

## Chapter 2

*Student:* \_\_\_\_\_

1. Which of the following is not one of the three basic financial statements required by Accounting Standards for Private Enterprises (ASPE)?
  - 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. Long term 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. Specific item
- 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 not influenced by its:

- A. capital structure.
- B. earnings volatility.
- C. sales, profit margins, and earnings.
- D. Purchase of machinery.

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 Balance Sheet cannot show:

- A. the current ratio.
- B. the value of common stock outstanding.
- C. the change in retained earnings.
- D. the price earnings relationship.

25. Well prepared accounting statements:

- A. let management know if cash flow from internal operations is large enough to make necessary equipment replacements.
- B. provide no new information to financial managers.
- C. determine the market price of common stock.
- D. eliminate 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. none of the choices are correct.

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

- A. whether a cash dividend is affordable.
- B. how increase 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 choices 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 choices 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. \$0
  - 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 choices 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 of the choices are correct

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 as 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 choices are correct.

40. For private companies, 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. Registered Retirement Savings Plan (RRSPs).
- C. stock options.
- D. golden parachutes.

44. Common stock dividends are \_\_\_\_\_ by preferred stock dividends.

- A. increased
- B. decreased
- C. not effected
- 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. Net worth for an individual is the same as \_\_\_\_\_ for a corporation.

- A. shareholders' equity
- B. capital assets minus long-term debt
- C. book value
- 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 dividend.
- 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. Which of the following is not subtracted to arrive at operating profit?

- A. Interest expense
- B. Cost of goods sold
- C. Amortization
- D. Selling and administration expense

55. 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

56. 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.

57. An item that must be paid 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 choices are correct.



58. Assuming no conversion rights of bond holders or preferred shareholders, the retained earnings of the firm belongs to:
- A. creditors.
  - B. preferred shareholders.
  - C. common shareholders.
  - D. Canada Revenue Agency.
59. 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
60. 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.

61. 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.

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

True False

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

True False

64. Accounting income is based on verifiably completed transactions.

True False

65. For private companies, asset accounts are listed in order of their liquidity.

True False

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

True False

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

True False

68. Book value is equal to net worth.

True False

69. 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

70. Shareholders' equity is equal to liabilities plus assets.

True False

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

True False

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

True False

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

True False

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

True False

75. Accumulated amortization shows up in the income statement.

True False

76. The change in accumulated amortization is usually equal to the amortization expense charged in the income statement.

True False

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

True False

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

True False

79. 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

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

True False

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

True False

82. Interest expense is deductible before taxes and therefore has an after tax cost equal to the interest paid times  $(1 - \text{tax rate})$ .

True   False

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

True   False

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

True   False

85. 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

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

True   False

87. An increase in a liability account represents a source of funds.

True   False

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

True   False

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

True False

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

True False

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

True False

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

True False

93. The investments account includes marketable securities.

True False

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

True False

95. 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

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

True False

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

True False

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

True False

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

True False

100. Paying dividends to common shareholders will not affect cash flows from financing activities.

True False

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

True False

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

True False

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

True False

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

True False

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

True False

106.Balance sheet items are usually adjusted for inflation.

True False

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

True False

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

True False

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

True False



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

True   False

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

True   False

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

True   False

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

True   False

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

True   False

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

True   False

116. An increase in assets represents a source of funds.

True   False

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

True False

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

True False

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

True False

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

True False

121.Amortization expense is charged in the income statement.

True False

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

True False

123.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

124. Earnings available to common shareholders includes potential dividends to be paid to preferred shareholders.

True   False

125. 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

126. 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

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

True   False

128. The sale of a firm's preferred shares is a source of funds, whereas the payment of preferred dividends is a use of funds.

True   False

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

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

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

132. Several theories have been suggested about the factors contributing to the management or "manipulation" of reported earnings. List and explain them.

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

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

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

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

137.Describe and briefly explain the steps used in the indirect method to compute cash flows from typical operating activities of a company.

138. 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.

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

140. What is a tax savings?

141. 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?

142. 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?

143. 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?



144. Blink and Wink (BW) manufactures contact lens. In its most recent fiscal year BW reported after-tax 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?

145. 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?

146. The following is the December 31, 2014 balance sheet for the Epics Corporation.

<u>Assets</u>		<u>Liabilities</u>	
Cash	\$70,000	Accounts payable	\$100,000
Accounts receivable	150,000	Notes payable	120,000
Inventory	<u>280,000</u>	Bonds payable	<u>300,000</u>
Total current assets	500,000	Total liabilities	520,000
Plant and equipment	1,250,000	Equity	
Less: acc. amortization	<u>250,000</u>	Common stock	500,000
Net plant and Equipment	1,000,000	Retained earnings	<u>480,000</u>
		Total equity	980,000
Total assets	<u>\$1,500,000</u>	Total liab. & equity	<u>\$1,500,000</u>

Sales for 2015 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, 2015?

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

- A) Prepare a Statement of Cash Flows for the year ended December 31, 2015.
- B) What is the dividend payout ratio?
- C) If we increased the dividend payout ratio to 100%, what would happen to retained earnings?

<b>A.E. Neuman Corporation</b>		<b>Balance Sheet</b>	
<b>ASSETS</b>	<b>2014</b>	<b>2015</b>	
Cash	\$45,000	\$50,000	
Marketable Securities	175,000	160,000	
Accounts Receivable	240,000	220,000	
Inventories	230,000	275,000	
Investments	70,000	55,000	
Total current assets	\$760,000	\$760,000	
Plant and Equipment	1,300,000	1,550,000	
Less Accumulated Amortization	450,000	600,000	
Net Plant and Equipment	\$850,000	\$950,000	
Total Assets	\$1,610,000	\$1,710,000	

**LIABILITIES AND SHAREHOLDERS' EQUITY**

Accounts Payable	\$110,000	\$85,000
Notes Payable	65,000	10,000
Accrued Expenses	30,000	5,000
Income Taxes Payable	5,000	10,000
Bonds Payable (2016)	800,000	900,000
Common Stock (100,000 shares)	200,000	200,000
Retained Earnings	400,000	500,000
Total Liabilities and Shareholders' Equity	<u>\$1,610,000</u>	<u>\$1,710,000</u>

**A.E. Neuman Corporation**  
**Income Statement**  
**For the Year Ended December 31, 2015**

Sales	\$ 5,500,000
Less: Cost of Goods Sold	4,200,000
Gross Profit	1,300,000
Less: Selling, General & Administrative Expenses	<u>260,000</u>
Operating Profit	1,040,000
Less: Amortization Expense	<u>150,000</u>
Earnings Before Interest and Taxes	890,000
Less: Interest Expense	<u>90,000</u>
Earnings Before Taxes	800,000
Less: Taxes (50%)	<u>400,000</u>
Net Income	<u><u>\$ 400,000</u></u>

148. Calculate the tax bill for a corporation that earned \$250,000 in 2015 in Manitoba as a manufacturer.

149. 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%.

150. 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).

151. 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

## Chapter 2 Key

1. Which of the following is not one of the three basic financial statements required by Accounting Standards for Private Enterprises (ASPE)?

- A. Income Statement
- B. Statement of Retained Earnings**
- C. Statement of Cash Flows
- D. Balance Sheet

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #1*

*Difficulty: Easy*

*Learning Objective: 02-01 Prepare and analyze the four basic financial statements.*

*Topic: 02-01 Income Statement*

*Type: Memory*

2. Which of the following would not be classified as a current asset?

- A. Marketable securities
- B. Long term Investments**
- C. Prepaid expenses
- D. Inventory

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #2*

*Difficulty: Easy*

*Learning Objective: 02-05 Explain and include the effects of IFRS (International Financial Reporting Standards) on financial analysis.*

*Topic: 02-07 Interpretation of Balance Sheet Items*

*Type: Memory*

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.

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #3*

*Difficulty: Medium*

*Learning Objective: 02-01 Prepare and analyze the four basic financial statements.*

*Topic: 02-07 Interpretation of Balance Sheet Items*

*Type: Memory*

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

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #4*

*Difficulty: Easy*

*Learning Objective: 02-01 Prepare and analyze the four basic financial statements.*

*Topic: 02-02 Return on Capital*

*Type: Memory*



5. The residual income of the firm belongs to:

- A. creditors.
- B. preferred shareholders.
- C. common shareholders.
- D. bondholders.

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #5*

*Difficulty: Medium*

*Learning Objective: 02-05 Explain and include the effects of IFRS (International Financial Reporting Standards) on financial analysis.*

*Topic: 02-07 Interpretation of Balance Sheet Items*

*Type: Memory*

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.

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #6*

*Difficulty: Medium*

*Learning Objective: 02-01 Prepare and analyze the four basic financial statements.*

*Topic: 02-01 Income Statement*

*Type: Concept*

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

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #7*

*Difficulty: Easy*

*Learning Objective: 02-05 Explain and include the effects of IFRS (International Financial Reporting Standards) on financial analysis.*

*Topic: 02-07 Interpretation of Balance Sheet Items*

*Type: Memory*

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

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #8*

*Difficulty: Medium*

*Learning Objective: 02-05 Explain and include the effects of IFRS (International Financial Reporting Standards) on financial analysis.*

*Topic: 02-07 Interpretation of Balance Sheet Items*

*Type: Concept*

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

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #9*

*Difficulty: Medium*

*Learning Objective: 02-05 Explain and include the effects of IFRS (International Financial Reporting Standards) on financial analysis.*

*Topic: 02-07 Interpretation of Balance Sheet Items*

*Type: Concept*

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.

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #10*

*Difficulty: Medium*

*Learning Objective: 02-03 Examine the limitations of the balance sheet as a measure of a firms financial position.*

*Topic: 02-09 Limitations of the Balance Sheet*

*Type: Concept*

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

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #11*

*Difficulty: Hard*

*Learning Objective: 02-03 Examine the limitations of the balance sheet as a measure of a firm's financial position.*

*Topic: 02-09 Limitations of the Balance Sheet*

*Type: Concept*

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

- A. Weighted average
- B. Specific item
- C. FIFO
- D. Lower of cost or market

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #12*

*Difficulty: Medium*

*Learning Objective: 02-03 Examine the limitations of the balance sheet as a measure of a firm's financial position.*

*Topic: 02-09 Limitations of the Balance Sheet*

*Type: Concept*

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

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #13*

*Difficulty: Medium*

*Learning Objective: 02-05 Explain and include the effects of IFRS (International Financial Reporting Standards) on financial analysis.*

*Topic: 02-08 Valuation Basics from the Balance Sheet*

*Type: Concept*

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

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #14*

*Difficulty: Easy*

*Learning Objective: 02-01 Prepare and analyze the four basic financial statements.*

*Topic: 02-03 Valuation Basics from the Income Statement*

*Type: Concept*

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.

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #15*

*Difficulty: Easy*

*Learning Objective: 02-01 Prepare and analyze the four basic financial statements.*

*Topic: 02-03 Valuation Basics from the Income Statement*

*Type: Memory*

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

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #16*

*Difficulty: Easy*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-12 Determining Cash Flows from Operating Activities*

*Type: Concept*

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

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #17*

*Difficulty: Easy*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-12 Determining Cash Flows from Operating Activities*

*Type: Concept*

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.

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #18*

*Difficulty: Easy*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-12 Determining Cash Flows from Operating Activities*

*Type: Concept*

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.

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #19*

*Difficulty: Easy*

*Learning Objective: 02-08 Explain the concept of tax savings for companies.*

*Topic: 02-23 Amortization (Capital Cost Allowance) as a Tax Shield*

*Type: Concept*

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.

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #20*

*Difficulty: Easy*

*Learning Objective: 02-08 Explain the concept of tax savings for companies.*

*Topic: 02-22 Cost of a Tax-Deductible Expense*

*Type: Concept*



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).

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #21*

*Difficulty: Easy*

*Learning Objective: 02-01 Prepare and analyze the four basic financial statements.*

*Topic: 02-01 Income Statement*

*Type: Memory*

22. The firm's price-earnings (P/E) ratio is not influenced by its:

- A. capital structure.
- B. earnings volatility.
- C. sales, profit margins, and earnings.
- D. Purchase of machinery.

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #22*

*Difficulty: Easy*

*Learning Objective: 02-01 Prepare and analyze the four basic financial statements.*

*Topic: 02-03 Valuation Basics from the Income Statement*

*Type: Concept*

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.

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #23*

*Difficulty: Medium*

*Learning Objective: 02-01 Prepare and analyze the four basic financial statements.*

*Topic: 02-02 Return on Capital*

*Type: Concept*

24. The Balance Sheet cannot show:

- A. the current ratio.
- B. the value of common stock outstanding.
- C. the change in retained earnings.
- D. the price earnings relationship.

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #24*

*Difficulty: Medium*

*Learning Objective: 02-03 Examine the limitations of the balance sheet as a measure of a firms financial position.*

*Topic: 02-09 Limitations of the Balance Sheet*

*Type: Concept*

25. Well prepared accounting statements:

- A. let management know if cash flow from internal operations is large enough to make necessary equipment replacements.
- B. provide no new information to financial managers.
- C. determine the market price of common stock.
- D. eliminate the effects of inflation from decision making.

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #25*

*Difficulty: Medium*

*Learning Objective: 02-03 Examine the limitations of the balance sheet as a measure of a firms financial position.*

*Topic: 02-09 Limitations of the Balance Sheet*

*Type: Concept*

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

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #26*

*Difficulty: Easy*

*Learning Objective: 02-06 Outline the effect of corporate tax considerations on aftertax cash flow.*

*Topic: 02-19 Corporate Tax Rates*

*Type: Concept*

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. none of the choices are correct.

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #27*

*Difficulty: Easy*

*Learning Objective: 02-05 Explain and include the effects of IFRS (International Financial Reporting Standards) on financial analysis.*

*Topic: 02-08 Valuation Basics from the Balance Sheet*

*Type: Concept*

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

- A. whether a cash dividend is affordable.
- B. how increase 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 choices are correct.

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #28*

*Difficulty: Easy*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-10 Statement of Cash Flows*

*Type: Concept*

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 choices are correct

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #29*

*Difficulty: Medium*

*Learning Objective: 02-05 Explain and include the effects of IFRS (International Financial Reporting Standards) on financial analysis.*

*Topic: 02-08 Valuation Basics from the Balance Sheet*

*Type: Concept*

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. \$0
  - B. \$50,000
  - C. \$100,000
  - D. \$25,000

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #30*

*Difficulty: Medium*

*Learning Objective: 02-05 Explain and include the effects of IFRS (International Financial Reporting Standards) on financial analysis.*

*Topic: 02-08 Valuation Basics from the Balance Sheet*

*Type: Concept*

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 choices are correct

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #31*

*Difficulty: Medium*

*Learning Objective: 02-07 Identify the different forms of investment income and the effects on investors taxes payable.*

*Topic: 02-21 Personal Taxes*

*Type: Concept*

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

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #32*

*Difficulty: Medium*

*Learning Objective: 02-05 Explain and include the effects of IFRS (International Financial Reporting Standards) on financial analysis.*

*Topic: 02-07 Interpretation of Balance Sheet Items*

*Type: Concept*

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 of the choices are correct

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #33*

*Difficulty: Medium*

*Learning Objective: 02-03 Examine the limitations of the balance sheet as a measure of a firm's financial position.*

*Topic: 02-09 Limitations of the Balance Sheet*

*Type: Concept*

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.

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #34*

*Difficulty: Medium*

*Learning Objective: 02-01 Prepare and analyze the four basic financial statements.*

*Topic: 02-01 Income Statement*

*Type: Concept*

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

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #35*

*Difficulty: Medium*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-11 Developing an Actual Statement*

*Type: Memory*

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.

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #36*

*Difficulty: Easy*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-12 Determining Cash Flows from Operating Activities*

*Type: Concept*



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.

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #37*

*Difficulty: Easy*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-12 Determining Cash Flows from Operating Activities*

*Type: Concept*

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

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #38*

*Difficulty: Easy*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-12 Determining Cash Flows from Operating Activities*

*Type: Concept*

39. Reinvested funds from retained earnings theoretically belong to:

- A. bondholders.
- B. common shareholders.
- C. employees.
- D. all of the choices are correct.

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #39*

*Difficulty: Easy*

*Learning Objective: 02-01 Prepare and analyze the four basic financial statements.*

*Topic: 02-02 Return on Capital*

*Type: Concept*

40. For private companies, asset accounts on the balance sheet are listed in the order of:

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

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #40*

*Difficulty: Easy*

*Learning Objective: 02-05 Explain and include the effects of IFRS (International Financial Reporting Standards) on financial analysis.*

*Topic: 02-07 Interpretation of Balance Sheet Items*

*Type: Concept*

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.

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #41*

*Difficulty: Easy*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-12 Determining Cash Flows from Operating Activities*

*Type: Concept*

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.

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #42*

*Difficulty: Medium*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-17 Free Cash Flow*

*Type: Concept*

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

- A. leveraged buyouts.
- B. Registered Retirement Savings Plan (RRSPs).
- C. stock options.
- D. golden parachutes.

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #43*

*Difficulty: Hard*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-17 Free Cash Flow*

*Type: Concept*

44. Common stock dividends are \_\_\_\_\_ by preferred stock dividends.

- A. increased
- B. decreased
- C. not effected
- D. Not enough information to tell

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #44*

*Difficulty: Medium*

*Learning Objective: 02-01 Prepare and analyze the four basic financial statements.*

*Topic: 02-01 Income Statement*

*Type: Concept*

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

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #45*

*Difficulty: Easy*

*Learning Objective: 02-01 Prepare and analyze the four basic financial statements.*

*Topic: 02-01 Income Statement*

*Type: Concept*

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.

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #46*

*Difficulty: Medium*

*Learning Objective: 02-01 Prepare and analyze the four basic financial statements.*

*Topic: 02-03 Valuation Basics from the Income Statement*

*Type: Concept*

47. Net worth is equal to shareholders' equity:

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

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #47*

*Difficulty: Medium*

*Learning Objective: 02-05 Explain and include the effects of IFRS (International Financial Reporting Standards) on financial analysis.*

*Topic: 02-08 Valuation Basics from the Balance Sheet*

*Type: Concept*

48. Net worth for an individual is the same as \_\_\_\_\_ for a corporation.

- A. shareholders' equity
- B. capital assets minus long-term debt
- C. book value
- D. current assets minus current debt

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #48*

*Difficulty: Medium*

*Learning Objective: 02-05 Explain and include the effects of IFRS (International Financial Reporting Standards) on financial analysis.*

*Topic: 02-08 Valuation Basics from the Balance Sheet*

*Type: Concept*

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.

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #49*

*Difficulty: Medium*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-16 Amortization and Cash Flow*

*Type: Concept*

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.

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #50*

*Difficulty: Medium*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-16 Amortization and Cash Flow*

*Type: Concept*

51. The P/E ratio is determined by:

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

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #51*

*Difficulty: Medium*

*Learning Objective: 02-01 Prepare and analyze the four basic financial statements.*

*Topic: 02-03 Valuation Basics from the Income Statement*

*Type: Memory*

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.

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #52*

*Difficulty: Easy*

*Learning Objective: 02-05 Explain and include the effects of IFRS (International Financial Reporting Standards) on financial analysis.*

*Topic: 02-08 Valuation Basics from the Balance Sheet*

*Type: Concept*



53. Preferred share dividends \_\_\_\_\_ earnings available to common shareholders.

A. increase

B. decrease

C. due not effect

D. not enough information to tell

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #53*

*Difficulty: Easy*

*Learning Objective: 02-01 Prepare and analyze the four basic financial statements.*

*Topic: 02-01 Income Statement*

*Type: Concept*

54. Which of the following is not subtracted to arrive at operating profit?

A. Interest expense

B. Cost of goods sold

C. Amortization

D. Selling and administration expense

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #54*

*Difficulty: Easy*

*Learning Objective: 02-01 Prepare and analyze the four basic financial statements.*

*Topic: 02-01 Income Statement*

*Type: Concept*

55. 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

*Block - Chapter 02 #55*

*Difficulty: Medium*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-17 Free Cash Flow*

*Type: Concept*

56. 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.

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #56*

*Difficulty: Medium*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-13 Determining Cash Flows from Investing Activities*

*Type: Concept*

57. An item that must be paid 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 choices are correct.

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #57*

*Difficulty: Easy*

*Learning Objective: 02-05 Explain and include the effects of IFRS (International Financial Reporting Standards) on financial analysis.*

*Topic: 02-07 Interpretation of Balance Sheet Items*

*Type: Memory*

58. Assuming no conversion rights of bond holders or preferred shareholders, the retained earnings of the firm belongs to:

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

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #58*

*Difficulty: Easy*

*Learning Objective: 02-05 Explain and include the effects of IFRS (International Financial Reporting Standards) on financial analysis.*

*Topic: 02-07 Interpretation of Balance Sheet Items*

*Type: Memory*

59. 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

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #59*

*Difficulty: Medium*

*Learning Objective: 02-05 Explain and include the effects of IFRS (International Financial Reporting Standards) on financial analysis.*

*Topic: 02-07 Interpretation of Balance Sheet Items*

*Type: Concept*

60. 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.

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #60*

*Difficulty: Easy*

*Learning Objective: 02-08 Explain the concept of tax savings for companies.*

*Topic: 02-23 Amortization (Capital Cost Allowance) as a Tax Shield*

*Type: Concept*

61. 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.

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #61*

*Difficulty: Easy*

*Learning Objective: 02-08 Explain the concept of tax savings for companies.*

*Topic: 02-22 Cost of a Tax-Deductible Expense*

*Type: Concept*

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

**TRUE**

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #62*

*Difficulty: Easy*

*Learning Objective: 02-01 Prepare and analyze the four basic financial statements.*

*Topic: 02-01 Income Statement*

*Type: Concept*

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

**FALSE**

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #63*

*Difficulty: Easy*

*Learning Objective: 02-01 Prepare and analyze the four basic financial statements.*

*Topic: 02-01 Income Statement*

*Type: Concept*

64. Accounting income is based on verifiably completed transactions.

TRUE

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #64*

*Difficulty: Easy*

*Learning Objective: 02-01 Prepare and analyze the four basic financial statements.*

*Topic: 02-01 Income Statement*

*Type: Concept*

65. For private companies, asset accounts are listed in order of their liquidity.

TRUE

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #65*

*Difficulty: Easy*

*Learning Objective: 02-05 Explain and include the effects of IFRS (International Financial Reporting Standards) on financial analysis.*

*Topic: 02-07 Interpretation of Balance Sheet Items*

*Type: Concept*

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

FALSE

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #66*

*Difficulty: Medium*

*Learning Objective: 02-05 Explain and include the effects of IFRS (International Financial Reporting Standards) on financial analysis.*

*Topic: 02-07 Interpretation of Balance Sheet Items*

*Type: Concept*

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

FALSE

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #67*

*Difficulty: Easy*

*Learning Objective: 02-05 Explain and include the effects of IFRS (International Financial Reporting Standards) on financial analysis.*

*Topic: 02-08 Valuation Basics from the Balance Sheet*

*Type: Concept*

68. Book value is equal to net worth.

**TRUE**

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #68*

*Difficulty: Easy*

*Learning Objective: 02-05 Explain and include the effects of IFRS (International Financial Reporting Standards) on financial analysis.*

*Topic: 02-08 Valuation Basics from the Balance Sheet*

*Type: Concept*

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

**TRUE**

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #69*

*Difficulty: Medium*

*Learning Objective: 02-05 Explain and include the effects of IFRS (International Financial Reporting Standards) on financial analysis.*

*Topic: 02-07 Interpretation of Balance Sheet Items*

*Type: Concept*

70. Shareholders' equity is equal to liabilities plus assets.

**FALSE**

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #70*

*Difficulty: Easy*

*Learning Objective: 02-05 Explain and include the effects of IFRS (International Financial Reporting Standards) on financial analysis.*

*Topic: 02-08 Valuation Basics from the Balance Sheet*

*Type: Memory*

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

TRUE

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #71*

*Difficulty: Easy*

*Learning Objective: 02-05 Explain and include the effects of IFRS (International Financial Reporting Standards) on financial analysis.*

*Topic: 02-08 Valuation Basics from the Balance Sheet*

*Type: Memory*

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

TRUE

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #72*

*Difficulty: Easy*

*Learning Objective: 02-05 Explain and include the effects of IFRS (International Financial Reporting Standards) on financial analysis.*

*Topic: 02-08 Valuation Basics from the Balance Sheet*

*Type: Concept*

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

TRUE

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #73*

*Difficulty: Easy*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-10 Statement of Cash Flows*

*Type: Concept*

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

FALSE

*Accessibility: Keyboard Navigation*



75. Accumulated amortization shows up in the income statement.

FALSE

76. The change in accumulated amortization is usually equal to the amortization expense charged in the income statement.

TRUE

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

TRUE

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

TRUE

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #78*

*Difficulty: Easy*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-16 Amortization and Cash Flow*

*Type: Concept*

79. 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

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #79*

*Difficulty: Medium*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-10 Statement of Cash Flows*

*Type: Concept*

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

FALSE

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #80*

*Difficulty: Medium*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-10 Statement of Cash Flows*

*Type: Concept*

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

FALSE

*Accessibility: Keyboard Navigation*

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

TRUE

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

FALSE

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

TRUE

85. 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**

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #85*

*Difficulty: Medium*

*Learning Objective: 02-05 Explain and include the effects of IFRS (International Financial Reporting Standards) on financial analysis.*

*Topic: 02-07 Interpretation of Balance Sheet Items*

*Type: Concept*

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

**FALSE**

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #86*

*Difficulty: Easy*

*Learning Objective: 02-05 Explain and include the effects of IFRS (International Financial Reporting Standards) on financial analysis.*

*Topic: 02-06 Effects of IFRS on Financial Analysis*

*Type: Concept*

87. An increase in a liability account represents a source of funds.

**TRUE**

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #87*

*Difficulty: Easy*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-12 Determining Cash Flows from Operating Activities*

*Type: Concept*

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

**TRUE**

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #88*

*Difficulty: Medium*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-10 Statement of Cash Flows*

*Type: Concept*

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

**FALSE**

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #89*

*Difficulty: Easy*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-10 Statement of Cash Flows*

*Type: Concept*

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

**FALSE**

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #90*

*Difficulty: Easy*

*Learning Objective: 02-06 Outline the effect of corporate tax considerations on aftertax cash flow.*

*Topic: 02-19 Corporate Tax Rates*

*Type: Memory*

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

**FALSE**

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #91*

*Difficulty: Medium*

*Learning Objective: 02-01 Prepare and analyze the four basic financial statements.*

*Topic: 02-02 Return on Capital*

*Type: Concept*

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

**FALSE**

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #92*

*Difficulty: Easy*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-10 Statement of Cash Flows*

*Type: Concept*

93. The investments account includes marketable securities.

**FALSE**

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #93*

*Difficulty: Medium*

*Learning Objective: 02-05 Explain and include the effects of IFRS (International Financial Reporting Standards) on financial analysis.*

*Topic: 02-07 Interpretation of Balance Sheet Items*

*Type: Concept*

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

**TRUE**

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #94*

*Difficulty: Easy*

*Learning Objective: 02-05 Explain and include the effects of IFRS (International Financial Reporting Standards) on financial analysis.*

*Topic: 02-07 Interpretation of Balance Sheet Items*

*Type: Concept*

95. 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**

*Accessibility: Keyboard Navigation*

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

TRUE

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

FALSE

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

TRUE

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

**TRUE**

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #99*

*Difficulty: Medium*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-14 Determining Cash Flows from Financing Activities*

*Type: Concept*

100. Paying dividends to common shareholders will not affect cash flows from financing activities.

**FALSE**

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #100*

*Difficulty: Medium*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-13 Determining Cash Flows from Investing Activities*

*Type: Concept*

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

**FALSE**

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #101*

*Difficulty: Medium*

*Learning Objective: 02-01 Prepare and analyze the four basic financial statements.*

*Topic: 02-01 Income Statement*

*Type: Concept*

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

**TRUE**

*Accessibility: Keyboard Navigation*



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

**FALSE**

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

**FALSE**

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

**TRUE**

106. Balance sheet items are usually adjusted for inflation.

FALSE

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #106*

*Difficulty: Medium*

*Learning Objective: 02-02 Examine the limitations of the income statement as a measure of a firm's profitability.*

*Topic: 02-05 Balance Sheet*

*Type: Concept*

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

TRUE

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #107*

*Difficulty: Medium*

*Learning Objective: 02-05 Explain and include the effects of IFRS (International Financial Reporting Standards) on financial analysis.*

*Topic: 02-07 Interpretation of Balance Sheet Items*

*Type: Concept*

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

TRUE

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #108*

*Difficulty: Medium*

*Learning Objective: 02-05 Explain and include the effects of IFRS (International Financial Reporting Standards) on financial analysis.*

*Topic: 02-07 Interpretation of Balance Sheet Items*

*Type: Concept*

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

**FALSE**

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #109*

*Difficulty: Medium*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-13 Determining Cash Flows from Investing Activities*

*Type: Concept*

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

**TRUE**

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #110*

*Difficulty: Medium*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-14 Determining Cash Flows from Financing Activities*

*Type: Concept*

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

**FALSE**

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #111*

*Difficulty: Medium*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-16 Amortization and Cash Flow*

*Type: Concept*

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

FALSE

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #112*

*Difficulty: Medium*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-17 Free Cash Flow*

*Type: Memory*

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

TRUE

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #113*

*Difficulty: Medium*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-17 Free Cash Flow*

*Type: Memory*

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

TRUE

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #114*

*Difficulty: Easy*

*Learning Objective: 02-07 Identify the different forms of investment income and the effects on investors taxes payable.*

*Topic: 02-21 Personal Taxes*

*Type: Concept*

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

FALSE

*Accessibility: Keyboard Navigation*

116. An increase in assets represents a source of funds.

**FALSE**

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

**FALSE**

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

**TRUE**

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

TRUE

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #119*

*Difficulty: Hard*

*Learning Objective: 02-01 Prepare and analyze the four basic financial statements.*

*Topic: 02-03 Valuation Basics from the Income Statement*

*Type: Concept*

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

TRUE

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #120*

*Difficulty: Hard*

*Learning Objective: 02-05 Explain and include the effects of IFRS (International Financial Reporting Standards) on financial analysis.*

*Topic: 02-07 Interpretation of Balance Sheet Items*

*Type: Concept*

121. Amortization expense is charged in the income statement.

TRUE

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #121*

*Difficulty: Medium*

*Learning Objective: 02-01 Prepare and analyze the four basic financial statements.*

*Topic: 02-01 Income Statement*

*Type: Concept*

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

FALSE

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #122*

*Difficulty: Medium*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

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

TRUE

Accessibility: Keyboard Navigation

Block - Chapter 02 #123

Difficulty: Easy

Learning Objective: 02-01 Prepare and analyze the four basic financial statements.

Topic: 02-01 Income Statement

Type: Concept

124. Earnings available to common shareholders includes potential dividends to be paid to preferred shareholders.

FALSE

Accessibility: Keyboard Navigation

Block - Chapter 02 #124

Difficulty: Easy

Learning Objective: 02-01 Prepare and analyze the four basic financial statements.

Topic: 02-02 Return on Capital

Type: Concept

125. 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

Accessibility: Keyboard Navigation

Block - Chapter 02 #125

Difficulty: Medium

Learning Objective: 02-07 Identify the different forms of investment income and the effects on investors taxes payable.

Topic: 02-21 Personal Taxes

Type: Concept

126. 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

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #126*

*Difficulty: Medium*

*Learning Objective: 02-01 Prepare and analyze the four basic financial statements.*

*Topic: 02-02 Return on Capital*

*Type: Concept*

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

FALSE

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #127*

*Difficulty: Easy*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-17 Free Cash Flow*

*Type: Memory*

128. The sale of a firm's preferred shares is a source of funds, whereas the payment of preferred dividends is a use of funds.

TRUE

*Accessibility: Keyboard Navigation*

*Block - Chapter 02 #128*

*Difficulty: Easy*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-14 Determining Cash Flows from Financing Activities*

*Type: Memory*



129. 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.

*Block - Chapter 02 #129*

*Difficulty: Easy*

*Learning Objective: 02-01 Prepare and analyze the four basic financial statements.*

*Topic: 02-01 Income Statement*

*Type: Concept*

130. 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

*Block - Chapter 02 #130*

*Difficulty: Easy*

131. 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.

*Block - Chapter 02 #131*

*Difficulty: Easy*

*Learning Objective: 02-01 Prepare and analyze the four basic financial statements.*

*Topic: 02-01 Income Statement*

*Topic: 02-02 Return on Capital*

*Topic: 02-03 Valuation Basics from the Income Statement*

*Type: Memory*

132. 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.)

*Block - Chapter 02 #132*

*Difficulty: Easy*

*Learning Objective: 02-02 Examine the limitations of the income statement as a measure of a firm's profitability.*

*Topic: 02-04 Limitations of the Income Statement*

*Type: Concept*

133. 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.

134. 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.

*Block - Chapter 02 #134*

*Difficulty: Medium*

*Learning Objective: 02-03 Examine the limitations of the balance sheet as a measure of a firm's financial position.*

*Topic: 02-09 Limitations of the Balance Sheet*

*Type: Memory*

135. 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.

*Block - Chapter 02 #135*

*Difficulty: Medium*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-10 Statement of Cash Flows*

*Type: Concept*

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

These sections are:

1. Operating activities
2. Investing activities
3. Financing activities

*Block - Chapter 02 #136*

*Difficulty: Medium*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-10 Statement of Cash Flows*

*Type: Concept*

*Type: Memory*

137. 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.

*Block - Chapter 02 #137*

*Difficulty: Hard*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-12 Determining Cash Flows from Operating Activities*

*Type: Concept*



138. 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.

*Block - Chapter 02 #138*

*Difficulty: Hard*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-17 Free Cash Flow*

*Type: Concept*

139. 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.)

*Block - Chapter 02 #139*

*Difficulty: Easy*

*Learning Objective: 02-07 Identify the different forms of investment income and the effects on investors taxes payable.*

*Topic: 02-21 Personal Taxes*

*Type: Memory*

140. 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.

*Block - Chapter 02 #140*

*Difficulty: Easy*

*Learning Objective: 02-07 Identify the different forms of investment income and the effects on investors taxes payable.*

*Topic: 02-21 Personal Taxes*

*Type: Memory*

141. 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

$$\text{EAT} = \$350,000 - \$45,000 = \$305,000$$

*Block - Chapter 02 #141*

*Difficulty: Easy*

*Learning Objective: 02-01 Prepare and analyze the four basic financial statements.*

*Topic: 02-01 Income Statement*

*Type: Memory*

142. 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?

$$\frac{P}{E} = \frac{\$4}{\$2}$$

$$\text{P/E} = 2 \text{ times}$$

For every \$1 earned by TBF you would be paying \$2 in price.

*Block - Chapter 02 #142*

*Difficulty: Easy*

*Learning Objective: 02-01 Prepare and analyze the four basic financial statements.*

*Topic: 02-03 Valuation Basics from the Income Statement*

*Type: Memory*

143. 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?

$$\text{Dividend Yield} = \frac{\text{Dividend}}{\text{Price}}$$

$$\text{Dividend Yield} = (\$1.50/\$33) \times 100 = 4.55\%$$

*Block - Chapter 02 #143*

*Difficulty: Easy*

*Learning Objective: 02-01 Prepare and analyze the four basic financial statements.*

*Topic: 02-03 Valuation Basics from the Income Statement*

*Type: Memory*

144. Blink and Wink (BW) manufactures contact lens. In its most recent fiscal year BW reported after-tax 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?

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

$$\text{Before Tax Interest Expense} = \frac{\$550,000}{1 - .35}$$

$$\text{Before Tax Interest Expense} = \$846,154$$

*Block - Chapter 02 #144*

*Difficulty: Medium*

*Learning Objective: 02-08 Explain the concept of tax savings for companies.*

*Topic: 02-22 Cost of a Tax-Deductible Expense*

*Type: Concept*

145. 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?

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

$$\text{BV per Share} = \frac{\$350,000 - \$85,000}{37,000}$$

$$\text{BV per Share} = \$265,000 / 37,000 = \$7.16$$

*Block - Chapter 02 #145*

*Difficulty: Easy*

*Learning Objective: 02-05 Explain and include the effects of IFRS (International Financial Reporting Standards) on financial analysis.*

*Topic: 02-08 Valuation Basics from the Balance Sheet*

*Type: Memory*

146. The following is the December 31, 2014 balance sheet for the Epics Corporation.

<u>Assets</u>		<u>Liabilities</u>	
Cash	\$70,000	Accounts payable	\$100,000
Accounts receivable	150,000	Notes payable	120,000
Inventory	<u>280,000</u>	Bonds payable	<u>300,000</u>
Total current assets	500,000	Total liabilities	520,000
Plant and equipment	1,250,000	Equity	
Less: acc. amortization	<u>250,000</u>	Common stock	500,000
Net plant and Equipment	1,000,000	Retained earnings	<u>480,000</u>
		Total equity	980,000
Total assets	<u>\$1,500,000</u>	Total liab. & equity	<u>\$1,500,000</u>

Sales for 2015 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, 2015?

**A) Income Statement**

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

**B)**

\$318,720	Net Income
<u>× .35</u>	Payout ratio
\$111,552	Dividends Paid
\$318,720	Net Income
<u>111,552</u>	Dividends Paid
207,168	Amount Retained
<u>+480,000</u>	Retained Earnings 04
\$687,168	Retained Earnings 05

Block - Chapter 02 #146

Difficulty: Medium

Learning Objective: 02-01 Prepare and analyze the four basic financial statements.

Learning Objective: 02-08 Explain the concept of tax savings for companies.

Topic: 02-01 Income Statement

Topic: 02-02 Return on Capital

*Topic: 02-03 Valuation Basics from the Income Statement*

*Topic: 02-22 Cost of a Tax-Deductible Expense*

*Type: Concept*

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

A) Prepare a Statement of Cash Flows for the year ended December 31, 2015.

B) What is the dividend payout ratio?

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

<b>A.E. Neuman Corporation</b>		<b>Balance Sheet</b>	
<b>ASSETS</b>	<b>2014</b>	<b>2015</b>	
Cash	\$45,000	\$50,000	
Marketable Securities	175,000	160,000	
Accounts Receivable	240,000	220,000	
Inventories	230,000	275,000	
Investments	70,000	55,000	
Total current assets	\$760,000	\$760,000	
Plant and Equipment	1,300,000	1,550,000	
Less Accumulated Amortization	450,000	600,000	
Net Plant and Equipment	\$850,000	\$950,000	
Total Assets	\$1,610,000	\$1,710,000	

**LIABILITIES AND SHAREHOLDERS' EQUITY**

Accounts Payable	\$110,000	\$85,000
Notes Payable	65,000	10,000
Accrued Expenses	30,000	5,000
Income Taxes Payable	5,000	10,000
Bonds Payable (2016)	800,000	900,000
Common Stock (100,000 shares)	200,000	200,000
Retained Earnings	400,000	500,000
Total Liabilities and Shareholders' Equity	<u>\$1,610,000</u>	<u>\$1,710,000</u>



**A.E. Neuman Corporation**  
**Income Statement**  
**For the Year Ended December 31, 2015**

Sales	\$ 5,500,000
Less: Cost of Goods Sold	4,200,000
Gross Profit	1,300,000
Less: Selling, General & Administrative Expenses	<u>260,000</u>
Operating Profit	1,040,000
Less: Amortization Expense	<u>150,000</u>
Earnings Before Interest and Taxes	890,000
Less: Interest Expense	<u>90,000</u>
Earnings Before Taxes	800,000
Less: Taxes (50%)	<u>400,000</u>
Net Income	<u><u>\$ 400,000</u></u>

A)

**Operating Activities**

Net Income (earnings after taxes)	\$400,000
Add items not requiring an outlay of cash:	
Amortization	<u>150,000</u>
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	<u>5,000</u>
Net change in non-cash working capital	<u>125,000</u>
Cash provided by operating activities	425,000

**Investing Activities**

Decrease in investments	15,000
Increase in plant & equipment	<u>(250,000)</u>
Cash used in investing activities	(235,000)

**Financing Activities**

Increase in bonds payable	100,000
Dividends paid	<u>(300,000)</u>
Cash used in financing activities	(200,000)

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

B)

$$\begin{aligned}\text{Dividend payout ratio} &= \frac{\text{Dividends paid, 2015}}{\text{Net Income, 2015}} \\ &= \frac{\$300,000}{\$400,000} = 0.75 = 75\%\end{aligned}$$

C) The 2015 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.

*Block - Chapter 02 #147*

*Difficulty: Medium*

*Learning Objective: 02-01 Prepare and analyze the four basic financial statements.*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-01 Income Statement*

*Topic: 02-02 Return on Capital*

*Topic: 02-03 Valuation Basics from the Income Statement*

*Topic: 02-11 Developing an Actual Statement*

*Topic: 02-12 Determining Cash Flows from Operating Activities*

*Topic: 02-13 Determining Cash Flows from Investing Activities*

*Topic: 02-14 Determining Cash Flows from Financing Activities*

*Topic: 02-15 Combining the Three Sections of the Statement*

*Type: Concept*

148. Calculate the tax bill for a corporation that earned \$250,000 in 2015 in Manitoba as a manufacturer.

Tax Rate	Incremental Income	Tax Liability
13%	\$250,000	=\$32,500

*Block - Chapter 02 #148*

*Difficulty: Medium*

*Learning Objective: 02-06 Outline the effect of corporate tax considerations on aftertax cash flow.*

*Topic: 02-19 Corporate Tax Rates*

*Type: Concept*

149. 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%.

Annual interest	=	$10,000 \times \$1,000 \times 8\%$
	=	\$800,000
After tax cost	=	$\$800,000 \times (1 - \text{tax rate})$
	=	$\$800,000 \times (1 - .42)$
	=	\$464,000

*Block - Chapter 02 #149*

*Difficulty: Medium*

*Learning Objective: 02-06 Outline the effect of corporate tax considerations on aftertax cash flow.*

*Topic: 02-20 Effective Tax Rate Examples*

*Type: Concept*

150. 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).

<b>ElectroWizard Company</b> <b>Income Statement</b> <b>for the year ended 12/31/ __</b>		
Sales (50,000 @ \$32)		\$1,600,000
Less: Cost of Goods Sold		<u>300,000</u>
Gross Profit		1,300,000
Less: Operating Expenses		
Selling and administrative	\$80,000	
Amortization	<u>10,000</u>	<u>90,000</u>
Operating Profit (EBIT)		1,210,000
Less: Interest expense (\$100,000 @ 12%)	<u>12,000</u>	
Earnings Before Taxes		1,198,000
Less: Taxes @ 40%		<u>479,200</u>
Net Income		<u>\$718,800</u>
Common Shares		100,000
Earnings Per Share		\$7.189

*Block - Chapter 02 #150*

*Difficulty: Medium*

*Learning Objective: 02-01 Prepare and analyze the four basic financial statements.*

*Learning Objective: 02-06 Outline the effect of corporate tax considerations on aftertax cash flow.*

*Topic: 02-01 Income Statement*

*Topic: 02-02 Return on Capital*

*Topic: 02-03 Valuation Basics from the Income Statement*

*Topic: 02-20 Effective Tax Rate Examples*

*Type: Concept*

151. 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

<u>+ O</u>	1. Increase in accounts payable
<u>+ O</u>	2. Decrease in inventory
<u>+ O</u>	3. Net income from operations
<u>- F</u>	4. Payment of dividends
<u>- F</u>	5. Sale of preferred stock
<u>- O</u>	6. Increase in accrued expenses
<u>- I</u>	7. Purchase of new equipment
<u>- O</u>	8. Decrease in amortization expense
<u>- O</u>	9. Increase in accounts receivable
<u>- O</u>	10. Decrease in notes payable
<u>+ F</u>	11. Increase in net worth
<u>+ F</u>	12. Increase in long-term liabilities
<u>- I</u>	13. Increase in investments
<u>+ O</u>	14. Decrease in marketable securities
<u>- F</u>	15. Reduction in retained earnings
<u>- F</u>	16. Repurchase of common shares outstanding
<u>- O</u>	17. Increase in prepaid expense
<u>- O</u>	18. Decrease in income taxes payable
<u>- F</u>	19. Retirement of long-term bonds payable
<u>+ F</u>	20. Sale of new common stock

*Block - Chapter 02 #151*

*Difficulty: Medium*

*Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.*

*Topic: 02-11 Developing an Actual Statement*

*Topic: 02-12 Determining Cash Flows from Operating Activities*

*Topic: 02-13 Determining Cash Flows from Investing Activities*

*Topic: 02-14 Determining Cash Flows from Financing Activities*

*Topic: 02-15 Combining the Three Sections of the Statement*

*Type: Concept*

## Chapter 2 Summary

<u>Category</u>	<u># of Questions</u>
Accessibility: Keyboard Navigation	127
Block - Chapter 02	151
Difficulty: Easy	68
Difficulty: Hard	9
Difficulty: Medium	74
Learning Objective: 02-01 Prepare and analyze the four basic financial statements.	42
Learning Objective: 02-02 Examine the limitations of the income statement as a measure of a firms profitability.	3
Learning Objective: 02-03 Examine the limitations of the balance sheet as a measure of a firms financial position.	7
Learning Objective: 02-04 Explain the importance of cash flows as identified in the statement of cash flows.	47
Learning Objective: 02-05 Explain and include the effects of IFRS (International Financial Reporting Standards) on financial analysis.	37
Learning Objective: 02-06 Outline the effect of corporate tax considerations on aftertax cash flow.	6
Learning Objective: 02-07 Identify the different forms of investment income and the effects on investors taxes payable.	5
Learning Objective: 02-08 Explain the concept of tax savings for companies.	7
Topic: 02-01 Income Statement	23
Topic: 02-02 Return on Capital	11
Topic: 02-03 Valuation Basics from the Income Statement	15
Topic: 02-04 Limitations of the Income Statement	1
Topic: 02-05 Balance Sheet	2
Topic: 02-06 Effects of IFRS on Financial Analysis	1
Topic: 02-07 Interpretation of Balance Sheet Items	22
Topic: 02-08 Valuation Basics from the Balance Sheet	15
Topic: 02-09 Limitations of the Balance Sheet	7
Topic: 02-10 Statement of Cash Flows	10
Topic: 02-11 Developing an Actual Statement	3
Topic: 02-12 Determining Cash Flows from Operating Activities	16
Topic: 02-13 Determining Cash Flows from Investing Activities	6

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Topic: 02-14 Determining Cash Flows from Financing Activities	5
Topic: 02-15 Combining the Three Sections of the Statement	2
Topic: 02-16 Amortization and Cash Flow	6
Topic: 02-17 Free Cash Flow	7
Topic: 02-19 Corporate Tax Rates	4
Topic: 02-20 Effective Tax Rate Examples	2
Topic: 02-21 Personal Taxes	5
Topic: 02-22 Cost of a Tax-Deductible Expense	4
Topic: 02-23 Amortization (Capital Cost Allowance) as a Tax Shield	3
Type: Concept	121
Type: Memory	31