Test Bank for Analysis for Financial Management 12th Higgins

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Chapter 02 Test Bank

1. An inventory turnover ratio of 10 means that, on average, items are held in inventory for 10 days.

FALSE

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Difficulty: 1 Easy
Gradable: automatic

2. All else equal, an increase in a company's asset turnover will decrease its ROE.

FALSE

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Difficulty: 1 Easy
Gradable: automatic

3. A company's return on assets will always equal or exceed its profit margin.

FALSE

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Difficulty: 2 Medium
Gradable: automatic

4. A company's price-to-earnings ratio is always equal to one minus its earnings yield.

FALSE

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Difficulty: 1 Easy
Gradable: automatic

5. Return on assets can be calculated as profit margin times asset turnover.

TRUE

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Difficulty: 1 Easy
Gradable: automatic

6. All else equal, a firm would prefer to have a higher gross margin.

TRUE

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Difficulty: 1 Easy
Gradable: automatic

7. The times-interest-earned ratio always equals or exceeds the times-burden-covered ratio.

TRUE

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Gradable: automatic

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8. If a firm increases its accounts payable period, other things equal, it increases the cash conversion cycle.

FALSE

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Difficulty: 1 Easy
Gradable: automatic

9. Across companies, ROA and financial leverage tend to be inversely related.

TRUE

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Difficulty: 2 Medium
Gradable: automatic

10. One advantage of ROE is that it is a risk-adjusted measure of performance.

FALSE

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Difficulty: 1 Easy
Gradable: automatic

11. The most popular yardstick of financial performance among investors and senior managers is the

A. profit margin.
B. return on equity.
C. return on assets.
D. times-burden-covered ratio.
E. earnings yield.
F. None of the options are correct.

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Difficulty: 1 Easy
Gradable: automatic

12. Which of these ratios, or levers of performance, are the determinants of ROE?
I. profit margin
II. financial leverage
III. times interest earned
IV. asset turnover

A. I and IV only
B. II and IV only
C. I, II, and IV only
D. I, II, and III only
E. I, III, and IV only
F. I, II, III, and IV

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13. Ratios that measure how efficiently a firm manages its assets and operations to generate net income are referred to as _____ ratios.

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A. asset turnover and control
B. financial leverage
C. coverage
D. profitability
E. None of the options are correct.

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Difficulty: 1 Easy
Gradable: automatic

14. Which of the following ratios are measures of a firm's liquidity?
I. fixed asset turnover ratio
II. current ratio
III. debt-equity ratio IV. acid test

A. I and III only
B. II and IV only
C. III and IV only
D. I, II, and III only
E. I, III, and IV only

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Difficulty: 1 Easy
Gradable: automatic

15. Ptarmigan Travelers had sales of $420,000 in 2016 and $480,000 in 2017. The firm's current asset accounts remained constant. Given this information, which one of the following statements must be true?

A. The total asset turnover rate increased.
B. The days' sales in receivables increased.
C. The inventory turnover rate increased.
D. The fixed asset turnover decreased.
E. The collection period decreased.

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Difficulty: 2 Medium
Gradable: automatic

16. In comparison to industry averages, Okra Corp. has a low inventory turnover, a high current ratio, and an average quick ratio. Which of the following would be the most reasonable inference about Okra Corp.?

A. Its current liabilities are too low.
B. Its cost of goods sold is too low.
C. Its cash and securities balance is too low.
D. Its inventory level is too high.

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17. Which one of the following ratios identifies the amount of sales a firm generates for every $1 in assets?

A. current ratio

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B. debt-to-equity
C. retention
D. asset turnover
E. return on assets

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Difficulty: 1 Easy
Gradable: automatic

18. A times-interest-earned ratio of 3.5 indicates that the firm

A. pays 3.5 times its earnings in interest expense.
B. has interest expense equal to 3.5% of EBIT.
C. has interest expense equal to 3.5% of net income.
D. has EBIT equal to 3.5 times its interest expense.

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Difficulty: 1 Easy
Gradable: automatic

19. At the end of 2017, Stacky Corp. had $500,000 in liabilities and a debt-to-assets ratio of 0.5. For 2017, Stacky had an asset turnover of 3.0. What were annual sales for Stacky in 2017?

A. $333,333
B. $1,200,000
C. $1,800,000
D. $3,000,000

Liabilities/Assets = 0.5 = $500,000/$1,000,000 So Assets = $1,000,000
Then, Sales/$1,000,000 = 3 So sales = $3,000,000

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Difficulty: 2 Medium
Gradable: automatic

20. Klamath Corporation has asset turnover of 3.5, a profit margin of 5.2%, and a current ratio of 0.5. What is Klamath Corporation's return on equity?

A. 8.7%
B. 9.1%
C. 18.2%
D. Insufficient information to find ROE

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Difficulty: 1 Easy
Gradable: automatic

21. Assume you are a banker who has loaned money to a firm, but that firm is now facing increased competition and reduced cash flows. Which one of the following ratios would you most closely monitor to evaluate the firm's ability to repay its loan?

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A. current ratio
B. debt-to-equity ratio
C. times-interest-earned ratio
D. times-burden-covered ratio
E. None of the options are correct.

The times-burden-covered ratio is the best answer, as it indicates how well the firm's cash flows cover both debt principal and interest payments. The times-interest-earned ratio applies most appropriately when we are confident the firm can roll over existing debt; this is not the case here.

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Difficulty: 2 Medium
Gradable: automatic

22. Breakers Bay Inc. has succeeded in increasing the amount of goods it sells while holding the amount of inventory on hand at a constant level. Assume that both the cost per unit and the selling price per unit also remained constant. All else held constant, how will this accomplishment be reflected in the firm's financial ratios?

A. decrease in the fixed asset turnover rate
B. decrease in the financial leverage ratio
C. increase in the inventory turnover rate
D. increase in the days' sales in inventory
E. decrease in the total asset turnover rate

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Difficulty: 2 Medium
Gradable: automatic

23. Which one of the following statements is correct?

A. If the debt-to-assets ratio is greater than 0.50, then the debt-to-equity ratio must be less than 1.0.
B. Long-term creditors would prefer the times-interest-earned ratio be 1.4 rather than 1.5.
C. The assets-to-equity ratio can be computed as 1 plus the debt-to-equity ratio.
D. To realize the best risk and reward profile, financial leverage should be maximized.
E. None of the options are correct.

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Difficulty: 2 Medium
Gradable: automatic

24. On a common-size balance sheet, all accounts are expressed as a percentage of

A. sales.
B. profits.
C. equity.
D. total assets.
E. None of the options are correct.

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Difficulty: 1 Easy
Gradable: automatic

25. Primavera Holdings has a profit margin of 25%, an asset turnover of 0.5, and financial leverage (assets to equity) of 1.5. Primavera has $20 billion in assets, of which half, is in cash and marketable securities. Assume that Primavera earns a 3 percent after-tax return on cash and securities. What would Primavera's return on equity be if it paid out 90% of its cash and marketable securities as a dividend to shareholders?

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A. Negative
B. Between 0% and 20%
C. Between 20% and 40%
D. between 40% and 60%
E. Greater than 60%

Currently, equity = $13.33 billion (20/13.33 = 1.5), sales = 10 (10/20 = 0.5) and net income = 2.5 (2.5/10 = 25%).
Paying a $9 billion dividend would reduce assets to $11 billion and equity to $4.33 billion. Net income would fall by 3% × $9 billion = $0.27 billion, to $2.23 billion.
ROE would then be 2.23/4.33 = 51.50%

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Difficulty: 3 Hard
Gradable: automatic

26. Which one of the following statements does NOT describe a problem with using ROE as a performance measure?

A. ROE measures return on accounting book value, and this problem is not solved by using market value.
B. ROE is a forward-looking, one-period measure, while business decisions span the past and present.
C. ROE measures only return, while financial decisions involve balancing risk against return.
D. None of these describe problems with ROE.
E. All of these describe problems with ROE.

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Difficulty: 2 Medium
Gradable: automatic

[The following information applies to the questions displayed below.]

Link, Inc.
Selected financial data ($ thousands)

	2016	2017
Income statement and related items		
Sales	$160,835	$ 274,219
Cost of goods sold	141,829	209,628
Net income	(91,432)	(257,981)
Cash flow from operations	(35,831)	(12,538)
Balance sheet items		
Cash	$236,307	$ 164,952
Marketable securities	209,670	22,638
Accounts receivable	12,645	21,655
Inventory	3,971	40,556
Total current assets	462,593	249,801
Accounts payable	17,735	13,962
Accrued liabilities	27,184	76,596
Total current liabilities	44,919	90,558

27. Please refer to the financial data for Link, Inc. above. The current ratio for Link at the end of 2017 is

A. 10.21.
B. 2.31.
C. 2.76.

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D. 10.30.
E. None of the options are correct.

249,801/90,558 = 2.76

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Difficulty: 1 Easy
Gradable: automatic

28. Please refer to the financial data for Link, Inc. above. Which of the following statements best describes how the Link's short-term liquidity changed from 2016 to 2017?

A. Link's short-term liquidity has improved modestly.
B. Link's short-term liquidity has deteriorated very little, but from a low initial base.
C. Link's short-term liquidity has improved considerably, but from a low initial base.
D. Link's short-term liquidity has deteriorated considerably, but from a high initial base.
E. None of the options are correct.

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Difficulty: 2 Medium
Gradable: automatic

29. Please refer to the financial data for Link, Inc. above. Assume a 365-day year for your calculations. Link's collection period in days, based on sales, at the end of 2017 is

A. 24.3.
B. 219.6.
C. 35.7.
D. 28.8.
E. None of the options are correct.

21,655/(274,219/365) = 28.8

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Difficulty: 2 Medium
Gradable: automatic

30. Please refer to the financial data for Link, Inc. above. Assume a 365-day year for your calculations. Link's inventory turnover, based on cost of goods sold, at the end of 2017 is

A. 5.2.
B. 24.3.
C. 28.8.
D. 35.7.
E. None of the options are correct.

209,628/40,556 = 5.2

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Difficulty: 2 Medium
Gradable: automatic

31. Please refer to the financial data for Link, Inc. above. Assume a 365-day year for your calculations. Link's payables period in days, based on cost of goods sold, at the end of 2017 is

A. 5.2.
B. 24.3.
C. 28.8.

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D. 35.7.
E. None of the options are correct.

13,962/(209,620/365) = 24.3

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Difficulty: 2 Medium
Gradable: automatic

32. Please refer to the financial data for Link, Inc. above. Assume a 365-day year for your calculations. Link's days' sales in cash at the end of 2017 is:

A. 24.3
B. 28.8
C. 219.6
D. 249.7
E. None of the options are correct.

(164,952 + 22,638)/(274,219/365) = 249.7

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Difficulty: 2 Medium
Gradable: automatic

33. Please refer to the financial data for Link, Inc. above. Link's gross margin for 2017 is

A. −94%.
B. 13%.
C. 26%.
D. 31%.
E. None of the options are correct.

(274,219 − 209,628)/274,219 = 23.6%

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Difficulty: 1 Easy
Gradable: automatic

34. Please refer to the financial data for Link, Inc. above. Link's profit margin for 2017 is

A. −94%.
B. −57%.
C. 13%.
D. 31%.
E. None of the options are correct.

−257,981/274,219 = −94%

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Difficulty: 1 Easy
Gradable: automatic

35. Please refer to the income statement for VGA Associates below. Assuming that cost of goods sold are variable and operating expenses are fixed, what was VGA Associates' breakeven sales volume in 2017?

VGA Associates
Income statement for 2017

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Sales	$200,000
Cost of goods sold	150,000
Gross profit	50,000
Operating expenses	20,000
Operating income	30,000
Interest expense	5,000
Pre-tax income	25,000
Taxes	5,000
Net income	$20,000

A. $20,000
B. $80,000
C. $150,000
D. $180,000
E. None of the options are correct.

Gross margin = 50,000/200,000 = 25%.
Breakeven sales volume = Operating expenses/Gross margin = $20,000/0.25 = $80,000.

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Difficulty: 2 Medium
Gradable: automatic

36. Please refer to the income statement for VGA Associates below. If VGA had a principal repayment of $8,000 due in 2017, what was its times-burden-covered ratio in 2017?

VGA Associates

Income statement for 2017

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Sales	$ 200,000
Cost of goods sold	150,000
Gross profit	50,000
Operating expenses	20,000
Operating income	30,000
Interest expense	5,000
Pre-tax income	25,000
Taxes	5,000
Net income	$ 20,000

A. 0.67
B. 1.33
C. 2.31
D. 6.00
E. None of the options are correct.

$$TBC = \frac{EBIT}{Int.Exp. + \frac{Prin.Repay.}{1 - t}}$$

$$TBC = \frac{30{,}000}{5{,}000 + \frac{8{,}000}{1 - 0.2}} = 2$$

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Difficulty: 2 Medium
Gradable: automatic

37. Ellsbury Corporation has a goal to reduce its cash conversion cycle. Which of the following actions, holding all else equal, is likely to accomplish this goal?

A. Ellsbury changes the credit terms it offers to customers, allowing them to pay in 45 days instead of 30 days.
B. Ellsbury increases the efficiency of its production process, reducing by 10% the average time it takes to convert raw materials to finished products.
C. Ellsbury starts paying off all outstanding invoices to suppliers twice a month instead of once a month.

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D. Ellsbury increases its cash/assets ratio from 12% to 15%.

A would increase CCC, because A/R would increase.
B would reduce CCC, because inventory would decrease.
C would increase CCC, because A/P would decrease.
D would not affect CCC.

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Difficulty: 2 Medium
Gradable: automatic

38. What is the length of the cash conversion cycle for a firm with $3 million in inventory, $1.5 million in accounts payable, a collection period of 40 days, and an annual cost of goods sold of $18 million?

A. 34.0 days
B. 51.2 days
C. 70.4 days
D. 131.2 days
E. None of the options are correct.

CCC = Days Inventory Outstanding + Collection Period − Payables Period
= Inventory/(COGS/365) + Receivables/(Sales/365) − Payables/(COGS/365)
= 3/(18/365) + 40 − 1.5/(18/365)
= 60.8 + 40 − 30.4 = 70.4 days

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Difficulty: 2 Medium
Gradable: automatic

39. Answer the questions below based on the following information. The tax rate is 35%, and all dollars are in millions. Assume that the companies have no liabilities other than the debt shown below.

	Suunto Inc.	Runrun Corp.
Earnings before interest and taxes	$ 280	$ 294
Debt (at 10% interest)	$ 140	$ 840
Equity	$ 560	$ 210

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a. Calculate each company's ROE, ROA, and ROIC.
b. Why is Runrun's ROE so much higher than Suunto's? Does this mean Runrun is a better company? Why or why not?
c. Why is Suunto's ROA higher than Runrun's? What does this tell you about the two companies?
d. How do the two companies' ROICs compare? What does this suggest about the two companies?

a.

	Suunto Inc.	Runrun Corp.
Net income	172.9	136.5
ROE	31 %	65 %
ROA	25 %	13 %
ROIC	26 %	18 %

b. Runrun's higher ROE is a natural reflection of its higher financial leverage. It does not mean that Runrun is the better company.
c. This is also due to Runrun's higher leverage. ROA penalizes levered companies by comparing the net income available to equity to the capital provided by owners and creditors. It does not mean that Runrun is a worse company than Suunto.
d. ROIC abstracts from differences in leverage to provide a direct comparison of the earning power of the two companies' assets. On this metric, Suunto is the superior performer. Before drawing any firm conclusions, however, it is important to ask how the business risks faced by the companies compare and whether the observed ratios reflect long-run capabilities or transitory events.

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Gradable: manual

[The following information applies to the questions displayed below.]

The financial statements for Limited Brands, Inc. follow (fiscal years ending January):

Limited Brands, Inc.
Balance Sheets ($ Millions)

	2007	2006	2005

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Total Assets	7,093.00	6,346.00	6,089.00
Liabilities			
Long-Term Debt Due In One Year	8	7	0
Payables and Accrued Expenses	1,701.00	1,568.00	1,451.00
Total Current Liabilities	1,709.00	1,575.00	1,451.00
Long-Term Debt	1,665.00	1,669.00	1,646.00
Deferred Taxes	173	146	177
Minority Interest	71	33	33
Other Liabilities	520	452	447
Total Liabilities	4,138.00	3,875.00	3,754.00
Total Equity	2,955.00	2,471.00	2,335.00
Total Liabilities & Equity	7,093.00	6,346.00	6,089.00
Common Shares Outstanding	398	395	407

Income Statements ($ MILLIONS)

	2007	2006
Sales	10,671.00	9,669.00
Cost of Goods Sold	6,342.00	5,920.00
Gross Profit	4,329.00	3,749.00
Selling, General, & Administrative Exp.	2,837.00	2,502.50
Operating Income Before Deprec.	1,492.00	1,246.50
Depreciation, Depletion, & Amortization	316	299
Operating Profit	1,176.00	947.5
Interest Expense	102	94
Non-Operating Income/Expense	23	25
Special Items	0	78.5
Pretax Income	1,097.00	957
Total Income Taxes	422	291
Adjusted Available for Common	675	666
Extraordinary Items	1	17
Adjusted Net Income	676	683
Dividends per share	$ 0.6	$ 0

40. Please refer to Limited Brands, Inc.'s financial statements above. Use the company's operating profit as an approximation of its EBIT, and assume a 40% tax rate for your calculations. For the fiscal years ending in January of 2006 and 2007, calculate:

a. Debt-to-equity ratio
b. Times-interest-earned ratio
c. Times burden covered

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		Fiscal Year Ending	
		Jan. 2007	Jan. 2006
a.	Debt-to-equity ratio	1.4	1.57
b.	Times-interest-earned ratio	11.53	10.08
c.	Times burden covered	10.35	10.08

(Note that principal payment in year t equals current portion of long-term debt in year t -1.)

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Difficulty: 2 Medium
Gradable: manual

41. Please refer to Limited Brands, Inc.'s financial statements above. Use the company's operating profit as an approximation of its EBIT, and assume a 40% tax rate for your calculations. What percentage decline in earnings before interest and taxes could Limited Brands have sustained in fiscal years ending in January 2006 and 2007 before failing to cover:

a. Interest and principal repayment requirements?
b. Interest, principal, and common dividend payments?

a. For the fiscal year ending January 2006: Interest expense = $94 Principal repayment = $0 (long−term debt due in one year from 2005) EBIT = $947.5, so it could have fallen (947.5 − 94)/947.5 = 90.1% before failing to cover interest and principal.
For the fiscal year ending January 2007: Interest expense = $102 Principal repayment = $7 (long−term debt due in one year from 2006) EBIT = $1,176, so it could have fallen (1,176 − 102 − 7/0.6)/1,176 = 90.3% before failing to cover interest and principal.

b. For the fiscal year ending January 2006: Interest expense = $94 Principal repayment = $0 (long−term debt due in one year from 2005) Common dividends = Shares outstanding × Dividends per share = 395 × 0.61 = $241.0 EBIT = $947.5, so it could have fallen (947.5 − 94 − 241/0.6)/947.5 = 47.7% before failing to cover interest, principal, and dividends.
For the fiscal year ending January 2007: Interest expense = $102 Principal repayment = $7 (long−term debt due in one year from 2006) Common dividends = Shares outstanding × Dividends per share = 398 × 0.60 = $238.8 EBIT = $1,176, so it could have fallen (1,176 − 102 − 245.8/0.6)/1,176 = 56.5% before failing to cover interest, principal, and dividends.

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Difficulty: 2 Medium
Gradable: manual

42. Please refer to Limited Brands, Inc.'s financial statements above. Prepare common-size financial statements for Limited Brands, Inc. for 2006–2007.

BALANCE SHEETS (% of Assets)

	2007	2006	2005

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TOTAL ASSETS	100	%	100	%	100	%
LIABILITIES						
Long-Term Debt Due In One Year	0.11	%	0.11	%	0	%
Payables and Accrued Expenses	23.98	%	24.71	%	23.83	%
Total Current Liabilities	24.09	%	24.82	%	23.83	%
Long-Term Debt	23.47	%	26.3	%	27.03	%
Deferred Taxes	2.44	%	2.3	%	2.91	%
Minority Interest	1	%	0.52	%	0.54	%
Other Liabilities	7.33	%	7.12	%	7.34	%
TOTAL LIABILITIES	58.34	%	61.06	%	61.65	%
TOTAL EQUITY	41.66	%	38.94	%	38.35	%
TOTAL LIABILITIES & EQUITY	100	%	100	%	100	%
Common Shares Outstanding	398		395		407	

INCOME STATEMENTS (% of Sales)

	2007		2006	
Sales	100	%	100	%
Cost of Goods Sold	59.4	%	61.23	%
Gross Profit	40.6	%	38.77	%
Selling, General, & Administrative Exp.	26.6	%	25.88	%
Operating Income Before Deprec.	14	%	12.89	%
Depreciation, Depletion, & Amortization	2.96	%	3.09	%
Operating Profit	11	%	9.8	%
Interest Expense	0.96	%	0.97	%
Non-Operating Income/Expense	0.22	%	0.26	%
Special Items	0	%	0.81	%
Pretax Income	10.3	%	9.9	%
Total Income Taxes	3.95	%	3.01	%
Adjusted Available for Common	6.33	%	6.89	%
Extraordinary Items	0.01	%	0.18	%
Adjusted Net Income	6.33	%	7.06	%

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43. Please refer to the financial statements for Roxbury Corporation. Estimate the length of Roxbury's cash conversion cycle in 2017.

Roxbury Corporation
2016 and 2017, ($ millions)

INCOME STATEMENT

	2016	2017
Net sales	$ 47,616	$ 52,378
Cost of goods sold	40,718	44,790
GS&A expense	6,171	6,788
EBIT	727	800
Interest expense	215	255
Earnings before tax	512	545
Tax	154	164
Net income	$ 358	$ 382

BALANCE SHEET

	2016	2017
Cash & securities	$ 951	$ 1,046
Accounts receivable	6,66	7,333
Inventories	5,236	5,760
Net fixed assets	2,048	2,253
Total assets	$ 14,901	$ 16,392
Bank loan	$ 392	$ 547
Accounts payable	7,419	8,161
Long-term debt	2,148	2,551
Total liabilities	9,959	11,259
Common stock	1,293	1,293
Retained earnings	3,649	3,840
Total equity	4,942	5,133
Total liabilities & equity	$ 14,901	$ 16,392

CCC = Days Inventory Outstanding + Collection Period − Payables Period
= Inventory/(COGS/365) + Receivables/(Sales/365) − Payables/(COGS/365)
= 5760/(44,790/365) + 7333/(52,378/365) − 8161/(44,790/365)
= 46.9 + 51.1 − 66.5 = 31.5 days

Accessibility: Keyboard Navigation
Difficulty: 2 Medium
Gradable: manual

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Chapter 02 Test Bank Summary

Category	*# of Questions*
Accessibility: Keyboard Navigation	43
Difficulty: 1 Easy	20
Difficulty: 2 Medium	22
Difficulty: 3 Hard	1
Gradable: automatic	38
Gradable: manual	5

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