TEST FINANCIAL STATEMENT ANALYSIS

57 QUESTIONS AND ANSWERS

Schweser Printable Answers - Test Management Exam 1 - #7 FSA, Corp Fi

Test ID#: 25

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Question 1 - #98190

Which of the following statements represents information at a specific point in time?

A) The income statement and the balance sheet.
B) The income statement.
C) The balance sheet.

Your answer: C was correct!

The balance sheet represents information at a specific point in time. The income statement represents information over a period of time.

This question tested from Session 7, Reading 29, LOS b.

Question 2 - #98098

Sergey Martinenko is an investment analyst with Profis, Martinenko and Verona. He is explaining to his new assistant, John Stevenson, why it is crucial for an investment analyst to read the footnotes to a firm's financial statement and the Management Discussion and Analysis (MD&A) before making an investment decision. Which rationale is Martinenko *least likely* to provide to Stevenson regarding the importance of analyzing the footnotes and MD&A?

A) Accruals, adjustments and assumptions are often explained in the footnotes and MD&A.
B) The footnotes disclose whether or not the company is adhering to GAAP.
C) Evaluating the footnotes helps the analyst assess whether management is manipulating earnings.

Your answer: C was incorrect. The correct answer was B) The footnotes disclose whether or not the company is adhering to GAAP.

Various accruals, adjustments, and management assumptions that went into the financial statements are often explained in the footnotes to the statements and in Management's Discussion and Analysis. Because adjustments and assumptions within the financial statements are to some extent at the discretion of management, the possibility exists that management can try to manipulate or misrepresent the company's financial performance. With this information, the analyst can better judge how well the financial statements reflect the company's true performance, and in what ways he needs to adjust the data for his own analysis. Whether or not the company is adhering to GAAP is addressed in the auditor's opinion, not the footnotes.

This question tested from Session 7, Reading 30, LOS h.

Question 3 - #98121

Which of the following is a company *least* likely required to present according to International Accounting Standard (IAS) No. 1?

A) A summary of accounting policies.

B) Disclosures of material events.

C) Statement of changes in owners' equity.

Your answer: C was incorrect. The correct answer was B) Disclosures of material events.

International Accounting Standard (IAS) No. 1 defines which financial statements are required and how they must be presented. The required financial statements are:

- Balance sheet.
- Income statement.
- Cash flow statement.
- Statement of changes in owners' equity.
- Explanatory notes, including a summary of accounting policies.

Disclosures of material events that affect the company are required by the Securities and Exchange Commission (Form 8-K) for firms that are publicly traded in the United States.

This question tested from Session 7, Reading 31, LOS e.

Question 4 - #98151

Prema Singh is the bookkeeper for Octabius Industries. Singh has been asked by the CFO of Octabius to review all purchases that occurred between February 1 and February 8 to investigate an error on the receiving dock. Singh will *most likely* look at the:

A) initial trial balance.

B) general ledger.

C) general journal.

Your answer: C was correct!

Journal entries record every transaction, showing which accounts are changed by what amounts. A listing of all the journal entries in order by date is called the "general journal."

This question tested from Session 7, Reading 30, LOS g.

Question 5 - #98196

Which of the following is the *best* description of the financial statement analysis framework?

A) State the objective and context, gather data, process the data, analyze and interpret the data, report the conclusions or recommendations, update the analysis.

B) Gather data, analyze and interpret the data, process the conclusions, assess the context, report the recommendations, update the analysis.

C) Gather data, analyze and interpret the data, determine the context, report the conclusions, update the analysis.

Your answer: C was incorrect. The correct answer was A) State the objective and context, gather data, process the data, analyze and interpret the data, report the conclusions or recommendations, update the analysis.

The financial statement analysis framework consists of six steps:

1. *State the objective and context.*
2. *Gather data.*
3. *Process the data.*
4. *Analyze and interpret the data.*
5. *Report the conclusions or recommendations.*
6. *Update the analysis.*

This question tested from Session 7, Reading 29, LOS f.

Question 6 - #98104

Which of the following statements is the *most* accurate?

A) The SEC requires foreign firms that issue securities in the U.S. to reconcile their financial statements to U.S. GAAP.

B) The IASB requires companies that report to US GAAP to issue a reconciliation statement showing what its financial results would have been under IASB reporting requirements.

C) The going concern assumption is less relevant in the IASB framework than in the FASB framework.

Your answer: C was incorrect. The correct answer was A) The SEC requires foreign firms that issue securities in the U.S. to reconcile their financial statements to U.S. GAAP.

In many cases a company will present a reconciliation statement showing what its financial results would have been under an alternative reporting system, but that is not always required. The SEC requires foreign firms that issue securities in the U.S. to reconcile their financial statements to U.S. GAAP. The IASB framework places more emphasis on the going concern assumption than the FASB framework.

This question tested from Session 7, Reading 31, LOS f.

Question 7 - #98130

Which of the following items would *least likely* be included in cash flow from financing?

A) Dividends paid to shareholders.

B) Gain on sale of stock of a subsidiary.

C) Purchase of treasury stock.

Your answer: C was incorrect. The correct answer was B) Gain on sale of stock of a subsidiary.

Gains or losses will be found in cash flow from investments.

This question tested from Session 7, Reading 30, LOS a.

Question 8 - #98079

Which of the following is *least* likely to be considered a stated goal of the International Accounting Standards Board (IASB)?

A) Develop global accounting standards requiring transparency, comparability, and high quality in financial statements.

B) Remain neutral in the debate on the use of global accounting standards to avoid appearance of a conflict of interest.

C) Account for the needs of emerging markets and small firms when implementing global accounting standards.

Your answer: C was incorrect. The correct answer was B) Remain neutral in the debate on the use of global accounting standards to avoid appearance of a conflict of interest.

The IASB has four stated goals:
1. Develop global accounting standards requiring transparency, comparability, and high quality in financial statements.
2. Promote the use of global accounting standards.
3. Account for the needs of emerging markets and small firms when implementing global accounting standards.
4. Achieve convergence between various national accounting standards and global accounting standards.

This question tested from Session 7, Reading 31, LOS b.

Question 9 - #98085

When a publicly traded U.S. company prepares a proxy statement for its shareholders prior to the annual meeting or other shareholder vote, it also files the statement with the SEC as Form:

A) 8-K.

B) 144.

C) DEF-14A.

Your answer: C was correct!

Form DEF-14A: When a company prepares a proxy statement for its shareholders prior to the annual meeting or other shareholder vote, it also files the statement with the SEC as Form DEF-14A.
Form 8-K: Companies must file this form to disclose material events including significant asset acquisitions and disposals, changes in management or corporate governance, or matters related to its accountants, financial statements, or the markets on which its securities trade.
Form 144: A company can issue securities to certain qualified buyers without registering the securities with the SEC, but must notify the SEC that it intends to do so.

This question tested from Session 7, Reading 31, LOS b.

Question 10 - #98179

The term “convergence” is *most* accurately used to describe:

A) the process of developing one universally accepted set of accounting standards.
B) the reduction of the premium on a bond as it nears maturity.
C) when expected return and required return are equal.

Your answer: C was incorrect. The correct answer was A) the process of developing one universally accepted set of accounting standards.

Moving towards agreement on a single set of accounting standards is referred to as “convergence.”

This question tested from Session 7, Reading 31, LOS c.

Question 11 - #98165

According to FASB, timeliness is a characteristic of:

A) relevance.
B) reliability.
C) both relevance and reliability.

Your answer: C was incorrect. The correct answer was A) relevance.

Per FASB Concept Statement # 2, timeliness is an attribute of relevance and not of reliability.

This question tested from Session 7, Reading 31, LOS d.

Question 12 - #98094

Which of the following statements about financial reporting standards is *least* accurate? Reporting standards:

A) narrow the range within which management estimates can be seen as reasonable.
B) ensure that the information is “useful to a wide range of users.”
C) are disclosed on Form 8K by publicly traded firms in the United States.

Your answer: C was correct!

Reporting standards ensure that the information is “useful to a wide range of users,” including security analysts, by making financial statements comparable to one another and narrowing the range within which management’s estimates can be seen as reasonable. Securities & Exchange Commission Form 8K addresses acquisitions, divestitures, etc. and not reporting standards.

This question tested from Session 7, Reading 31, LOS a.

Question 13 - #97835

The Allen Corporation had 100,000 shares of common stock outstanding at the beginning of the year. Allen issued 30,000 shares of common May 1. On July 1, the company issued a 10% stock dividend. On September 1, Allen issued 1,000, 10% bonds convertible into 21 shares of stock each. What is the weighted average number of shares to be used in computing basic and diluted earnings per share (EPS), assuming the convertible bonds are dilutive?

	Basic Shares	Diluted Shares
A)	132,000	139,000
B)	130,000	132,000
C)	132,000	146,000

Your answer: C was incorrect. The correct answer was A)
132,000 139,000

Calculating Basic Shares:

Jan 1 100,000 shares outstanding
May 1 30,000 shares issued
July 1 10% stock dividend issued

The 10% stock dividend is retroactive therefore:

110,000 shares × 12 months = 1,320,000
33,000 shares × 8 months = 264,000
Total share-month = 1,584,000
Average shares = (1,584,000 / 12) = 132,000

Calculating diluted shares:

(1,000 bonds) × (21 shares each) × (4 months) = 84,000 total share-month
84,000 / 12 = 7,000 Average shares

Total diluted shares = 7,000 (from convertible bonds) + 132,000 (from stock) = 139,000

This question tested from Session 8, Reading 32, LOS i.

Question 14 - #97412

Which of the following is **TRUE** about the consideration of depreciation in the operations section of a cash flow statement?

	Direct Method	Indirect Method
A)	Does not consider	Considers
B)	Does not consider	Does not consider
C)	Considers	Considers

Your answer: C was incorrect. The correct answer was A) Does not consider Considers

The indirect method must add back depreciation expense because the starting point is net income. Since the direct method does not begin with net income it does not need to consider non-cash expenses such as depreciation.

This question tested from Session 8, Reading 34, LOS f, (Part 1).

Question 15 - #97414

The Beeline Company has the following balance sheet and income statement.

Beeline Company Balance Sheet
As of December 31, 2004

	2003	*2004*		*2003*	*2004*
Cash	$50	$60	Accounts payable	$100	$150
Accounts receivable	100	110	Long-term debt	400	300
Inventory	200	180	Common stock	50	50
			Retained earnings	400	500
Fixed assets (gross)	800	900	Total liabilities and equity	$950	$1,000
Less: Accumulated depreciation	200	250			
Fixed assets (net)	600	650			
Total assets	$950	$1,000			

Beeline Company Income Statement
For year ended December 31, 2004

Sales	$1,000
Less:	
COGS	600
Depreciation	50
Selling, general, and administrative expenses	160
Interest expense	23
Income before taxes	$167
Less tax	67
Net income	$100

The cash flow from operations for 2004 is:

A) $260.
B) $210.
C) $150.

Your answer: C was incorrect. The correct answer was B) $210.

Cash flow from operations (CFO) calculated using the indirect method is: net income (100) + depreciation (50) – increase in accounts receivable (10) + decrease in inventory (20) + increase in accounts payable (50) = $210.

This question tested from Session 8, Reading 34, LOS f, (Part 1).

Question 16 - #97418

John Stone, CFA, is an investment advisor specializing in the preparation of company and industry reports for high net worth customers at Learmon Brothers. Currently, Stone is preparing a report on Soft Corporation, a rapidly growing software company. The explosive growth of this company was financed primarily by an initial public offering in which 3,000,000 shares were issued at a price of $20 per share on June 27, 2004. Soft Corporation received additional capital when employee stock options for 1,000,000 shares at a price of $10 were exercised on January 1, 2005. Stone realizes the importance of cash flow on a company's financial health and would like to include a projected statement of cash flows for 2005. Soft Corporation financial statements are presented in Tables 1 and 2. Included are the projected statements for the year ending December 31, 2005.

Table 1
Soft Corporation Balance Sheets
as of December 31
(in millions)

	Actual 2004	*Projected 2005*
Cash	$24.0	$26.0
Accounts Receivable	17.0	24.0
Inventory	100.0	150.0
PP&E	100.0	125.0
Accumulated depreciation	(30.0)	(35.0)
Total Assets	$211.0	$290.0
Accounts payable	$91.0	$101.0
Long-term debt	20.0	40.0
Common stock	80.0	90.0
Retained earnings	20.0	59.0
Total liabilities and equity	$211.0	$290.0

Table 2
Soft Corporation Income Statement
for Years Ended December 31
(in millions except per share data)

	Actual 2004	*Projected 2005*
Sales	$80.0	$198.0
COGS	(38.0)	(90.0)
Gross profit	$42.0	$108.0
SG&A	(13.0)	(30.0)
Depreciation	(3.0)	(5.0)
Operating expenses	$(16.0)	$(35.0)
Interest expense	$(4.0)	$(5.0)

Pretax Income	22.0	68.0
Income tax expense	(7.0)	(25.0)
Net income	$15.0	$43.0
EPS	$2.0	$4.3
Average shares outstanding (millions)	7.5	10.0
Dividends per share	$0.1	$0.4

Part 1)
Stone decides to use the direct method to compute Soft Corporation's projected net cash flow from financing activities. Under this method, what will Stone report Soft Corporation's projected net cash flow from financing activities to be for 2005 (in millions)?

A) 26.0.

B) 36.0.

C) 30.0.

Your answer: C was incorrect. The correct answer was A) 26.0.

There are three components that Stone will need to calculate Soft Corporation's projected net cash flow from financing activities, issuance of long-term debt, issuance of common stock, and payment of cash dividends. The calculation will be the same under both the direct and indirect methods and is as follows:

(40.0 – 20.0) + (10.0) – (4.0) = 26.0

The issuance of common stock is from the exercise of the employee stock options. The correct choice is 26.0.

This question tested from Session 8, Reading 34, LOS f, (Part 1).

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Part 2)
Under the direct method, what will Stone find Soft Corporation's projected net change in cash to be for the year ending December 31, 2005?

A) $9,000,000.
B) $2,000,000.
C) $4,000,000.

Your answer: C was incorrect. The correct answer was B) $2,000,000.

Soft Corporation's net cash flow from operations are $1.0 million, they spent $(25.0) million on PP&E, and received $26.0 million from financing activities. This makes the net change in cash $2,000,000. Note that projected cash for 2005 is 2.0 million greater than at year-end 2004.

This question tested from Session 8, Reading 34, LOS f, (Part 1).

Question 17 - #98091

Which revenue recognition method is used when the payment is assured and revenue is earned as costs are incurred?

A) Installment sales method.
B) Cost recovery method.
C) Percentage-of-completion method.

Your answer: C was correct!

The installment sales method is used when the assurance of payment and estimated bad debts does not exist before cash is collected. Sales revenue and COGS are recognized only when cash is received.

The cost recovery method is used when future cash collections are not assured even after receipt of partial payments. Gross profit is not recognized until all of the cost of goods sold is collected.

This question tested from Session 8, Reading 32, LOS b, (Part 2).

Question 18 - #97991

In accounting for long-term construction contracts, the percentage-of-completion method is preferable to the completed contract method when:

A) the contracts are of a relatively short duration (less than one year).
B) estimates of the costs to complete and the extent of progress toward completion are reasonably dependable.
C) lack of dependable cost estimates cause forecasts to be doubtful.

Your answer: C was incorrect. The correct answer was B) estimates of the costs to complete and the extent of progress toward completion are reasonably dependable.

In accounting for long-term construction contracts, the percentage-of-completion method is preferable to the completed contract method when estimates of the costs to complete and the extent of progress toward completion are reasonably dependable.

This question tested from Session 8, Reading 32, LOS b, (Part 2).

Question 19 - #97328

Which of the following statements about accounting procedures and their impact on the statement of cash flows is *least valid*? All else equal:

A) the cash flow from operations (CFO) for a company that issues a bond at a premium will be understated compared to a firm that issues a bond at par.
B) a nonprofitable company that uses LIFO to account for inventory will have higher total cash flow than a nonprofitable company that uses FIFO during a period of rising prices.
C) a company that finances through common stock issues may have the same cash flow from financing (CFF) as a firm that issues debt.

Your answer: C was incorrect. The correct answer was B) a nonprofitable company that uses LIFO to account for inventory will have higher total cash flow than a nonprofitable company that uses FIFO during a period of rising prices.

Because of the impact of income taxes, a *profitable* company that accounts for inventory using LIFO will have higher total cash flow than a *profitable* company that uses FIFO. The company that uses LIFO will have higher cost of goods sold, resulting in lower net income and thus lower taxes.

- The other statements are correct. A company that issues common stock is *not* required to pay dividends (which would reduce cash flow from financing). Thus, it may have the same CFF as a firm that issues debt since interest paid on debt is a component of CFO.
- The cash flow from operations for a company that issues a bond at a premium will be understated compared to a firm that issues a bond at par. When a company issues bonds at a premium, the coupon payment is “too big” (reduces CFO) and thus interest expense is reduced by the amount of the amortization of the premium (increases CFF).

This question tested from Session 8, Reading 34, LOS f, (Part 1).

Question 20 - #97813

Securities that improve basic per share earnings, or reduce per share losses, if they are exercised or converted to common stock are called:

A) antidilutive securities.

B) dilutive securities.

C) embedded securities.

Your answer: C was incorrect. The correct answer was A)

antidilutive securities.

Antidilutive securities, upon exercise, increase basic EPS or decrease per share losses. Shares from conversion are not included in the calculation of basic or diluted EPS.

This question tested from Session 8, Reading 32, LOS i.

Question 21 - #95144

Holden Company’s fixed asset footnote included the following:

- During 20X7, Holden sold machinery for a gain of $100,000. The machinery had an original cost of $500,000 and its accumulated depreciation was $240,000.
- At the end of 20X7, Holden purchased machinery at a cost of $1,000,000. Holden paid $400,000 cash. The balance was financed by the seller at 8% interest.
- Depreciation expense was $2,080,000 for the year ended 20X7.

Calculate Holden’s cash flow from investing activities for the year ended 20X7.

A) $360,000 inflow.

B) $300,000 outflow.

C) $40,000 outflow.

Your answer: C was correct!

Given the gain of $100,000 and book value of the machinery sold of $260,000 ($500,000 original cost – $240,000 accumulated depreciation), the proceeds from the sale of the machinery were $360,000 ($100,000 gain + $260,000 book value). For 20X7, CFI was an outflow of $40,000 ($360,000 sale proceeds – $400,000 machinery purchase). The $600,000 financed by the seller is a non-cash transaction and is reported in the notes to the cash flow statement.

This question tested from Session 8, Reading 34, LOS a, (Part 1).

Question 22 - #97962

Consider the following information on the past year's operating performance and current capital structure for the following two companies:

Supple Moves	*Perfect Collection*
Paid no dividends	Paid common & pref. div.
Ave. Stock Price of $42.00	Ave. Stock Price of $22.00
Positive net income	Positive net income
110,000 warrants with an exercise price of $50.00	Convertible debt with an 8.0% coupon, conversion ratio at 10.0.
	150,000 options outstanding with an exercise price of $19.50

Based on the information above, which of the companies has a complex capital structure?

A) Perfect Collection Only.

B) Supple Moves and Perfect Collection.

C) Both companies.

Your answer: C was incorrect. The correct answer was B) Supple Moves and Perfect Collection.

A complex capital structure is one that has *potentially* dilutive elements. Here, Supple Moves and Perfect Collection both meet this criteria. (The warrants for Supple Moves will be dilutive if the average stock prices were over $50.00.)

This question tested from Session 8, Reading 32, LOS h, (Part 1).

Question 23 - #97766

During 2004, Covax Corp. reported net income of $2.4 million and 2 million shares of common stock. Covax paid cash dividends of $14,000 to its preferred shareholders and $30,000 to its common shareholders. In 2004, Covax issued 900, $1,000 par, 5.5 percent bonds for $900,000. Each bond is convertible to 50 shares of common stock. Assume the tax rate is 40%. Compute Covax's basic and diluted EPS.

	Basic EPS	Diluted EPS
A)	$1.19	$1.22
B)	$1.19	$1.18
C)	$1.22	$1.22

Your answer: C was incorrect. The correct answer was B)
$1.19 $1.18

2004 Basic EPS:

2004 Diluted EPS:

This question tested from Session 8, Reading 32, LOS h, (Part 2).

Question 24 - #94776

First in, first out (FIFO) inventory equals:

A) LIFO inventory + LIFO reserve.
B) LIFO cost of goods sold – changes in LIFO reserve.
C) the change in LIFO reserve – LIFO ending reserve.

Your answer: C was incorrect. The correct answer was A)

LIFO inventory + LIFO reserve.

To convert LIFO inventory balances to a FIFO basis, simply add the LIFO reserve to the LIFO inventory:

$INV_F = INV_L + \text{LIFO Reserve}$

This question tested from Session 9, Reading 35, LOS f.

Question 25 - #95996

Which of the following statements regarding inventory accounting methods is *most* accurate? In periods of:

A) declining prices FIFO results in higher net income than LIFO.
B) rising prices and stable unit purchases, using the LIFO method results in a lower current ratio than the FIFO method.
C) rising prices and stable unit purchases, using the FIFO method results in higher inventory turnover than the LIFO method.

Your answer: C was incorrect. The correct answer was B)

rising prices and stable unit purchases, using the LIFO method results in a lower current ratio than the FIFO method.

In periods of rising prices LIFO results in lower current assets because the ending inventory is based on inventory items that were purchased first at a lower price.

This question tested from Session 9, Reading 35, LOS e, (Part 2).

Question 26 - #93648

JME purchased 400 units of inventory that cost $4.00 each. Later the firm purchased an additional 500 units that cost $5.00 each. JME sold 700 units of inventory for $7.00 each. If JME uses a first in, first out (FIFO) cost flow method, the amount of gross profit appearing on the income statement is:

A) $2,400.
B) $1,800.
C) $3,100.

Your answer: C was incorrect. The correct answer was B) $1,800.

(700 × 7.00) – [(400 × 4.00) + (300 × 5.00)] = 1,800

This question tested from Session 9, Reading 35, LOS c, (Part 1).

Question 27 - #96453

	Units	Unit Price
Beginning Inventory	699	$5.00
Purchases	710	$8.00
Sales	806	$15.00
SGA Expenses	$3,141 per annum	

Part 1)

Determine the cost of goods sold using the weighted average method and also using the first in, first out (FIFO) method.

	Weighted Average	FIFO
A)	$4,986.02	$4,133.45
B)	$4,351.00	$5,248.44
C)	$5,248.44	$4,351.00

Your answer: C was correct!

Weighted average = cost of goods available / total units available. COGS = Units sold × wt. ave = 806 × 6.51171 = $5,248.44.

FIFO COGS = (699 × 5) + (107 × 8) = $4,351.00.

This question tested from Session 9, Reading 35, LOS c, (Part 1).

	Units	Unit Price
Beginning Inventory	699	$5.00
Purchases	710	$8.00

Sales	806	$15.00
SGA Expenses	$3,141 per annum	

Part 2)
What is the ending inventory level in dollars using the FIFO method?

A) $4,824.00.
B) $6,160.00.
C) $4,582.80.

Your answer: C was incorrect. The correct answer was A) $4,824.00.

Ending Inventory = 603 × 8 = $4,824.00.

This question tested from Session 9, Reading 35, LOS c, (Part 1).

Question 28 - #96004

Under U.S. GAAP:

A) firms are allowed to capitalize research and development (R&D) costs when specific criteria are met.
B) franchise or license costs for agreements of less than five years are expensed as incurred.
C) advertising costs for other than direct-response advertising costs are expensed as incurred.

Your answer: C was correct!

In the U.S., research and development (R&D) costs are always expensed when incurred. Advertising costs are also expensed as incurred. However, direct response advertising costs can be capitalized when specific criteria are met. Franchise or license costs may be capitalized regardless of the time period of the agreement.

This question tested from Session 9, Reading 36, LOS c.

Question 29 - #95094

If a lessee enters into a finance lease rather than an operating lease, it can expect to have a:

A) higher return on assets.
B) higher debt-to-equity ratio.
C) lower debt-to-equity ratio.

Your answer: C was incorrect. The correct answer was B)

higher debt-to-equity ratio.

Leasing the asset with an operating lease avoids recognition of the debt on the lessee's balance sheet. Having fewer assets and liabilities on the balance sheet than would exist if the assets were purchased increases profitability ratios (e.g., return on assets) and decreases leverage ratios (e.g., debt-to-equity ratio). In the case of a finance lease, the assets are reported on the balance sheet and are depreciated.

This question tested from Session 9, Reading 38, LOS g.

Question 30 - #95850

Which of the following statements regarding finance and operating leases is *least* accurate?

A) During the life of an operating lease, the rent expense equals the lease payment.

B) For financial reporting of finance and operating leases, no entry is required on the lessee's balance sheet at the inception of the lease.

C) Asset turnover is higher for the lessee with an operating lease than a finance lease.

Your answer: C was incorrect. The correct answer was B)

For financial reporting of finance and operating leases, no entry is required on the lessee's balance sheet at the inception of the lease.

If the lease is an operating lease there is no entry made on the balance sheet for the lessee. For finance leases, the leased asset and liability are recognized on the balance sheet by the amount equal to the present value of the minimum lease payments using as the discount rate the lower of the lessor's implicit rate or the lessee's incremental borrowing rate.

This question tested from Session 9, Reading 38, LOS g.

Question 31 - #93647

JME had beginning inventory of $200 and ending inventory of $300. JME had COGS of $800. JME must have purchased inventory amounting to:

A) $700.

B) $900.

C) $1,100.

Your answer: C was incorrect. The correct answer was B) $900.

$200 + X - 300 = 800$

$X = \text{purchases} = 900$

This question tested from Session 9, Reading 35, LOS c, (Part 1).

Question 32 - #94463

Interest expense is reported on the income statement as a function of:

A) the coupon payment.

B) the market rate.

C) the unamortized bond discount.

Your answer: C was incorrect. The correct answer was B) the market rate.

Interest expense is always equal to the book value of the bond at the beginning of the period multiplied by the market rate at issuance.

This question tested from Session 9, Reading 38, LOS a.

Question 33 - #95845

The difference between income tax expense and taxes payable is a:

A) deferred income tax expense.

B) deferred tax liability.

C) timing difference.

Your answer: C was incorrect. The correct answer was A)

deferred income tax expense.

Taxes payable is defined as the taxes due to the government as determined by taxable income and the tax rate, while income tax expense is the amount actually recognized on the income statement. Deferred income tax expense is defined as the difference in income tax expense and taxes payable. Each individual deferred item is expected to be paid (or recovered) in future years.

This question tested from Session 9, Reading 37, LOS a.

Question 34 - #95793

A tax loss carryforward is *best* described as the:

A) net taxable loss that can be used to refund paid taxes from the previous year.

B) difference of deferred tax liabilities and deferred tax assets.

C) net taxable loss that can be used to reduce taxable income in the future.

Your answer: C was correct!

A tax loss carryforward is the net taxable loss that can be used to reduce taxable income in the future.

This question tested from Session 9, Reading 37, LOS a.

Question 35 - #97859

Are changes in accounting principles and extraordinary items treated similarly in accordance with U.S. Generally Accepted Accounting Principles and International Financial Reporting Standards?

Accounting principles	Extraordinary items

A)	No	No
B)	Yes	No
C)	Yes	Yes

Your answer: C was incorrect. The correct answer was B)
Yes No

Treatment of a change in an accounting principle is similar under U.S. GAAP and IFRS. Under both standards, a change in accounting principle is made retrospectively. The treatment of extraordinary items differs between U.S. GAAP and IFRS. Under U.S. GAAP, extraordinary items are reported net of tax below income from continuing operations. IFRS does not permit firms to treat transactions as extraordinary in the income statement.

This question tested from Session 10, Reading 43, LOS b.

Question 36 - #97871

To calculate the cash ratio, the total of cash and marketable securities is divided by:

A) current liabilities.
B) total liabilities.
C) total assets.

Your answer: C was incorrect. The correct answer was A)

current liabilities.

Current liabilities are used in the denominator for the: current, quick, and cash ratios.

This question tested from Session 10, Reading 39, LOS c.

Question 37 - #87610

Samson Therapeutics records all leases as operating leases. The company *most likely* wanted to reduce:

A) expenses.
B) leverage.
C) inventory.

Your answer: C was incorrect. The correct answer was B) leverage.

Capitalized leases are recorded on the balance sheet, and by recording all leases as operating leases, the company can reduce its leverage. Lease accounting has no effect on inventory, and operating leases will increase expenses, not reduce them.

This question tested from Session 10, Reading 40, LOS b.

Question 38 - #87621

Jane Kilgore, a stock analyst, is concerned about Maxwell Research's organizational structure. To investigate the stability of that structure, Kilgore would be *best* served by looking at:

A) the amount of judgment calls used in company accounting.

B) accounting-department turnover.

C) management turnover.

Your answer: C was correct!

All of the factors listed above are of concern to an analyst looking at the possibility of fraudulent accounting. But to assess the stability of the organizational structure, the best option is a look at management turnover. High turnover rates in the accounting department may be indicative of deficient internal controls, but are too localized to be a true indicator of organizational stability. Excessive judgment calls in accounting are worrisome, but is not likely to be a direct reflection of an unstable organizational structure, as much as poor operational policies.

This question tested from Session 10, Reading 40, LOS e.

Question 39 - #96767

Given the following income statement and balance sheet for a company:

	Balance Sheet	
Assets	*Year 2006*	*Year 2007*
Cash	200	450
Accounts Receivable	600	660
Inventory	500	550
Total CA	1300	1660
Plant, prop. equip	1000	1580
Total Assets	2600	3240
Liabilities		
Accounts Payable	500	550
Long term debt	700	1052
Total liabilities	1200	1602
Equity		
Common Stock	400	538
Retained Earnings	1000	1100
Total Liabilities & Equity	2600	3240

Income Statement

Sales	3000
Cost of Goods Sold	(1000)
Gross Profit	2000
SG&A	500
Interest Expense	151
EBT	1349
Taxes (30%)	405
Net Income	944

Which of the following is *closest* to the company's return on equity (ROE)?

A) 0.29.
B) 1.83.
C) 0.62.

Your answer: C was correct!

There are several ways to approach this question but the easiest way is to recognize that ROE = NI / average equity thus ROE = 944 / 1,519 = 0.622.

If using the traditional DuPont, ROE = (NI / Sales) × (Sales / Assets) × (Assets / Equity):

ROE = (944 / 3,000) × (3,000 / 2,920) × (2,920 / 1,519) = 0.622

The 5-part Dupont formula gives the same result:

ROE = (net income / EBT)(EBT / EBIT)(EBIT / revenue)(revenue / total assets)(total assets / total equity)

Where EBIT = EBT + interest = 1,349 + 151 = 1,500

ROE 2007 = (944 / 1,349)(1,349 / 1,500)(1,500 / 3,000)(3,000 / 2,920)(2,920 / 1,519) = 0.622

This question tested from Session 10, Reading 39, LOS d.

Question 40 - #97816

An analyst has gathered the following information about a company:

Balance Sheet

Assets	
Cash	100
Accounts Receivable	750
Marketable Securities	300
Inventory	850
Property, Plant & Equip	900

Accumulated Depreciation	(150)
Total Assets	2750
Liabilities and Equity	
Accounts Payable	300
Short-Term Debt	130
Long-Term Debt	700
Common Stock	1000
Retained Earnings	620
Total Liab. and Stockholder's equity	2750

Income Statement

Sales	1500
COGS	1100
Gross Profit	400
SG&A	150
Operating Profit	250
Interest Expense	25
Taxes	75
Net Income	150

What is the inventory turnover ratio?

A) 1.29.
B) 1.59.
C) 0.77.

Your answer: C was incorrect. The correct answer was A)

1.29.

Inventory turnover = 1,100(COGS) / 850(inventory) = 1.29

This question tested from Session 10, Reading 39, LOS c.

Question 41 - #97695

National Scooter Company and Continental Chopper Company are motorcycle manufacturing companies. National's target market includes consumers that are switching to motorcycles because of the high cost of operating automobiles and they compete on price with other manufacturers. The average age of National's customers is 24 years.

Continental manufactures premium motorcycles and aftermarket accessories and competes on the basis of quality and innovative design. Continental is in the third year of a five-year project to develop a customized hybrid motorcycle. Which of the two firms would most likely report higher gross profit margin, and which firm would most likely report higher operating expense stated as a percentage of total cost?

	Higher gross profit margin	Higher percentage operating expense
A)	Continental	National
B)	Continental	Continental
C)	National	Continental

Your answer: C was incorrect. The correct answer was B)
Continental Continental

Continental likely has the highest gross profit margin percentage since it is selling a customized product and does not compete primarily based on price. Because of the research and development costs of developing a new hybrid motorcycle, Continental likely has the higher operating expense stated as a percentage of total cost.

This question tested from Session 10, Reading 42, LOS a.

Question 42 - #97719

For 2007, Morris Company had 73 days of inventory on hand. Morris would like to decrease its days of inventory on hand to 50. Morris' cost of goods sold for 2007 was $100 million. Morris expects cost of goods sold to be $124.1 million in 2008. Assuming a 365 day year, compute the impact on Morris' operating cash flow of the *change* in average inventory for 2008.

A) $3.0 million source of cash.
B) $6.3 million source of cash.
C) $3.0 million use of cash.

Your answer: C was incorrect. The correct answer was A) $3.0 million source of cash.

2007 inventory turnover was 5 (365 / 73 days in inventory). Given inventory turnover and COGS, 2007 average inventory was $20 million ($100 million COGS / 5 inventory turnover). 2008 inventory turnover is expected to be 7.3 (365 / 50 days in inventory). Given expected inventory turnover, 2008 average inventory is $17 million ($124.1 million COGS / 7.3 expected inventory turnover). To achieve 50 days of inventory on hand, average inventory must decline $3 million ($20 million 2007 average inventory – $17 million 2008 expected inventory). A decrease in inventory is a source of cash.

This question tested from Session 10, Reading 42, LOS b.

Question 43 - #97841

On January 1, 2004, Cayman Corporation bought manufacturing equipment for $30 million. On December 31, 2006, Cayman determined the equipment was impaired and recognized a $5 million impairment loss in its income statement. As of December 31, 2007, the fair value of the equipment exceeded the book value by $7 million. What amount of the recovery in value can Cayman recognize in its 2007 income statement under U.S. Generally Accepted Accounting Principles (U.S. GAAP) and under International Financial Reporting Standards (IFRS)?

	U.S. GAAP	IFRS
A)	$0	$7 million
B)	$0	$5 million
C)	$5 million	$7 million

Your answer: C was incorrect. The correct answer was B)
$0 $5 million

U.S. GAAP does not permit upward valuations of plant and equipment. Under IFRS, the recovery is reported in the income statement to the extent that the previous downward adjustment (loss) was reported in net income. Otherwise, the increase in value is reported as an adjustment to equity. Thus, under IFRS, $5 million will be reported in 2007 net income and $2 million will be directly added to to equity (as an adjustment to equity).

This question tested from Session 10, Reading 43, LOS a.

Question 44 - #87622

Analyst Jane Kilgore is worried about the quality of Maxwell Research's earnings for the following reasons:

- Management turnover is high.
- Technology systems are outdated.
- The organizational structure is complex.
- Maxwell uses the unit-of-production method.

Which of Kilgore's concerns is *least* valid?

A) Management turnover is high.

B) Maxwell uses the unit-of-production method.

C) Technology systems are outdated.

Your answer: C was incorrect. The correct answer was B) Maxwell uses the unit-of-production method.

The unit-of-production method in and of itself is not a sign of poor earnings quality. Both remaining observations reflect signs of common risk factors for entities at which executives have the opportunity to commit fraud.

This question tested from Session 10, Reading 40, LOS e.

Question 45 - #96771

What is a company's equity if their return on equity (ROE) is 12%, and their net income is 10 million?

A) 120,000,000.

B) 83,333,333.

C) 1,200,000.

Your answer: C was incorrect. The correct answer was B)

83,333,333.

One of the many ways ROE can be expressed is: ROE = net income / equity

0.12 = $10,000,000 / equity

Equity = $10,000,000 / 0.12 = $83,333,333

This question tested from Session 10, Reading 39, LOS e.

Question 46 - #97060

With other variables remaining constant, if profit margin rises, ROE will:

A) increase.

B) fall.

C) remain the same.

Your answer: C was incorrect. The correct answer was A) increase.

The DuPont equation shows clearly that ROE will increase as profit margin increases, as long as asset turn and leverage do not fall.

This question tested from Session 10, Reading 39, LOS e.

Question 47 - #96555

Which of the following strategies is *most likely* to be considered good payables management?

A) Taking trade discounts only if the firm's annual return on short-term investments is less than the discount percentage.

B) Paying trade invoices on the day they arrive.

C) Paying invoices on the last possible day to still get the supplier's discount for early payment.

Your answer: C was correct!

Paying invoices on the last day to get a discount (for early payment) ifs often the most advantageous strategy for a firm. If the annualized percentage cost of not taking advantage of the discount is less than the firm's short-term cost of funds, it would be advantageous to pay on the due date. However, the discount percentage is not an annualized rate, so it cannot be compared directly to the firm's annual return on short-term investments. Paying prior to the discount cut-off date or prior to the due date sacrifices interest income for no advantage.

This question tested from Session 11, Reading 46, LOS f.

Question 48 - #97161

The 6% semiannual coupon, 7-year notes of Woodbine Transportation, Inc. trade for a price of $94.54. What is the company's after-tax cost of debt capital if its marginal tax rate is 30%?

A) 4.9%.
B) 2.1%.
C) 4.2%.

Your answer: C was incorrect. The correct answer was A) 4.9%.

To determine Woodbine's before-tax cost of debt, find the yield to maturity on its outstanding notes:

PV = -94.54; FV = 100; PMT = 6 / 2 = 3; N = 14; CPT → I/Y = 3.50 × 2 = 7%

Woodbine's after-tax cost of debt is $k_d(1 - t) = 7\%(1 - 0.3) = 4.9\%$

This question tested from Session 11, Reading 45, LOS f.

Question 49 - #97759

Assume a firm uses a constant WACC to select investment projects rather than adjusting the projects for risk. If so, the firm will tend to:

A) reject profitable, low-risk projects and accept unprofitable, high-risk projects.
B) accept profitable, low-risk projects and accept unprofitable, high-risk projects.
C) accept profitable, low-risk projects and reject unprofitable, high-risk projects.

Your answer: C was incorrect. The correct answer was A) reject profitable, low-risk projects and accept unprofitable, high-risk projects.

The firm will reject profitable, low-risk projects because it will use a hurdle rate that is too high. The firm should lower the required rate of return for lower risk projects. The firm will accept unprofitable, high-risk projects because the hurdle rate of return used will be too low relative to the risk of the project. The firm should increase the required rate of return for high-risk projects.

This question tested from Session 11, Reading 45, LOS a.

Question 50 - #97767

Ravencroft Supplies is estimating its weighted average cost of capital (WACC). Ravencroft's optimal capital structure includes 10% preferred stock, 30% debt, and 60% equity. They can sell additional bonds at a rate of 8%. The cost of issuing new preferred stock is 12%. The firm can issue new shares of common stock at a cost of 14.5%. The firm's marginal tax rate is 35%. Ravencroft's WACC is *closest* to:

A) 13.3%.
B) 11.5%.
C) 12.3%.

Your answer: C was incorrect. The correct answer was B)

11.5%.

0.10(12%) + 0.30(8%)(1 – 0.35) + 0.6(14.5%) = 11.46%.

This question tested from Session 11, Reading 45, LOS a.

Question 51 - #97551

- The company has a target capital structure of 40% debt and 60% equity.
- Bonds pay 10% coupon (semi-annual payout), mature in 20 years, and sell for $849.54.
- The company stock beta is 1.2.
- Risk-free rate is 10%, and market risk premium is 5%.
- The company is a constant growth firm that just paid a dividend of $2.00, sells for $27.00 per share, and has a growth rate of 8%.
- The company's marginal tax rate is 40%.

Part 1)
The after-tax cost of debt is:

A) 8.0%.

B) 9.1%.

C) 7.2%.

Your answer: C was correct!

N = 40; PMT = 50; FV = 1,000; PV = 849.54; Compute i = 6%, double = 12%, now (12)(1 – 0.4) = 7.2%.

This question tested from Session 11, Reading 45, LOS h.

- The company has a target capital structure of 40% debt and 60% equity.
- Bonds pay 10% coupon (semi-annual payout), mature in 20 years, and sell for $849.54.
- The company stock beta is 1.2.
- Risk-free rate is 10%, and market risk premium is 5%.
- The company is a constant growth firm that just paid a dividend of $2.00, sells for $27.00 per share, and has a growth rate of 8%.
- The company's marginal tax rate is 40%.

Part 2)
The cost of equity using the capital asset pricing model (CAPM) approach and the discounted cash flow approach is:

	CAPM	Discounted Cash Flow
A)	16.0%	15.4%
B)	16.6%	15.4%
C)	16.0%	16.0%

Your answer: C was correct!

CAPM = 10 + (5)(1.2) = 16%.

Discounted Cash Flow: D_1 = 2(1.08) = 2.16, now (2.16 / 27) + 0.08 = 16%

This question tested from Session 11, Reading 45, LOS h.

Question 52 - #97599

A $100 par, 8% preferred stock is currently selling for $80. What is the cost of preferred equity?

A) 10.8%.
B) 8.0%.
C) 10.0%.

Your answer: C was correct!

k_{ps} = $8 / $80 = 10%

This question tested from Session 11, Reading 45, LOS h.

Question 53 - #97483

A company is planning a $50 million expansion. The expansion is to be financed by selling $20 million in new debt and $30 million in new common stock. The before-tax required return on debt is 9% and the required return for equity is 14%. If the company is in the 40% tax bracket, the marginal weighted average cost of capital is *closest* to:

A) 9.0%.
B) 10.0%
C) 10.6%.

Your answer: C was correct!

(0.4)(9%)(1 - 0.4) + (0.6)(14%) = 10.56%

This question tested from Session 11, Reading 45, LOS a.

Question 54 - #96616

An investment policy statement for a firm's short-term cash management function would *least* appropriately include:

A) a list of permissible securities.
B) information on who is allowed to invest corporate cash.
C) procedures to follow if the investment guidelines are violated.

Your answer: C was incorrect. The correct answer was A) a list of permissible securities.

An investment policy statement typically begins with a statement of the purpose and objective of the investment portfolio, some general guidelines about the strategy to be employed to achieve those objectives, and the types of securities that will be used. A list of permitted securities for investment would be limited and likely too restrictive. A list of permitted security types is appropriate and can provide the necessary flexibility to increase yield within the safety and liquidity constraints appropriate for the firm.

This question tested from Session 11, Reading 46, LOS e, (Part 2).

Question 55 - #97272

The after-tax cost of preferred stock is always:

A) less than the before-tax cost of preferred stock.
B) equal to the before-tax cost of preferred stock.
C) higher than the cost of common shares.

Your answer: C was incorrect. The correct answer was B) equal to the before-tax cost of preferred stock.

The after-tax cost of preferred stock is equal to the before-tax cost of preferred stock, because preferred stock dividends are not tax deductible. The cost of preferred shares is usually higher than the cost of debt, but less than the cost of common shares.

This question tested from Session 11, Reading 45, LOS g.

Question 56 - #96785

The debt of Savanna Equipment, Inc. has an average maturity of ten years and a BBB rating. A market yield to maturity is not available because the debt is not publicly traded, but the market yield on debt with similar characteristics is 8.33%. Savanna is planning to issue new ten-year notes that would be subordinate to the firm's existing debt. The company's marginal tax rate is 40%. The *most* appropriate estimate of the after-tax cost of this new debt is:

A) 5.0%.
B) More than 5.0%.
C) Between 3.3% and 5.0%.

Your answer: C was incorrect. The correct answer was B) More than 5.0%.

The after-tax cost of debt similar to Savanna's existing debt is $k_d(1 - t) = 8.33\%(1 - 0.4) = 5.0\%$. Because the anticipated new debt will be subordinated in the company's debt structure, investors will demand a higher yield than the existing debt carries. Therefore, the appropriate after-tax cost of the new debt is more than 5.0%.

This question tested from Session 11, Reading 45, LOS f.

Question 57 - #96560

Compared to the prior year, Chart Industries has reported that its operating cycle has remained relatively stable while its cash conversion cycle has decreased. The *most likely* explanation for this is that the firm:

A) has improved its inventory turnover.
B) is relying more on its suppliers for short-term liquidity.

C) is paying its bills for raw materials more rapidly.

Your answer: C was incorrect. The correct answer was B) is relying more on its suppliers for short-term liquidity.

The cash conversion cycle is its operating cycle minus its average days payables outstanding. Therefore, the firm’s average days payables must have increased, a clear indication that the firm is relying more heavily on credit from its suppliers. Improved inventory turnover would tend to increase both the operating and cash conversion cycles. Relaxed credit policies would tend to increase the firm’s operating cycle as receivables turnover would tend to decrease.

This question tested from Session 11, Reading 46, LOS b.
