LO.a: Demonstrate the use of a framework for the analysis of financial statements, given a particular problem, question, or purpose (e.g., valuing equity based on comparables, critiquing a credit rating, obtaining a comprehensive picture of financial leverage, evaluating the perspectives given in management's discussion of financial results).

1. The primary goal of financial statement analysis is to:
   A. document portfolio changes to comply with the Prudent Investor Rule.
   B. justify trading decisions to comply with the Code and Standards.
   C. facilitate an economic decision.

LO.b: Identify financial reporting choices and biases that affect the quality and comparability of companies' financial statements, and explain how such biases may affect financial decisions.

2. During an inflationary period, which of the following method of inventory valuation will a firm seeking to lower current tax liability select?
   A. Average cost.
   B. LIFO.
   C. FIFO.

3. Company ABC has recently reduced the average useful life of their depreciable assets. Assuming everything else remains constant, which of the following will *most likely* occur?
   A. Net income will increase.
   B. Net income will decrease.
   C. Net income will remain the same.

LO.c: Evaluate the quality of a company's financial data, and recommend appropriate adjustments to improve quality and comparability with similar companies, including adjustments for differences in accounting standards, methods, and assumptions.

4. Company XYZ currently shows minimum expected operating leases over the next three years of $5 million, $4 million and $3 million respectively. The firm's current financing rate is 5% and the rate implicit in the lease contract is 5.5%. Which of the following adjustments are necessary to modify the balance sheet to include this off-balance sheet financing?
   A. Increase long term assets and long term liabilities by $10.98 million.
   B. Increase long term assets and long term liabilities by $10.88 million.
   C. Increase long term assets by $10.98 million and decrease long term liabilities by $10.98 million.

5. Which of the following is *not* an adjustment for off-balance sheet items?
   A. Estimating the probable obligation for contingent liabilities.
   B. Capitalizing operating leases, including this amount as an asset and a liability.
   C. Using the equity method in place of the proportionate consolidation to reflect the investment in affiliates.

LO.d: Evaluate how a given change in accounting standards, methods, or assumptions affects financial statements and ratios.

6. The current ratio for Company ABC is 1.5. Due to a change in accounting standards, company ABC must now consolidate its qualified special purpose entity (QSPE). After consolidation ABC's current ratio will:
   A. increase.
   B. decrease.
   C. remain the same.

LO.e: Analyze and interpret how balance sheet modifications, earnings normalization, and cash flow statement related modifications affect a company's financial statements, financial ratios, and overall financial condition.

7. Company XYZ reported a net income of $5 million in 2010. In reviewing the annual report an analyst notices that XYZ booked an expense of $1 million for cost of relocating its main office. Assuming a tax rate of 30%, what would normalized earnings be for 2010?
   A. $4.3 million.
   B. $5.7 million.
   C. $6.0 million.

Solutions

1. C is correct. The primary goal of financial statement analysis is to facilitate an economic decision. Financial statement analysis may assist in documentation and justification of trading decisions, however these are not the primary purposes.

2. B is correct. During an inflationary period, using LIFO would increase COGS, since the most recent (highest cost) inventory would be sold. Therefore, earnings and taxes would be lowest under LIFO.

3. B is correct. Depreciation expense increases as the depreciable life of an asset decreases. Thus, net income will decline.

4. A is correct. The PV of the operating lease is: $5/(1.05) + 4/(1.05)^2 + 3(1.05)^3 = \$10.98$ million. Note: To calculate the PV we use lower of the firm's financing rate or the interest rate implicit in the lease. The proper adjustment is to increase both long-term assets and liabilities by the same amount.

5. C is correct. The correct adjustment is that proportionate consolidation should be used in place of the equity method.

6. B is correct. Consolidation of the QSPE would increase the assets and the liabilities by the same amount. If the current ratio is greater than one, consolidation would decrease the current ratio.

7. B is correct. The company will increase 2010 earnings by the tax-adjusted value of the $1 million one-time expense (1 × (1 - 0.3) = 0.7). Therefore the normalized earnings are $5.7 million.