially a measure of how efficient management is in generating revenues and controlling expenses. True  False

104. The P/E ratio provides no indication of investors' expectations about the future of a company. True  False

105. The real value of a firm is the same in an economic and accounting sense. True  False

106. A balance sheet represents the assets, liabilities, and shareholders' equity of a company at a given point in time. True  False

107. Balance sheet items are usually adjusted for inflation. True  False

108. Marketable securities are temporary investments of excess cash and are carried at the lower of cost or market. True  False

109. Retained earnings represent the firm's cumulative earnings since inception, minus dividends and other adjustments. True  False

110. Cash flow consists of illiquid cash equivalents which are difficult to convert to cash within 90 days. True  False

111. The sale of a firm's securities is a source of funds, whereas the payment of dividends is a use of funds.
112. The use of amortization is an attempt to allocate the past and future costs of an asset over its useful life.

True  False

113. Free cash flow is equal to cash flow from operating activities plus amortization. True  False

114. Free cash flow is equal to cash flow from operating activities minus necessary capital expenditures and normal dividend payments.

True  False

115. Taxes on individuals have traditionally been progressive, meaning that the more taxable income you have, the higher your marginal tax rate.

True  False

116. The P/E ratio is strongly related to the past performance of the firm. True  False

117. An increase in a liability represents a source of funds.

True  False

118. Sales less cost of goods sold is equal to earnings before taxes.

True  False

119. Sales less cost of goods sold is equal to gross profit.

True  False

120. When a firm has a sharp drop off in earnings, its P/E ratio may be artificially high. True  False

121. The investments account does not directly affect cash and cash equivalents. True  False

122. Amortization expense is charged in the income statement.

True  False

123. An increase in inventory represents a source of funds.

True  False

124. The income statement allows analysts and investors to measure a firm's profitability of over a period of a month, quarter or year.

True  False

125. Earnings Available to Common Shareholders includes potential dividends to be paid to preferred shareholders.
True  False

126. The effective tax rate on dividend income is lower than interest income because of the dividend tax credit (DTC). Canadians are allowed to claim the DTC because the government wants to reduce the effects of double taxation.

True  False

127. Prior Adjustments may be added or subtracted from a firm's Retained Earnings. These "adjustments" are usually for accounting errors or substantive changes to historical cost of assets or liabilities.

True  False

128. Preferred and/or Common Share dividends are added to Cash Flow from Operations in determining Free Cash Flow.

True  False

129. Matching. Match each key term with the most correct definition from the numbered list.

1. balance sheet
   - All the assets of the firm minus the liabilities and preferred stock.  ____

2. shareholders' equity
   - A financial statement that indicates what the firm owns, and how these assets are financed in the form of liabilities or ownership interest.  ____

3. marketable securities
   - Changes accrual-based information from income statement and balance sheet to cash based information.  ____

4. income statement
   - The relative convertibility of short-term assets into cash.  ____

5. cash flows from operations
   - The levy expressed as a percentage that applies to each new dollar of taxable income.  ____

6. marginal corporate tax rate
   - The multiplier applied to income per share to determine current value.  ____

7. cash flows from investing
   - The income available to common shareholders divided by the number of common shares outstanding.  ____

8. notes payable
   - A financial statement that measures the profitability of the firm over a period of time.  ____

9. statement of cash flows
   - Temporary investments of excess cash.  ____

10. earnings per share
    - Represents the net cash flow that results from changes in the amount of a firm's long-term assets.  ____

11. net worth or book value
    - The total ownership position of preferred and common shareholders.  ____
12. P/E ratio Traditional method of accounting using original costs minus amortization. _____
13. historical cost accounting Represents the net cash flow that results from a firm's production and sales activities. _____
14. free cash flow Short-term signed obligations to banks or other creditors. _____
15. cash flow from financing Cash flow that is generated (or reduced) from the sale or repurchase of securities or the payment of cash dividends. _____
16. liquidity The allocation of the initial cost of an asset over its useful life. _____
17. amortization Cash flows from operations minus working capital minus dividend payments. _____

130. What is an income statement and what is its purpose as it relates to financial management?

131. What is the P/E ratio? Why is it an important ratio? List 3 factors that influence the P/E ratio.

132. In the text, the author said that "Earnings are flexible." What was meant by this?

133. Several theories have been suggested about the factors contributing to the management or "manipulation" of reported earnings. List and explain them.
134. Explain these terms found on a typical balance sheet. Provide examples of each if applicable.

135. List and describe the limitations of the balance sheet.

136. What is a cash flow statement? What information can it provide? Why is a cash flow statement important to small business?

137. List the 3 primary sections on the cash flow statement.

138. Describe and briefly explain the steps used in the indirect method to compute cash flows from typical operating activities of a company.
139. Define free cash flow. Explain what it is equal to and why it is important a finance manager needs to know the value of free cash flow.

140. What causes the after tax cash flow to the individuals to vary?

141. What is a tax savings?

142. Valley Home Improvements (VHI) earned $350,000 after taxes in its most recent fiscal year. If VHI's Board of Directors declared a total of $45,000 in preferred dividends what would be the total amount available to pay common shareholders?
143. Two-by-Four Wood Products (TBF) report net income of $2 per share in its most recent financial statements. If TBF has no preferred shares outstanding and the market price of its stock is $4 what is TBF's P/E ratio?

144. Jane is considering an investment in Fauna Flowers (FF). FF is trading at $33 a share. If the company's current dividend is $1.50 a share, what is FF's dividend yield?

145. Blink and Wink (BW) manufactures contact lens. In its most recent fiscal year BW reported aftertax interest expense on a new bond issue of $550,000. If BW's effective tax rate is 35%, what was the firm's before tax interest expense?

146. Cool Ties and Things (CTT) has Total Shareholder's Equity of $350,000. CTT issued $85,000 in preferred stock two years ago. If CTT has 37,000 shares issued and outstanding what is CTT's book value per share?

147. The following is the December 31, 2004 balance sheet for the Epics Corporation.
Sales for 2005 were $2,000,000, with the cost of goods sold being 55% of sales. Amortization expense was 10% of the gross plant and equipment at the beginning of the year. Interest expense was 9% on the notes payable and 11% on the bonds payable. Selling, general, and administrative expenses were $200,000 and the firm's tax rate is 40%.

A) Prepare an income statement.
B) If the dividend payout ratio for Epics is 35%, what is the value of the retained earnings account on December 31, 2005?

148. Given the financial information for the A.E. Neuman Corporation,

B) What is the dividend payout ratio?
C) If we increased the dividend payout ratio to 100%, what would happen to retained earnings?
149. Calculate the tax bill for a corporation that earned $250,000 in 2005 in Manitoba as a manufacturer.
150. Calculate the after tax cost of the interest. Assume the company has issued 10,000 bonds with a coupon rate of 8% and a face value of $1,000 per bond, and the company has a marginal tax rate of 42%.

151. ElectroWizard Company produces a popular video game called Destructo, which sells for $32. Last year ElectroWizard sold 50,000 Destructo games, each of which costs $6 to produce. ElectroWizard incurred selling and administrative expenses of $80,000 and amortization expense of $10,000. In addition, ElectroWizard has a $100,000 loan outstanding at 12%. Its tax rate is 40%. There are 100,000 common shares outstanding. Prepare an income statement for ElectroWizard in good form (include EPS).

152. Identify each of the following as increasing (+) or decreasing (-) cash flows from operating activities (O), investment activities (I), or financing activities (F). (EXAMPLE: the sale of plant and equipment would increase cash flows from investing activities, and the correct answer would be + I).
02 KEY

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C. **current asset.**
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B. common stock
C. preferred stock
D. bonds

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C. **$40 per share**  
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C. reduce taxes by $400,000.
D. have no effect on income or taxes, since amortization is not a cash expense.

20. Assuming a tax rate of 30%, the after tax cost of interest expense of $200,000 is

A. $60,000.
B. **$140,000.**
C. $200,000.
D. $120,000.

21. Gross profit is equal to

A. sales minus cost of goods sold.
B. sales minus (selling and administrative expenses).
C. sales minus (cost of goods sold and selling and administrative expenses).
D. sales minus (cost of goods sold and amortization expense).

22. The firm's price-earnings (P/E) ratio is influenced by its

A. capital structure.
B. earnings volatility.
C. sales, profit margins, and earnings.
D. **all of the other answers are correct**

23. Total shareholders' equity consists of
A. preferred stock and common stock.
B. common stock and retained earnings.
C. common stock and contributed surplus.
D. preferred stock, common stock, contributed surplus, and retained earnings.

24. The current cost method of inflation-adjusted accounting statements

A. is sometimes referred to as replacement cost accounting.
B. affects inventory and plant and equipment values the most.
C. lowers historical profits through adjustments to amortization expense and inventory costs.
D. all of the other answers are correct

25. An inflation-adjusted accounting statement

A. lets management know if cash flow from internal operations is large enough to make necessary equipment replacements.
B. provides no new information to financial managers.
C. helps make common stock prices more predictable.
D. eliminates the effects of inflation from decision making.

26. The Glorius VanderBuilt Denim Slacks Company has taxable income of $100,000. Assuming a 34% tax rate, what is the tax payable?

A. $34,000
B. $66,000
C. $100,000
D. $12,250

27. Book value of a firm
A. is usually the same as the firm's market value.
B. is based on current asset costs.
C. **is the same as net worth.**
D. two of the above

28. A statement of cash flows allows a financial analyst to determine

A. whether a cash dividend is affordable.
B. how increases in asset accounts have been financed.
C. whether long-term assets are being financed with long-term or short-term financing.
D. all of the other answers are correct

29. A firm has $200,000 in current assets, $400,000 in long-term assets, $80,000 in current liabilities, and $200,000 in long-term liabilities. What is its net working capital?

A. $120,000
B. $320,000
C. $520,000
D. None of the other answers are correct

30. A firm has current assets of $25,000, long term assets of $100,000, long term liabilities of $50,000, and $50,000 in shareholders' equity. What is its net working capital?

A. zero
B. $50,000
C. $100,000
D. $25,000

31. Assuming a tax rate of 40%, the after tax cost of a $200,000 dividend payment is
32. Which of the following would not be included in the balance sheet investment account?

A. shares of other corporations
B. long term government bonds
C. marketable securities
D. investments in other corporations

33. Which of the following is not true of current cost accounting?

A. The book value of equipment is near replacement value.
B. The book value of the common stock equals market value.
C. Dividends and income are adjusted for inflation.
D. All the above are always true.

34. The primary disadvantage of accrual accounting is that

A. it does not match revenues and expenses in the period in which they are incurred.
B. it does not appropriately measure accounting profit.
C. it does not recognize the actual exchange of cash.
D. it does not adequately show the actual cash flow position of the firm.

35. The statement of cash flows does not include which of the following sections?

A. cash flows from operating activities
B. cash flows from sales activities
C. cash flows from investing activities
D. cash flows from financing activities

36. Which of the following would represent a use of funds and, indirectly, a reduction in cash balances?

A. **an increase in inventories**
B. a decrease in marketable securities
C. an increase in accounts payable
D. the sale of new bonds by the firm

37. Which of the following would represent a source of funds and, indirectly, an increase in cash balances?

A. **a reduction in accounts receivable**
B. the repurchase of shares of the firm's stock
C. a decrease in net income
D. a reduction in notes payable

38. A firm's purchase of plant and equipment would be considered a

A. use of cash for financing activities.
B. use of cash for operating activities.
C. source of cash for investment activities.
D. **use of cash for investment activities.**

39. Reinvested funds from retained earnings theoretically belong to

A. bondholders.
B. **common shareholders.**
C. employees.
D. all of the other answers are correct
40. Asset accounts on the balance sheet are listed in the order of

A. liquidity.
B. profitability.
C. size.
D. importance.

41. An increase in investments in long-term securities will

A. increase cash flow from investing activities.
B. decrease cash flow from investing activities.
C. increase cash flow from financing activities.
D. decrease cash flow from financing activities.

42. Free cash flow is equal to cash flow from operating activities

A. plus capital expenditures, minus dividends.
B. plus capital expenditures, plus dividends.
C. plus dividends, minus capital expenditures.
D. minus capital expenditures, minus dividends.

43. In the last decade, free cash flow has been associated with special financial activities such as

A. leveraged buyouts.
B. RRSPs.
C. stock options.
D. golden parachutes.
44. Preferred stock dividends __________ earnings available to common shareholders.

A. increase
B. **decrease**
C. do not effect
D. not enough information to tell

45. Increasing interest expense will have what effect on EBIT?

A. increase it
B. decrease it
C. **no effect**
D. not enough information to tell

46. When a firm's earnings are falling more rapidly than its stock price, its P/E ratio will

A. remain the same.
B. **go up**.
C. go down.
D. could go either up or down

47. Net worth is equal to shareholders' equity

A. plus dividends.
B. **minus preferred stock**.
C. plus preferred stock.
D. minus liabilities

48. Book value is the same as
A. shareholders' equity.
B. capital assets minus long-term debt.
C. net worth.
D. current assets minus current debt

49. Amortization tends to

A. increase cash flow and decrease income.
B. decrease cash flow and increase income.
C. affect only cash flow.
D. affect only income.

50. Accrual based accounting results in income and cash flow being

A. the same.
B. different.
C. equal except for amortization.
D. equal except for dividends

51. The P/E ratio is determined by

A. net worth divided by earnings.
B. market capitalization divided by earnings.
C. net worth per share divided by earnings per share.
D. market value per share divided by earnings per share

52. A balance sheet valuation measure is

A. earnings per share.
B. the P/E ratio.
53. Preferred share dividends ________ earnings available to common shareholders.
   A. increase
   B. **decrease**
   C. due not effect
   D. not enough information to tell

54. When a firm's earnings are falling more rapidly than its share price, its P/E ratio will
   A. remain the same.
   B. **go up.**
   C. go down.
   D. could go either up or down.

55. Which of the following is not subtracted to arrive at operating income?
   A. **interest expense.**
   B. cost of goods sold.
   C. amortization.
   D. selling and administration expense.

56. Given the following what is free cash flow?

   | Cash flow from operations | $175,000 |
   | Capital expenditures      | 35,000   |
   | Dividends                 | 25,000   |

   A. **$115,000.**
B. $235,000.
C. $150,000.
D. $140,000

57. All of the following would be included in Cash Flows from Investing, except:

A. Investments in Plant
B. **Merchandise Purchases**
C. Purchases of Investments
D. Sale of Long-Term Investments

58. An item that may be converted to cash within one year or one operating cycle of the firm is classified as a

A. current liability.
B. long-term asset.
C. **current asset.**
D. None of the other answers are correct.

59. The residual income of the firm belongs to

A. creditors.
B. preferred shareholders.
C. **common shareholders.**
D. Canada Revenue Agency.

60. A firm has $7,500,000 in its common stock account and $2,500,000 in its retained earnings account. The firm issued 100,000 shares of common stock. What was the original issue price if only one stock issue has ever been sold?
A. $75 per share  
B. $25 per share  
C. $100 per share  
D. Not enough information to tell

61. Assuming a tax rate of 35%, amortization expenses of $800,000 will
A. reduce income by $280,000.  
B. reduce taxes by $280,000.  
C. reduce taxes by $800,000.  
D. have no effect on income or taxes, since amortization is not a cash expense.

62. Assuming a tax rate of 30%, the after tax cost of interest expense of $400,000 is
A. $120,000.  
B. $280,000.  
C. $400,000.  
D. $240,000.

63. The income statement is the primary financial statement for measuring the profitability of a firm over a period of time.  

TRUE

64. The income statement measures the increase in the assets of a firm over a period of time.  

FALSE
65. Accounting income is based on verifiably completed transactions.

**TRUE**

66. Asset accounts are listed in order of their liquidity.

**TRUE**

67. Book value per share and market value per share are usually the same dollar amount.

**FALSE**

68. Book value per share is of greater concern to the financial manager than market value per share.

**FALSE**

69. Book value is equal to net worth.

**TRUE**

70. Equity is a measure of the monetary contributions that have been made directly or indirectly on behalf of the shareholders of the company.

**TRUE**
71. Shareholders' equity is equal to liabilities plus assets.

FALSE

72. Shareholders' equity is equal to assets minus liabilities.

TRUE

73. Shareholders' equity minus preferred stock is the same thing as what is sometimes called net worth or book value.

TRUE

74. The statement of cash flows helps measure how the changes in a balance sheet are financed between two time periods.

TRUE

75. An increase in an asset represents a source of funds.

FALSE

76. Accumulated amortization shows up in the income statement.

FALSE
77. The change in accumulated amortization should always be equal to the amortization expense charged in the income statement.

FALSE

78. Net working capital is the difference between current assets and current liabilities.

TRUE

79. Amortization is an accounting entry and does not involve a cash expense.

TRUE

80. An advantage of the net working capital approach over the cash approach is that it looks at the changes of every account of the statement of cash flows.

FALSE

81. Cash flow is equal to earnings before taxes minus amortization.

FALSE
82. The corporate tax rate is 25% on the first $200,000 of income and 50% on any amount over $200,000.

FALSE

83. Interest expense is deductible before taxes and therefore has an after tax cost equal to the interest paid times (1-tax rate).

TRUE

84. Preferred stock dividends are paid out before income taxes.

FALSE

85. Total assets of a firm are financed with liabilities and shareholders' equity.

TRUE

86. Retained earnings shown on the balance sheet represents available cash on hand generated from prior year's earnings but not paid out in dividends.

FALSE

87. Current cost accounting adjusts financial statements by using the consumer price index.

FALSE
88. An increase in a liability account represents a source of funds.

**TRUE**

89. The statement of cash flows includes the effects of dividends paid and amortization expense.

**TRUE**
90. The net working capital approach to funds flow analysis looks at the difference between total assets and total liabilities.

FALSE

91. The marginal corporate tax rate for incomes over $1,000,000 is 50%.

FALSE

92. Preferred stock is excluded from shareholders' equity because it is a hybrid security and does not have full voting rights.

FALSE

93. Current cost accounting undervalues plant and equipment because it does not adjust for inflation.

FALSE

94. The investments account includes marketable securities.

FALSE
95. The investments account represents a commitment of funds of at least one year.

**TRUE**

96. A $125,000 credit sale could be a part of a firm's cash flow from operations if paid off within a firm's fiscal year.

**TRUE**

97. An increase in accounts receivable represents a reduction in cash flows from operations.

**TRUE**

98. An increase in accounts payable represents a reduction in cash flows from operations.

**FALSE**

99. The purchase of a new factory would reduce the cash flows from investing activities.

**TRUE**

100. The sale of corporate bonds held by the firm as a long-term investment would increase cash flows from investing activities.

**TRUE**
101. Paying dividends to common shareholders will not affect cash flows from financing activities.

FALSE

102. It is not possible for a company with a high profit margin to have a low operating profit.

FALSE

103. Operating profit is essentially a measure of how efficient management is in generating revenues and controlling expenses.

TRUE

104. The P/E ratio provides no indication of investors' expectations about the future of a company.

FALSE

105. The real value of a firm is the same in an economic and accounting sense.

FALSE
106. A balance sheet represents the assets, liabilities, and shareholders’ equity of a company at a given point in time.

**TRUE**

107. Balance sheet items are usually adjusted for inflation.

**FALSE**
108. Marketable securities are temporary investments of excess cash and are carried at the lower of cost or market.

**TRUE**

109. Retained earnings represent the firm's cumulative earnings since inception, minus dividends and other adjustments.

**TRUE**

110. Cash flow consists of illiquid cash equivalents which are difficult to convert to cash within 90 days.

**FALSE**

111. The sale of a firm's securities is a source of funds, whereas the payment of dividends is a use of funds.

**TRUE**

112. The use of amortization is an attempt to allocate the past and future costs of an asset over its useful life.

**FALSE**

113. Free cash flow is equal to cash flow from operating activities plus amortization.

**FALSE**
114. Free cash flow is equal to cash flow from operating activities minus necessary capital expenditures and normal dividend payments.

**TRUE**

115. Taxes on individuals have traditionally been progressive, meaning that the more taxable income you have, the higher your marginal tax rate.

**TRUE**

116. The P/E ratio is strongly related to the past performance of the firm.

**FALSE**

117. An increase in a liability represents a source of funds.

**TRUE**

118. Sales less cost of goods sold is equal to earnings before taxes.

**FALSE**

119. Sales less cost of goods sold is equal to gross profit.
120. When a firm has a sharp drop off in earnings, its P/E ratio may be artificially high.

**TRUE**

121. The investments account does not directly affect cash and cash equivalents.

**TRUE**

122. Amortization expense is charged in the income statement.

**TRUE**

123. An increase in inventory represents a source of funds.

**FALSE**

124. The income statement allows analysts and investors to measure a firm's profitability of over a period of a month, quarter or year.

**TRUE**
125. Earnings Available to Common Shareholders includes potential dividends to be paid to preferred shareholders.

FALSE

126. The effective tax rate on dividend income is lower than interest income because of the dividend tax credit (DTC). Canadians are allowed to claim the DTC because the government wants to reduce the effects of double taxation.

TRUE

127. Prior Adjustments may be added or subtracted from a firm's Retained Earnings. These "adjustments" are usually for accounting errors or substantive changes to historical cost of assets or liabilities.

TRUE

128. Preferred and/or Common Share dividends are added to Cash Flow from Operations in determining Free Cash Flow.

FALSE

129. Matching. Match each key term with the most correct definition from the numbered list.

All the assets of the firm minus the liabilities and

1. balance sheet      preferred stock.  1  
   A financial statement that indicates what the firm
2. shareholders' owns, and how these assets are financed in the form of equity liabilities or ownership interest.   
3. marketable Changes accrual-based information from income
securities statement and balance sheet to cash based information. 9

4. income The relative convertibility of short-term assets into statement cash. 16

5. cash flows The levy expressed as a percentage that applies to from operations each new dollar of taxable income. 6

6. marginal corporate tax The multiplier applied to income per share to rate determine current value. 12

7. cash flows The income available to common shareholders from investing divided by the number of common shares outstanding. 10

A financial statement that measures the profitability

8. notes payable of the firm over a period of time. 4

9. statement of cash flows Temporary investments of excess cash. 3

10. earnings per share Represents the net cash flow that results from changes in the amount of a firm's long-term assets. 7

11. net worth or book value The total ownership position of preferred and common shareholders. 2

Traditional method of accounting using original

12. P/E ratio costs minus amortization. 13

13. historical cost accounting Represents the net cash flow that results from a firm's production and sales activities. 5

14. free cash flow Short-term signed obligations to banks or other creditors. 8

Cash flow that is generated (or reduced) from the

15. cash flow sale or repurchase of securities or the payment of cash from financing dividends 15

The allocation of the initial cost of an asset over its useful life.

16. liquidity Cash flows from operations minus working capital 17
17. Amortization minus dividend payments.

130. What is an income statement and what is its purpose as it relates to financial management?

The income statement

- Measures the profitability of a firm over a time period (month, year)
- Assists financial decision making and analysis, utilizing past patterns for predicting the timing, uncertainty, and amount of future earnings and cash flows.

131. What is the P/E ratio? Why is it an important ratio? List 3 factors that influence the P/E ratio.

The P/E ratio is Market share price/Earnings per share. This ratio allows comparison of the relative market value of many companies on the basis of $1 of earnings per share. Firms expected to provide greater than average future returns often have P/E ratios higher than the market average P/E ratio. As investors' expectations for future returns change, a company's P/E ratio can shift substantially. The price/earnings ratio (P/E ratio) of a firm is influenced by

- Earnings and sales growth
- Risk (business performance and debt-equity structure)
- Dividend payment policy
- Quality of management
- Many other factors

132. In the text, the author said that "Earnings are flexible." What was meant by this?

In efforts to meet earnings targets, accountants and managers had resorted to stretching accounting standards beyond their reasonable limits. Earnings can be managed or "manipulated" because professional accounting bodies allow latitude. Accruals, such as allowance for doubtful accounts or warranty expenses, and write-downs of assets (inventories and capital) are by their nature discretionary. Margins can also be managed, by classification of "overhead" as a cost of goods rather than administrative expenses. Management has this discretion due to its experience and the need to make estimates of many of the revenues and expenses that will flow through the firm.
133. Several theories have been suggested about the factors contributing to the management or "manipulation" of reported earnings. List and explain them.

- Bonuses (Compensation is tied to reported earnings.)
- Political considerations (High reported earnings attract societal attention.)
- Smoothing (Less volatile earnings are viewed favourably by the market.)
- Debt covenants (Debt contracts are often based on book value calculations.)
- Big bath (New CEOs will look better in the future if assets are written down as they take over, avoiding future amortization charges.)

134. Explain these terms found on a typical balance sheet. Provide examples of each if applicable.

Marketable securities, Accounts receivable, Inventory, Prepaid expenses, Investments, Plant and equipment, Accumulated amortization, Accounts payable, Notes payable, Accrued expense, Shareholders' equity.

Marketable securities are temporary investments of excess cash (lower of cost or current market value). Accounts receivable include an allowance for bad debts (based on historical evidence) to suggest their anticipated collection value.

Inventory may be in the form of raw material, goods in process, or finished goods. Prepaid expenses represent future expenses that have already been paid (insurance premiums, rent). Investments, unlike marketable securities, are a longer-term commitment of funds, including stocks, bonds, or investments in other corporations (often for acquisition). Plant and equipment is identified as original cost minus accumulated amortization.

Accumulated amortization is the sum of all past and present amortization charges on currently owned assets, whereas amortization expense is the current year's charge. Accounts payable represent amounts owed on open account to suppliers. Notes payable are generally short-term signed obligations to the banker or other creditors. Accrued expense is an obligation incurred but payment has not yet occurred (additional wages for services provided and owed workers).

Shareholders' equity represents the total contribution and ownership interest of preferred and common shareholders.

135. List and describe the limitations of the balance sheet.

The values on the balance sheet are often subject to interpretation or revaluation.
• Values are stated on a historical or original cost basis, not market values (some assets may be worth considerably more than their original cost or may require many times the original cost for replacement).
• Accounting policy choice, which should be disclosed in the financial notes, will influence the recorded values.
• Contingent liabilities omitted from the balance sheet, or items such as intangibles that are included, may have a hard-to-determine influence on economic value. Contingent liabilities should be disclosed in footnotes on the balance sheet, alerting us to their possible impact.

136. What is a cash flow statement? What information can it provide? Why is a cash flow statement important to small business?

The cash flow statement reports changes in cash and cash equivalents (rather than working capital) resulting from the activities of the firm during a given period. For many internal and external users of a firm's financial information, cash flow information is critical. The cash flow statement allows an analyst to identify

• Cash flow generated from the firm's assets
• Financial obligations (interest and dividends)
• Commitment to new assets

The statement of cash flows can highlight

• The relative build up in short-term and long-term assets
• The means of financing used to support any growth in the firm's asset base
• The appropriateness and the future implications of the financing used

The cash flow statements for the small business are particularly important, as cash flow is more relevant to the firm's short-term survival than its reported income. One is likely to be concerned about the quality, timing, and amount of earnings, and hence the firm's ability to acquire assets and meet its obligations. In the very competitive corporate environment of today exacting cash flow analysis is essential for a firm's survival.

137. List the 3 primary sections on the cash flow statement.

These sections are:

1. Operating activities
2. Investing activities
3. Financing activities
138. Describe and briefly explain the steps used in the indirect method to compute cash flows from typical operating activities of a company.

We follow these procedures to compute cash flows from operating activities using the indirect method.

- Start with net income.
- Recognize that noncash deductions in computing net income should be added back to net income to increase the cash balance. These include such items as amortization, deferred income taxes, restructuring charges, and foreign exchange losses. This produces cash flow from operations.
- Next identify changes in noncash working capital.
- Recognize that increases in current assets are a use of funds and reduce the cash balance (indirectly)—as an example, the firm spends more funds on inventory.
- Recognize that decreases in current assets are a source of funds and increase the cash balance (indirectly)—that is, the firm reduces funds tied up in inventory.
- Recognize that increases in current liabilities are a source of funds and increase the cash balance (indirectly)—that is, the firm gets more funds from creditors.
- Recognize that decreases in current liabilities are a use of funds and decrease the cash balance (indirectly)—that is, the firm pays off creditors.

139. Define free cash flow. Explain what it is equal to and why it is important a finance manager needs to know the value of free cash flow.

Free cash flow is equal to:
Cash flow from operating activities
Minus: Capital expenditures (required to maintain the productive capacity of the firm)
Minus: Dividends (needed to maintain the necessary payout on common stock and to cover any preferred stock obligation)

The concept of free cash flow forces the stock analyst or banker not only to consider how much cash is generated from operating activities, but also to subtract out the necessary capital expenditures on plant and equipment to maintain normal activities. Similarly, dividend payments to shareholders must be subtracted out, as these dividends must generally be paid to keep shareholders satisfied. The balance, free cash flow, is then available for special financial activities. In the last decade, special financing activities have often been synonymous with leveraged buyouts, in which a firm borrows money to buy its stock and take itself private with the hope of restructuring its balance sheet and perhaps going public again in a few years at a higher price than it paid. The analyst or banker normally looks at free cash flow to determine whether there are sufficient excess funds to pay back loans associated with special financial activities.
140. What causes the after tax cash flow to the individuals to vary?

The after tax cash flow to the individual varies depending on whether investment income is in the form of interest, dividends, or capital gain. (Highest to lowest marginal tax rate.)

141. What is a tax savings?

A tax savings is the reduction of taxes otherwise payable as a result of an allowable deduction of an expense from taxable income.

142. Valley Home Improvements (VHI) earned $350,000 after taxes in its most recent fiscal year. If VHI's Board of Directors declared a total of $45,000 in preferred dividends what would be the total amount available to pay common shareholders?

Earnings Available to Common Shareholders (EAT) = Earnings After Taxes - Preferred Dividends

\[ EAT = \$350,000 - \$45,000 = \$305,000 \]

143. Two-by-Four Wood Products (TBF) report net income of $2 per share in its most recent financial statements. If TBF has no preferred shares outstanding and the market price of its stock is $4 what is TBF's P/E ratio?

\[ \frac{4}{2} = 2 \]

\[ \text{P/E} = 2 \]

For every $1 earned by TBF you would be paying $2 in price.
144. Jane is considering an investment in Fauna Flowers (FF). FF is trading at $33 a share. If the company's current dividend is $1.50 a share, what is FF's dividend yield?

\[
\text{Dividend Yield} = \frac{\text{Dividend}}{\text{Price}}
\]

\[
\text{Dividend Yield} = \left(\frac{1.50}{33}\right) \times 100 = 4.55\%
\]

145. Blink and Wink (BW) manufactures contact lenses. In its most recent fiscal year BW reported aftertax interest expense on a new bond issue of $550,000. If BW's effective tax rate is 35%, what was the firm's before tax interest expense?

\[
\text{Before Tax Interest Expense} = \frac{\$550,000}{1 - \text{Tax Rate}}
\]

\[
\text{Before Tax Interest Expense} = \frac{550,000}{1 - .35} = 846,154
\]

146. Cool Ties and Things (CTT) has Total Shareholder's Equity of $350,000. CTT issued $85,000 in preferred stock two years ago. If CTT has 37,000 shares issued and outstanding what is CTT's book value per share?

\[
\text{BV per Share} = \frac{\text{Shareholder's Equity} - \text{Value of Preferred Shares O/S}}{\text{Common Share O/S}}
\]

\[
\text{BV per Share} = \frac{350,000 - 85,000}{37,000} = 265,000/37,000 = 7.16
\]
147. The following is the December 31, 2004 balance sheet for the Epics Corporation.

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Accounts payable</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>$100,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>Notes payable</td>
</tr>
<tr>
<td>Total current assets</td>
<td>120,000</td>
</tr>
<tr>
<td>Plant and equipment</td>
<td>Bonds payable</td>
</tr>
<tr>
<td>Less: acc. amortization</td>
<td>300,000</td>
</tr>
<tr>
<td>Net plant and Equipment</td>
<td>Total liabilities</td>
</tr>
<tr>
<td></td>
<td>520,000</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Total assets</td>
<td>Total liab. &amp; equity</td>
</tr>
<tr>
<td>$1,500,000</td>
<td>$1,500,000</td>
</tr>
</tbody>
</table>

Sales for 2005 were $2,000,000, with the cost of goods sold being 55% of sales. Amortization expense was 10% of the gross plant and equipment at the beginning of the year. Interest expense was 9% on the notes payable and 11% on the bonds payable. Selling, general, and administrative expenses were $200,000 and the firm's tax rate is 40%.

A) Prepare an income statement.
B) If the dividend payout ratio for Epics is 35%, what is the value of the retained earnings account on December 31, 2005?

A) **Income Statement**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Less: Cost of Goods Sold</td>
<td>1,100,000</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>900,000</td>
</tr>
<tr>
<td>Less: Selling, general and administrative expense</td>
<td>200,000</td>
</tr>
<tr>
<td>Amortization Expense</td>
<td>125,000</td>
</tr>
<tr>
<td>EBIT</td>
<td>575,000</td>
</tr>
<tr>
<td>Less: Interest Expense</td>
<td>43,800</td>
</tr>
<tr>
<td>(10,800 + 33,000)</td>
<td></td>
</tr>
<tr>
<td>EBT</td>
<td>531,200</td>
</tr>
<tr>
<td>Less: Taxes (40%)</td>
<td>212,480</td>
</tr>
<tr>
<td>Net Earnings</td>
<td>$318,720</td>
</tr>
</tbody>
</table>

B) Net Income $318,720

\[ \text{Payout ratio} = \frac{\text{Net Income}}{\text{Payout ratio} \times \text{.35}} \]

\[ \text{Dividends Paid} = \frac{\text{Payout ratio} \times \text{.35}}{\text{Net Income}} \]

148. Given the financial information for the A.E. Neuman Corporation,

B) What is the dividend payout ratio?
C) If we increased the dividend payout ratio to 100%, what would happen to retained earnings?

<table>
<thead>
<tr>
<th>A.E. Neuman Corporation</th>
<th>Balance Sheets</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ASSETS</strong></td>
<td>2004</td>
</tr>
<tr>
<td>Cash</td>
<td>$45,000</td>
</tr>
<tr>
<td>Marketable Securities</td>
<td>175,000</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>240,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>230,000</td>
</tr>
<tr>
<td>Investments</td>
<td>70,000</td>
</tr>
<tr>
<td><strong>Total current assets</strong></td>
<td>760,000</td>
</tr>
<tr>
<td>Plant and Equipment</td>
<td>1,300,000</td>
</tr>
<tr>
<td>Less Accumulated Amortization</td>
<td>450,000</td>
</tr>
<tr>
<td><strong>Net Plant and Equipment</strong></td>
<td>850,000</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td>$1,610,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>LIABILITIES AND SHAREHOLDERS’ EQUITY</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts Payable</td>
</tr>
<tr>
<td>Notes Payable</td>
</tr>
<tr>
<td>Accrued Expenses</td>
</tr>
<tr>
<td>Income Taxes Payable</td>
</tr>
<tr>
<td>Bonds Payable (2016)</td>
</tr>
<tr>
<td>Common Stock (100,000 shares)</td>
</tr>
<tr>
<td>Retained Earnings</td>
</tr>
<tr>
<td><strong>Total Liabilities and</strong></td>
</tr>
<tr>
<td>Shareholders' Equity</td>
</tr>
</tbody>
</table>

**A.E. Neuman Corporation**

**Income Statement For Year Ended December 31, 2005**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$5,500,000</td>
</tr>
<tr>
<td>Less: Cost of Goods Sold</td>
<td>4,200,000</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>1,300,000</td>
</tr>
<tr>
<td>Less: Selling, General &amp; Administrative Expense</td>
<td>260,000</td>
</tr>
<tr>
<td>Operating Profit</td>
<td>1,040,000</td>
</tr>
<tr>
<td>Less: Amortization Expense</td>
<td>150,000</td>
</tr>
<tr>
<td>Earnings Before Interest and Taxes</td>
<td>890,000</td>
</tr>
<tr>
<td>Less: Interest Expense</td>
<td>90,000</td>
</tr>
<tr>
<td>Earnings Before Taxes</td>
<td>800,000</td>
</tr>
<tr>
<td>Less: Taxes (50%)</td>
<td>400,000</td>
</tr>
<tr>
<td><strong>Net Income</strong></td>
<td>$400,000</td>
</tr>
</tbody>
</table>
Operating Activities
Net Income (earnings after taxes) $400,000
Add items not requiring an outlay of cash:
Amortization 150,000
Cash flow from operations 550,000
Changes in non-cash working capital:
Decrease in accounts receivable 20,000
Increase in inventories (45,000)
Decrease in accounts payable (25,000)
Decrease in notes payable (55,000)
Decrease in accrued expenses (25,000)
Increase in income taxes payable 5,000
Net change in non-cash working capital 125,000
Cash provided by operating activities 425,000

Investing Activities
Decrease in investments 15,000
Increase in plant & equipment (250,000)
Cash used in investing activities (235,000)

Financing Activities
Increase in bonds payable 100,000
Dividends paid (300,000)
Cash used in financing activities (200,000)

Net increase in cash and equivalents during year (10,000)
Cash and equivalents, beginning of year 220,000
Cash and equivalents, at year end $210,000

B)

Dividend payout ratio = \frac{\text{Dividends paid, 2005}}{\text{Net income, 2005}}
= \frac{300,000}{400,000} = .75 = 75% 

C) The 2005 value for retained earnings would decrease by $100,000. In addition, assets would have to decrease by $100,000 or other liabilities would have to increase by the same amount.

149. Calculate the tax bill for a corporation that earned $250,000 in 2005 in Manitoba as a manufacturer.

Tax rate (18.1%) Incremental Income $250,000 Tax Liability = $45,250
150. Calculate the after tax cost of the interest. Assume the company has issued 10,000 bonds with a coupon rate of 8% and a face value of $1,000 per bond, and the company has a marginal tax rate of 42%.

\[
\text{Annual interest} = 10,000 \times $1,000 \times 8\% = $800,000
\]

\[
\text{After tax cost} = $800,000 \times (1 - \text{tax rate}) = $800,000 \times (1 - .42) = $464,000
\]
151. ElectroWizard Company produces a popular video game called Destructo, which sells for $32. Last year ElectroWizard sold 50,000 Destructo games, each of which costs $6 to produce. ElectroWizard incurred selling and administrative expenses of $80,000 and amortization expense of $10,000. In addition, ElectroWizard has a $100,000 loan outstanding at 12%. Its tax rate is 40%. There are 100,000 common shares outstanding.

Prepare an income statement for ElectroWizard in good form (include EPS).

\[
\begin{array}{ll}
\text{ElectroWizard Company} & \\
\text{Income Statement} & \\
\text{for the year ended 12/31/} & \\
\hline
\text{Sales (50,000 @ $32)} & $1,600,000 \\
\text{Less: Cost of Goods Sold} & 300,000 \\
\text{Gross Profit} & 1,300,000 \\
\text{Less: Operating Expenses} & \\
\text{Selling and administrative} & $80,000 \\
\text{Amortization} & 10,000 \\
\text{Operating Profit (EBIT)} & 90,000 \\
\text{Less: Interest expense ($100,000 @ 12\%)} & 12,000 \\
\text{Earnings Before Taxes} & 1,198,000 \\
\text{Less: Taxes @ 40\%} & 479,200 \\
\text{Net Income} & $718,800 \\
\text{Common Shares} & 100,000 \\
\text{Earnings Per Share} & $7.189 \\
\end{array}
\]

152. Identify each of the following as increasing (+) or decreasing (-) cash flows from operating activities (O), investment activities (I), or financing activities (F). (EXAMPLE: the sale of plant and equipment would increase cash flows from investing activities, and the correct answer would be + I).
1. Increase in accounts payable
2. Decrease in inventory
3. Net income from operations
4. Payment of dividends
5. Sale of preferred stock
6. Increase in accrued expenses
7. Purchase of new equipment
8. Decrease in amortization expense
9. Increase in accounts receivable
10. Decrease in notes payable
11. Increase in net worth
12. Increase in long-term liabilities
13. Increase in investments
14. Decrease in marketable securities
15. Reduction in retained earnings
16. Repurchase of common shares outstanding
17. Increase in prepaid expense
18. Decrease in income taxes payable
19. Retirement of long-term bonds payable
20. Sale of new common stock

+ O
+ O
+ O
- F
- F
- Q
- Q
- I
- O
- Q
+ F
+ F
- I
+ O
- F
- F
- F
- O
- F
+ F

02 Summary

Category: # of Questions
<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>Block - Chapter 02</td>
<td>152</td>
</tr>
<tr>
<td>Difficulty: Easy</td>
<td>66</td>
</tr>
<tr>
<td>Difficulty: Hard</td>
<td>10</td>
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<td>Difficulty: Medium</td>
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<td>Gradable: manual</td>
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<td>Learning Objective: 1</td>
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<tr>
<td>Learning Objective: 6</td>
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<tr>
<td>Learning Objective: 8</td>
<td>3</td>
</tr>
<tr>
<td>Type: Concept</td>
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<tr>
<td>Type: Memory</td>
<td>28</td>
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