NACM

National Association of Credit Management

ANSWER SHEET EXAMINATION #2

1) D
2) B
3) C
4) A
5) D
6) D
7) D
8) C
9) D
10) B
11) A
12) A
13) D
14) C
15) A
16) C
17) B
18) B
19) C
20) B
21) B
22) D
23) B
24) A
25) C
26) D
27) B
28) B
29) C
30) A
31) B
32) D
33) D
34) D

Problem 1

a. I
b. F
c. F
d. F
e. F
f. I
g. I
h. F
i. F
j. I
k. F
l. I

Problem 2

a. F
b. C
c. C
d. O
e. F
f. F
g. O
h. O
i. O
j. I
k. O
l. O

NACM-CAP-Solutions
Financial Statement Analysis I
Examination - 2

The exam consists of 34 multiple-choice questions (1 point each), two problems (12 points each) and a comprehensive case with 5 parts (42 points). You have 3 hours to complete the exam.

Multiple-Choice Questions (1 point each)

1. **Which ratio or ratios measure the overall efficiency of the firm in managing its investment in assets and in generating return to shareholders?**
   a) Gross profit margin and net profit margin.
   b) Return on investment.
   c) Total asset turnover and operating profit margin.
   d) Return on investment and return on equity.

2. **An inflow of cash would result from which of the following?**
   a) The increase in an asset account other than cash.
   b) The decrease in an asset account other than cash.
   c) The decrease in an equity account.
   d) The decrease in a liability account.

3. **What is the first step in an analysis of financial statements?**
   a) Check the auditor's report.
   b) Check references containing financial information.
   c) Specify the objectives of the analysis.
   d) Do a common size analysis.

4. **How would short-term investments in marketable securities be classified?**
   a) Cash.
   b) Operating activities.
   c) Financing activities.
   d) Investing activities.

5. **What information can be gained from sources such as Industry Norms and Key Business Ratios, Annual Statement Studies, Analyst's Handbook, and Industry Surveys?**
   a) The general economic condition.
   b) Forecasts of earnings.
   c) Elaboration's of financial statement disclosures.
   d) A company's relative position within its industry.

6. **Why is the quick ratio a more rigorous test of short-term solvency than the current ratio?**
   a) The quick ratio considers only cash and marketable securities as current assets.
   b) The quick ratio eliminates prepaid expenses for the numerator.
   c) The quick ratio eliminates prepaid expenses for the denominator.
   d) The quick ratio eliminates inventories from the numerator.

7. **How would the repayment of debt principal be classified?**
   a) Operating outflow.
   b) Operating inflow.
   c) Investing outflow.
   d) Financing outflow.

8. **How would the sale of a building be classified?**
   a) Operating outflow.
   b) Operating inflow.
   c) Investing inflow.
   d) Financing inflow.

9. **What is a serious limitation of financial ratios?**
   a) Ratios are screening devices.
   b) Ratios can be used only by themselves
   c) Ratios indicate weaknesses only.
   d) Ratios are not predictive.

10. **What is the most widely used liquidity ratio?**
   a) Quick ratio.
   b) Current ratio.
   c) Inventory turnover.
   d) Debt ratio.

11. **How would payments for taxes be classified?**
   a) Operating outflow.
   b) Operating inflow.
   c) Investing outflow.
   d) Financing outflow.

12. **What is a creditor's objective in performing an analysis of financial statements?**
   a) To decide whether or not the borrower has the ability to repay interest and principal on borrowed funds.
   b) To determine the firm's capital structure.
   c) To determine the company's future earnings stream.
   d) To decide whether or not the firm has operated profitably in the past.

13. **Which of the following items is included in the adjustment of net income to obtain cash flow from operating activities?**
    a) Depreciation expense for the period.
    b) The change in deferred taxes.
    c) The amount by which equity income recognized exceeds cash received.
    d) All of the above.

14. **What type of accounts are notes payable and current maturities of long-term debt?**
    a) Cash accounts.
    b) Operating accounts.
    c) Financing accounts.
    d) Investing accounts.

15. **What are internal sources of cash?**
    a) Cash inflows from operating activities.
    b) Cash inflows from investing activities.
    c) Cash inflows from financing activities.
    d) All of the above.

16. **What information does the auditor's report contain?**
    a) The results of operations.
    b) An unqualified opinion.
    c) An opinion as to the fairness of the financial statements.
    d) A detailed coverage of the firm's liquidity, capital resources, and operations.

17. **How would revenue from sales of goods and services be classified?**
    a) Operating outflow.
    b) Operating inflow.
    c) Investing inflow.
    d) Financing inflow.

18. **What is Form 10-K?**
    a) A document filed with the AICPA, containing supplementary schedules showing management remuneration and elaborations of financial statement disclosures.
    b) A document filed with the Securities and Exchange Commission by companies selling securities to the public, containing much of the same information as the annual report as well as additional detail.
    c) A document filed with the Securities and Exchange Commission containing key business ratios and forecasts of earnings.
    d) A document filed with the Securities and Exchange Commission containing nonpublic information.

19. **What does an increasing collection period for accounts receivable suggest about a firm's credit policy?**
    a) The credit policy is too restrictive.
    b) The firm is probably losing qualified customers.
    c) The credit policy may be too lenient.
    d) The collection period has no relationship to a firm's credit policy.

20. What type of accounts are accounts receivable and inventory?

a) Cash accounts.
b) Operating accounts.
c) Financing accounts.
d) Investing accounts.

21. How is it possible for a firm to be profitable and still go bankrupt?

a) Earnings have increased more rapidly than sales.
b) The firm has positive net income but has failed to generate cash from operations.
c) Net income has been adjusted for inflation.
d) Sales have not improved even though credit policies have been eased.

22. What is an investor's objective in financial statement analysis?

a) To determine if the firm is risky.
b) To determine the stability of earnings.
c) To determine changes necessary to improve future performance.
d) To determine whether or not an investment is warranted by estimating a company's future earnings stream.

23. Which profit margin measures the overall operating efficiency of the firm?

a) Gross profit margin.
b) Operating profit margin.
c) Net profit margin.
d) Return on equity.

24. What are common size financial statements?

a) Statements that express each account on the balance sheet as a percentage of total assets and each account on the income statement as a percentage of net sales.
b) Statements that standardize financial data in terms of trends.
c) Statements that relate the firm to the industry in which it operates.
d) Statements based on common sense and judgment.

25. The change in retained earnings is affected by which of the following?

a) Net income and common stock.
b) Net income and paid-in capital.
c) Net income and payment of dividends.
d) Payment of dividends and common stock.

26. Which of the following is not required to be discussed in Management's Discussion and Analysis of the Financial Condition and Results of Operations?

a) Liquidity.
b) Capital resources.
c) Operations.
d) Earnings projections.

27. **Which method of calculating cash flow from operations requires the adjustment of net income for deferrals, accruals, non-cash, and non-operating expenses?**
    a) The direct method.
    b) The indirect method.
    c) The inflow method.
    d) The outflow method.

28. **What do the asset turnover ratios measure?**
    a) The liquidity of the firm's current assets.
    b) Management's effectiveness in generating sales from investments in assets.
    c) The overall efficiency and profitability of the firm.
    d) The distribution of assets in which funds are invested.

29. **An outflow of cash would result from which of the following?**
    a) The decrease in an asset account other than cash.
    b) The increase in a liability account.
    c) The decrease in a liability account.
    d) The increase in an equity account.

30. **What is a limitation common to both the current and quick ratio?**
    a) Accounts receivable may not be truly liquid.
    b) Inventories may not be truly liquid.
    c) Marketable securities are not liquid.
    d) Prepaid expenses are potential sources of cash.

31. **Which of the following could lead to cash flow problems?**
    a) Obsolete inventory, accounts receivable of inferior quality, easing of credit by suppliers.
    b) Slow-moving inventory, accounts receivable of inferior quality, tightening of credit by suppliers.
    c) Obsolete inventory, increasing notes payable, easing of credit by suppliers.
    d) Obsolete inventory, improved quality of accounts receivable, easing of credit by suppliers.

32. **What are external sources of cash?**
    a) Cash inflows from operating activities.
    b) Cash inflows from investing activities.
    c) Cash inflows from financing activities.
    d) Both (b) and (c).

33. **Which of the following current assets is included in the adjustment of net income to obtain cash flow from operating activities?**
    a) Accounts receivable.
    b) Inventory.
    c) Prepaid expenses.
    d) All of the above.

34. **The statement of cash flows segregates cash inflows and outflows by:**
a) Operating and financing activities.
b) Financing, and investing activities.
c) Operating and investing activities.
d) Operating, financing, and investing activities.

Problems: (24 points)

Problem 1

Indicate the following as financing activities (F) or investing activities (I). (12 points)

(a) Purchase of land __I__
(b) Repayment of debt principal __F__
(c) Purchase of treasury stock __F__
(d) Increase in short-term debt __F__
(e) Reduction of long-term debt __F__
(f) Gain on sale of land __I__
(g) Purchase of common stock of another firm __I__
(h) Resale of treasury stock __F__
(i) Payment of cash dividends __F__
(j) Purchase of equipment __I__
(k) Issuance of common stock __F__
(l) Sale of building __I__

Problem 2

Indicate which of the following current assets and current liabilities are operating accounts (O) and thus included in the adjustment of net income to cash flow from operating activities and which are cash (C), investing (I), or financing (F) accounts. **(12 points)**

(a)	Dividends payable	__F__
(b)	Marketable securities	__C__
(c)	Certificate of deposit	__C__
(d)	Accounts payable	__O__
(e)	Current portion of long-term debt	__F__
(f)	Notes payable (to bank)	__F__
(g)	Interest payable	__O__
(h)	Inventory	__O__
(i)	Accounts receivable	__O__
(j)	Notes receivable—officers	__I__
(k)	Accrued expenses	__O__
(l)	Income taxes payable	__O__

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Comprehensive Case (42 points)

OG Corporation's balance sheet and income statement is listed below.

Balance Sheet	**This Year**	**Last Year**
Cash	50,000	40,000
Accounts receivable	80,000	60,000
Inventories	180,000	110,000
Plant & equipment	300,000	260,000
Less accumulated depreciation	-40,000	-20,000
Total assets	**570,000**	**450,000**
Accounts payable	100,000	150,000
Accrued liabilities	70,000	50,000
Mortgage payable	80,000	
Common stock	130,000	90,000
Retained earnings	190,000	160,000
Total liabilities and equity	**570,000**	**450,000**

Income Statement	**This Year**	**Last Year**
Net Sales	680,000	600,000
Cost of goods sold	410,000	330,000
Gross profit	270,000	270,000
Operating expenses	190,000	192,000
Operating income	80,000	78,000
Interest expense	7,000	2,000
Profit before taxes	73,000	76,000
Taxes	22,000	22,800
Net income	**51,000**	**53,200**

Other data:

- Cash dividends paid this year were $21,000.
- The change in accumulated depreciation account is the depreciation for the year.

Answer the following five questions pertaining to the OG Corporation and be specific.

1. Prepare a common size vertical analysis of OG's balance sheet in good form. Round percentages to one decimal place. (5 points)

ASSETS

LIABILITIES AND EQUITY

2. Prepare a common size vertical analysis of OG's income statement and reconcile the retained earnings account. Round percentages to one decimal place. (5 points)

3. **Prepare the current year statement of cash flows for OG Corporation using the indirect method and reconcile the cash account. (5 points)**

INDIRECT METHOD

RECONCILE CASH

4. **Based on the financial statements prepared in questions (1) and (2), calculate the efficiency ratios, liquidity ratios, leverage ratios, and profitability ratios for OG Corporation for this year. Where data is available, also calculate ratios for last year. Use a 360-day year. All sales are on credit to business customers. Assume an income tax rate of 30 percent. (7 points)**

(Complete the attached ratio worksheet)

5. Based upon your answers to parts (1) through (4) would you provide a credit line to this company? Support your decision by reference to your work in parts (1) through (4). (20 points)