Question #1 of 35

An analyst finds return-on-equity (ROE) (based on beginning of the year equity) a good measure of management performance and wants to compare two firms: Firm A and Firm B. Firm A reports net income of $3.2 million and has a ROE of 18. Firm B reports income of $16 million and has an ROE of 16.

A review of the notes to the financial statements for Firm A, shows that the earnings include a loss from smelting operations of $400,000 and that the firm has exited this business. In addition, the firm sold the smelting equipment and had a gain on the sale of $300,000.

A similar review of the notes for Firm B discloses that the $16 million in net income includes $2.6 million gain on the sale of no longer needed office property. Assume that the tax rate for both firms is 36%, and that the notes describe pre-tax amounts. Which of the following is *closest* to the "normalized" ROE for Firm A and for Firm B, respectively?

A) 17.1 and 16.9.

B) 18.4 and 14.3.

C) 16.0 and 18.0.

Explanation

The ROE for Firm A is adjusted for the $400,000 loss on discontinued operations and the $300,000 non-recurring gain. The ROE for Firm B is adjusted to remove the effects of the $2.6 million one-time gain.

The first step in this problem is to solve for equity using ROE. Then, "normalize" net income by adjusting for discontinued operations and non-recurring items. Then, solve for "normalized" ROE.

Firm A:

$18\% = 3{,}200{,}000 / \text{Equity}_A$

$\text{Equity}_A = 17{,}777{,}778$ (rounding)

$\text{Normalized Net Income}_A = 3{,}200{,}000 + (1 - 0.36)(400{,}000 - 300{,}000)$

$\text{Normalized ROE}_A = 3{,}264{,}000 / 17{,}777{,}778 = 18.360\%$

Firm B:

$16\% = 16{,}000{,}000 / \text{Equity}_B$

$\text{Equity}_B = 100{,}000{,}000$

$\text{Normalized Net Income}_B = 16{,}000{,}000 + (1 - 0.36)(-2{,}600{,}000)$

$\text{Normalized ROE}_B = 14{,}336{,}000 / 100{,}000{,}000 = 14.336\%$

18.360 and 14.336 are *closest* to 18.4 and 14.3

(Study Session 6, Module 19.5, LOS 19.e)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #2 of 35

Holdall Corporation recently reclassified many of their assets such that the average useful life of their depreciable assets was reduced. Which of the following is the *most likely* result from this change on net income and inventory turnover? (Assume everything else remains constant.) Net income will:

A) decrease and inventory turnover will rise.

B) increase and inventory turnover will not change.

C) decrease and inventory turnover may or may not change.

Explanation

Depreciation expense increases as the depreciable life of an asset decreases. Thus, net income will decline. Depreciation will only affect inventory turnover if depreciation has been allocated to individual inventory items; when and why this happens is outside the scope of the Level II curriculum.

(Study Session 6, Module 19.2, LOS 19.b)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #3 of 35

An analyst is developing a framework for financial statement analysis for his firm. This framework is *most likely* to include:

A) Define the purpose of the analysis, process input data, and follow up. ✔

B) Determine the allocation of firm fees, interpret processed data, and communicate conclusions. ✘

C) Maintain integrity of capital markets, perform duties to clients and employers, and avoid conflicts of interest. ✘

Explanation

Proper analysis framework should include:

1. Define the purpose of the analysis.
2. Collect input data.
3. Process input data.
4. Interpret processed data.
5. Develop and communicate conclusions.
6. Follow up.

(Study Session 6, Module 19.1, LOS 19.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #4 of 35

Wanda Brunner, CFA, is analyzing Straight Elements, Inc., (SE). SE is a discount manufacturer of parts and supplies for the railroad industry. She has followed her firm's suggested financial analysis framework, and has assembled output from processing data. When applying the financial analysis framework, which of the following is the *best* example of output from processing data?

A) Audited financial statements.

B) Common-size financial statements.

C) A written list of questions to be answered by the analysis.

Explanation

Common-size financial statements are created in the data processing step of the framework for financial analysis. Audited financial statements would be obtained during the "collect input" phase of the financial analysis framework. Creating a written list of questions to be answered by the analysis is part of the "define the purpose" phase of the financial analysis framework.

(Study Session 6, Module 19.1, LOS 19.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #5 of 35

Which of the following statements is CORRECT when inventory prices are falling?

A) LIFO results in lower COGS, lower earnings, lower taxes, and higher cash flows.

B) LIFO results in higher COGS, lower earnings, higher taxes, and higher cash flows.

C) LIFO results in lower COGS, higher earnings, higher taxes, and lower cash flows.

Explanation

Remember, *prices are falling*. Under LIFO, the most recent purchases flow to COGS. So, LIFO results in lower COGS, higher earnings, higher taxes, and lower cash flows.

(Study Session 6, Module 19.5, LOS 19.e)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #6 of 35

ABC Tie Company reports income for the year 2009 as $450,000. The notes to its financial statements state that the firm uses the last in, first out (LIFO) convention to value its inventories, and that had it used first in, first out (FIFO) instead, inventories would have been $62,000 greater for the year 2008 and $78,000 greater for the year 2009. If earnings were restated using FIFO to determine the cost of goods sold (COGS), what would the net income be for the year 2009? Assume a tax rate of 36%. Net income would have been:

A) $455,760. ✗

B) $439,760. ✗

C) $460,240. ✓

Explanation

The reduction in COGS would result in an *increase* in net income (62,000 − 78,000) × (1 − 0.36).

(Study Session 6, Module 19.5, LOS 19.e)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #7 of 35

Assume that inventory costs are increasing in line with an overall inflation rate of 3 percent. If a firm reports inventory using the last in, first out (LIFO) method, which of the following is *most* accurate?

A) The less expensive inventory is flowing out to COGS. ✗

B) Lower profits and lower taxes are reported because new inventory is flowing out to COGS. ✓

C) LIFO reserve measures the accumulation of taxes paid. ✗

Explanation

LIFO firm reports lower profits and lower taxes because all of the new, mores expensive inventory is flowing out to COGS thus, LIFO reserve measures the accumulation of taxes *not* paid and profits *not* recognized.

(Study Session 6, Module 19.7, LOS 19.d)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #8 of 35

Star Chemical Inc. (SCI) reported the following year-end data:

Depreciation expense	$25 million
Net income	$35 million
Dividends	$10 million
Total assets	$250 million
Shareholder's equity	$195 million
Effective tax rate	35 percent

SCI also reported that it changed from an accelerated depreciation method to straight line depreciation. The change resulted in a decrease in depreciation expense of $5 million. Management felt that the change "would not have a material effect on financial performance measures." Ignoring deferred taxes, what are the return on assets (ROA) and return on equity (ROE) measures under the old depreciation methods?

A) ROA is 12.96% and ROE is 16.56%.

B) ROA is 13.30% and ROE is 17.05%.

C) ROA is 13.50% and ROE is 17.51%.

Explanation

The change in depreciation methods results in net income increasing by $3.25 million ($5 million × (1-0.35)) and total assets increasing by $5 million. Without the change in depreciation methods SCI would have reported:

Depreciation expense	$30 million	($25 + $5)
Net income	$31.75 million	($35 – $3.25)
Total assets	$245 million	($250 – $5)
Shareholder's equity	$191.75 million	($195 − $3.25)

Note that assets would have been lower by $5 million due to the accelerated depreciation and equity would be lower by $3.25 million ($5 × (1 − 0.35)) due to lower retained earnings. In order to balance the $5 million reduction in assets, equity will fall by $3.25 million and tax liabilities will fall by $1.75 million. Therefore, ROA would have been 12.96% ($31.75 / $245) and ROE would have been 16.56% ($31.75 / $191.75).

(Study Session 6, Module 19.2, LOS 19.b)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #9 of 35

SnapPrints and NetPhoto Case Scenario

Josephine Howard, CFA is an equity analyst for an investment bank. She is preparing financial reports for two publicly traded digital photography companies, SnapPrints and Net Photo. Howard just attended a CFA Institute sponsored conference on detecting quality issues in financial statements and is eager to apply what she has learned.

SnapPrints provides photo prints and various other photo-related products, including calendars, T-shirts, and coffee mugs. NetPhoto is SnapPrints' largest competitor. NetPhoto has been receiving increasing attention from the analyst community due to its high sales growth rate, although NetPhoto's sales are still less than 50% of SnapPrints' sales.

During the conference, Howard learned about the importance of analyzing accruals to evaluate earnings quality. Therefore, Howard is going to analyze the accruals for each company as part of her review. Howard remembers a discussion from the conference about disaggregating income into its major components to improve earnings forecasts, but she cannot remember which component (cash or accruals) should receive a higher weighting in the forecast.

Howard gathered the following data from the income statement and statement of cash flows for SnapPrints.

Selected SnapPrints Income StatementItems (000s) Year Ended December 31, 2009	
Sales	45,000
Cost of Good Sold	(30,000)
Depreciation Expense	(3,000)
SG&A Expense	(2,000)
Interest Expense	(1,500)
Income Tax Expense	(3,000)
Net Income	**5,500**

Cash Flows for SnapPrints (000s) Year Ended December 31, 2009	
Cash from Operations	6,500
Cash from Investing	(3,500)
Cash from Financing	(1,200)
Change in Cash	**1,800**

Howard collected the following balance sheet data for NetPhoto.

Selected Balance Sheet items for NetPhoto as of December 31, in $Ms						
	2009	**2008**			**2009**	**2008**
Cash	5,500	4,500		Accounts Payable	4,500	4,300
Accounts Receivable	6,500	5,500		Short-term Notes Payable	5,800	6,500
Inventory	11,500	14,000		Long-Term Debt	28,500	29,750
Fixed Assets, Net	35,000	34,300		*Total Liabilities*	*38,800*	*40,550*
				Common Stock	15,000	12,800
				Retained Earnings	4,700	4,950
Total Assets	*58,500*	*58,300*		*Total Liabilities and Equity*	*58,500*	*58,300*

Howard has concerns about revenue recognition practices at both firms and has collected the following data.

	2009	**2008**	**2007**	**2006**
SnapPrints				
Revenue	45,000	44,000	44,400	38,500
Cash Collections	43,000	45,000	44,000	37,000
NetPhoto				
Revenue	22,000	15,000	11,500	7,500
Cash Collections	11,000	12,000	8,500	7,000

Compared to aggregate accruals, the accrual ratio is especially useful when:

A) comparing year-over-year accruals.

B) the cash component is large.

C) comparing across companies.

Explanation

The accrual ratio presents accruals for the period as a proportion of average net operating assets. This ratio is especially useful for comparing accruals across companies.

(Study Session 6, Module 19.5, LOS 19.e)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #10 of 35

Due to a change in accounting standards, TRK Construction's QSPE must now be consolidated. The QSPE has purchased, TRK's accounts receivables and had financed those with short-term notes payables. Assume that TRK's current ratio before consolidation is 1.10. Consolidation will *most likely* result in which of the following:

A) a decrease in the current ratio.

B) no change in the current ratio.

C) an increase in the current ratio.

Explanation

The correct treatment for consolidation of the QSPE would be an increase in current assets (accounts receivable) and in current liabilities (notes payable) by the same amount. If the current ratio is greater than one, consolidation would decrease the current ratio.

(Study Session 6, Module 19.7, LOS 19.d)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #11 of 35

SnapPrints and NetPhoto Case Scenario

Josephine Howard, CFA is an equity analyst for an investment bank. She is preparing financial reports for two publicly traded digital photography companies, SnapPrints and Net Photo. Howard just attended a CFA Institute sponsored conference on detecting quality issues in financial statements and is eager to apply what she has learned.

SnapPrints provides photo prints and various other photo-related products, including calendars, T-shirts, and coffee mugs. NetPhoto is SnapPrints' largest competitor. NetPhoto has been receiving increasing attention from the analyst community due to its high sales growth rate, although NetPhoto's sales are still less than 50% of SnapPrints' sales.

During the conference, Howard learned about the importance of analyzing accruals to evaluate earnings quality. Therefore, Howard is going to analyze the accruals for each company as part of her review. Howard remembers a discussion from the conference about disaggregating income into its major components to improve earnings forecasts, but she cannot remember which component (cash or accruals) should receive a higher weighting in the forecast.

Howard gathered the following data from the income statement and statement of cash flows for SnapPrints.

Selected SnapPrints Income StatementItems (000s) Year Ended December 31, 2009	
Sales	45,000
Cost of Good Sold	(30,000)
Depreciation Expense	(3,000)
SG&A Expense	(2,000)
Interest Expense	(1,500)
Income Tax Expense	(3,000)
Net Income	**5,500**

Cash Flows for SnapPrints (000s) Year Ended December 31, 2009	
Cash from Operations	6,500
Cash from Investing	(3,500)
Cash from Financing	(1,200)
Change in Cash	**1,800**

Howard collected the following balance sheet data for NetPhoto.

Selected Balance Sheet items for NetPhoto as of December 31, in $Ms						
	2009	**2008**			**2009**	**2008**
Cash	5,500	4,500		Accounts Payable	4,500	4,300
Accounts Receivable	6,500	5,500		Short-term Notes Payable	5,800	6,500
Inventory	11,500	14,000		Long-Term Debt	28,500	29,750
Fixed Assets, Net	35,000	34,300		*Total Liabilities*	*38,800*	*40,550*
				Common Stock	15,000	12,800
				Retained Earnings	4,700	4,950
Total Assets	*58,500*	*58,300*		*Total Liabilities and Equity*	*58,500*	*58,300*

Howard has concerns about revenue recognition practices at both firms and has collected the following data.

	2009	**2008**	**2007**	**2006**
SnapPrints				
Revenue	45,000	44,000	44,400	38,500
Cash Collections	43,000	45,000	44,000	37,000
NetPhoto				
Revenue	22,000	15,000	11,500	7,500
Cash Collections	11,000	12,000	8,500	7,000

In reviewing the footnotes to NetPhoto's financial statements, Howard discovers that the firm has engaged in a LIFO liquidation. The *most likely* effects on the financial statements (compared to no LIFO liquidation) are:

A) a decrease in inventory turnover and an increase in the gross profit margin.

B) an increase in the gross profit margin and an increase in days of inventory.

C) a decrease in COGS and an increase in the net profit margin.

Explanation

A LIFO liquidation refers to slowing the purchase of inventory items so that older lower costs are used to calculate COGS. Compared to following regular purchase policies, this will reduce COGS, reduce inventory, and artificially increase gross and net margins. Since the percentage decrease in inventory is likely greater than the percentage decrease in COGS, the inventory turnover ratio is likely increased, rather than decreased, by a LIFO liquidation.

(Study Session 6, Module 19.5, LOS 19.e)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #12 of 35

Millennium Airlines Corp. (MAC) reported the following year-end data:

Rent expense	$24 million
Depreciation expense	$17 million
EBIT	$88 million
Interest expense	$22 million
Total assets	$500 million
Long-term debt	$150 million
Capital lease obligations	$100 million
Total equity	$250 million

MAC also reported that the present value of its operating leases at the beginning of the year was $128 million at 10% interest rate. The term on the leases was 8 years. Ignoring taxes, what are the effects on the leverage (liabilities / total capital) and times interest earned if an analyst chooses to capitalize the leases using a straight-line depreciation (zero salvage, life = lease term) assumption? Leverage measures:

A) increase to 65% from 50% and times interest earned decreases to 1.78 times from 4 times.

B) remain unchanged and times interest earned decreases to 1.78 times from 4 times.

C) increase to 60% from 50% and times interest earned decreases to 2.76 times from 4 times.

Explanation

Using the reported data the leverage measure is 0.50 ((150 + 100) / (150 + 100 + 250)) and times interest earned is 4 times (88 / 22). Following the capitalization of the operating leases the balance sheet values are:

Total assets	$612 million	(500 assets + 128 leases - 16 depreciation on leases)
Value of operating leases	$116.80 million	(Ending Lease liability = 128 Beg lia + 12.8 Int - 24 Rent payment)
Long-term debt	$150 million	unchanged
Capital lease obligations	$100 million	unchanged
Total equity	$245.2 million	(250 + 24 rent payment – 16 dep – 12.8 interest)

Therefore, the leverage measure is 0.60 ((116.80 + 150 + 100) / (116.8 + 150 + 100 + 245.2)).

The income statement is affected in the following way:

reported EBIT	88	
+ rent expense	24	
= EBIT excluding cost of operating leases	112	
- depreciation of operating leases	16	($128 million/8 years)
= adjusted EBIT	96	

Interest expense will increase by $12.8 million ($128 million × 0.10) to $34.8 million. Therefore times interest earned decreases to 2.76 times (96 / 34.8). Recall that when capitalizing operating leases interest expense is calculated as the present value of the lease obligations multiplied by implied interest rate.

(Study Session 6, Module 19.2, LOS 19.b)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #13 of 35

Lucky Strike Mining Corp. (LSMC) reports in a footnote to the financial statements that it is party to a variable interest entity (VIE) through which it leases heavy equipment. LSMC has chosen not to report a residual value guarantee of $120 million for the equipment because it is not required to do so under accounting standards. However, the standards will change next year. What is the appropriate analytical treatment of this residual value guarantee?

A) Increase long-term liabilities by $120 million and decrease equity by $120 million.

B) Ignore the liability because current accounting standards do not require it to be included on the balance sheet. Include it in next year's balance sheet adjustments.

C) Increase long-term liabilities and long-term assets by $120 million.

Explanation

The analytical adjustment for off-balance-sheet financing is to increase both balance sheet assets and liabilities by the amount of the liability that is off-balance-sheet. Thus in this case, we want to increase long-term liabilities and long-term assets by $120 million. Because assets and liabilities are increased by the same amount, stockholders' equity is not affected by this adjustment.

(Study Session 6, Module 19.7, LOS 19.c)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #14 of 35

SnapPrints and NetPhoto Case Scenario

Josephine Howard, CFA is an equity analyst for an investment bank. She is preparing financial reports for two publicly traded digital photography companies, SnapPrints and Net Photo. Howard just attended a CFA Institute sponsored conference on detecting quality issues in financial statements and is eager to apply what she has learned.

SnapPrints provides photo prints and various other photo-related products, including calendars, T-shirts, and coffee mugs. NetPhoto is SnapPrints' largest competitor. NetPhoto has been receiving increasing attention from the analyst community due to its high sales growth rate, although NetPhoto's sales are still less than 50% of SnapPrints' sales.

During the conference, Howard learned about the importance of analyzing accruals to evaluate earnings quality. Therefore, Howard is going to analyze the accruals for each company as part of her review. Howard remembers a discussion from the conference about disaggregating income into its major components to improve earnings forecasts, but she cannot remember which component (cash or accruals) should receive a higher weighting in the forecast.

Howard gathered the following data from the income statement and statement of cash flows for SnapPrints.

Selected SnapPrints Income StatementItems (000s) Year Ended December 31, 2009	
Sales	45,000
Cost of Good Sold	(30,000)
Depreciation Expense	(3,000)
SG&A Expense	(2,000)
Interest Expense	(1,500)
Income Tax Expense	(3,000)
Net Income	**5,500**

Cash Flows for SnapPrints (000s) Year Ended December 31, 2009	
Cash from Operations	6,500
Cash from Investing	(3,500)
Cash from Financing	(1,200)
Change in Cash	**1,800**

Howard collected the following balance sheet data for NetPhoto.

Selected Balance Sheet items for NetPhoto as of December 31, in $Ms						
	2009	2008			2009	2008
Cash	5,500	4,500		Accounts Payable	4,500	4,300
Accounts Receivable	6,500	5,500		Short-term Notes Payable	5,800	6,500
Inventory	11,500	14,000		Long-Term Debt	28,500	29,750
Fixed Assets, Net	35,000	34,300		*Total Liabilities*	*38,800*	*40,550*
				Common Stock	15,000	12,800
				Retained Earnings	4,700	4,950
Total Assets	*58,500*	*58,300*		*Total Liabilities and Equity*	*58,500*	*58,300*

Howard has concerns about revenue recognition practices at both firms and has collected the following data.

	2009	2008	2007	2006
SnapPrints				
Revenue	45,000	44,000	44,400	38,500
Cash Collections	43,000	45,000	44,000	37,000
NetPhoto				
Revenue	22,000	15,000	11,500	7,500
Cash Collections	11,000	12,000	8,500	7,000

Based on her calculations of accruals, Howard believes that NetPhoto has a higher accruals ratio over the recent past compared with SnapPrints. If both companies have recently had extreme earnings, Howard would *most likely* conclude that:

A) SnapPrints' income will revert to its mean, but NetPhoto's income will not.

B) NetPhoto's income will revert to its mean more quickly than SnapPrints'.

C) SnapPrints' income will revert to its mean more quickly than NetPhoto's.

Explanation

Analysts should be aware that extreme earnings levels will not persist and that earnings will typically revert to normal levels over time. Additionally, the larger the accruals component of earnings relative to the cash component, the more rapidly earnings will revert to their mean. All else equal, if NetPhoto has a higher accruals ratio than SnapPrints, NetPhoto's earnings should revert to the mean more rapidly.

(Study Session 6, Module 19.5, LOS 19.e)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #15 of 35

An analyst is analyzing a discount manufacturer of parts and supplies. She has followed her firm's suggested financial analysis framework and has communicated with company suppliers, customers, and competitors. This is an input that occurs while:

A) establishing the objective of the analysis. ✗

B) processing data. ✗

C) collecting data. ✓

Explanation

Communication with management, suppliers, customers, and competitors is an input during the data collection step. Processing data is the third phase of the financial analysis framework. Establishing the objective of the analysis is part of the "define the purpose" phase of the financial analysis framework.

(Study Session 6, Module 19.1, LOS 19.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #16 of 35

SnapPrints and NetPhoto Case Scenario

Josephine Howard, CFA is an equity analyst for an investment bank. She is preparing financial reports for two publicly traded digital photography companies, SnapPrints and Net Photo. Howard just attended a CFA Institute sponsored conference on detecting quality issues in financial statements and is eager to apply what she has learned.

SnapPrints provides photo prints and various other photo-related products, including calendars, T-shirts, and coffee mugs. NetPhoto is SnapPrints' largest competitor. NetPhoto has been receiving increasing attention from the analyst community due to its high sales growth rate, although NetPhoto's sales are still less than 50% of SnapPrints' sales.

During the conference, Howard learned about the importance of analyzing accruals to evaluate earnings quality. Therefore, Howard is going to analyze the accruals for each company as part of her review. Howard remembers a discussion from the conference about disaggregating income into its major components to improve earnings forecasts, but she cannot remember which component (cash or accruals) should receive a higher weighting in the forecast.

Howard gathered the following data from the income statement and statement of cash flows for SnapPrints.

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Depreciation Expense	(3,000)
SG&A Expense	(2,000)
Interest Expense	(1,500)
Income Tax Expense	(3,000)
Net Income	**5,500**

Cash Flows for SnapPrints (000s) Year Ended December 31, 2009	
Cash from Operations	6,500
Cash from Investing	(3,500)
Cash from Financing	(1,200)
Change in Cash	**1,800**

Howard collected the following balance sheet data for NetPhoto.

Selected Balance Sheet items for NetPhoto as of December 31, in $Ms						
	2009	2008			2009	2008
Cash	5,500	4,500		Accounts Payable	4,500	4,300
Accounts Receivable	6,500	5,500		Short-term Notes Payable	5,800	6,500
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				Retained Earnings	4,700	4,950
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Howard has concerns about revenue recognition practices at both firms and has collected the following data.

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NetPhoto				
Revenue	22,000	15,000	11,500	7,500
Cash Collections	11,000	12,000	8,500	7,000

The aggregate accruals (in $M's) for SnapPrints and the accrual ratio for NetPhoto are *closest* to:

A) −4,500 and −1.49%.

B) 3,700 and −0.51%.

C) 2,500 and −2.04%.

Explanation

Aggregate accruals using the cash flow method are calculated as net income minus cash flow from operation minus cash flow from investing activities. For SnapPrints we have:

$$\text{accruals}^{CF} = \text{NI} - \text{CFO} - \text{CFI}$$

$$\text{accruals}^{CF} = 5{,}500 - 6{,}500 - (-3{,}500) = 2{,}500$$

In order to calculate the accrual ratio for NetPhoto, the first step is to compute the net operating assets. Net operating assets are equal to operating assets minus operating liabilities, where operating assets are total assets minus cash, cash equivalents, and marketable securities, and operating liabilities are total liabilities minus total debt.

	2009	2008
Total Assets	58,500	58,300
Cash	−5,500	−4,500
Operating Assets	*53,000*	*53,800*
Total Liabilities	38,800	40,550
Short-term Notes Payable	−5,800	−6,500
Long-Term Debt	−28,500	−29,750
Operating Liabilities	*4,500*	*4,300*
Net Operating Assets	*48,500*	*49,500*

The accruals ratio for NetPhoto using the balance sheet approach is:

$$\text{accruals ratio}^{BS} = \frac{(\text{NOA}^{END} - \text{NOA}^{BEG})}{(\text{NOA}^{END} + \text{NOA}^{BEG})/2}$$

$$\text{accruals ratio}^{BS} = \frac{(48{,}500 - 49{,}500)}{(48{,}500 + 49{,}500)/2} = -2.04\%$$

(Study Session 6, Module 19.5, LOS 19.e)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #17 of 35

An investor relations spokesperson for the Square Door Corporation was quoted as saying that Square Door shares were a bargain, selling at a price-to-earnings (P/E) ratio of 12, relative to the S&P 500 average P/E of 15.3. The financial statements reported net earnings of $126 million, or $4.00 per share. The notes to the financial statements included a statement that income for the year included a $31.5 million (after-tax) gain from the reclassification of certain assets from its investment portfolio to its trading portfolio. What would be the normalized P/E?

A) 13

B) 15.

C) 16

Explanation

Since the P/E ratio was 12 and EPS was $4, the price of the stock was $48 (12 × 4). After removing the nonrecurring gain, earnings will be $94.5 million (126 − 31.5). We know the number of shares is 31.5 million (126 Million ÷ 4). So the new EPS number is 3 (94.5 million ÷ 31.5 million) and new P/E ratio is 16 (48 ÷ 3).

(Study Session 6, Module 19.5, LOS 19.e)

Related Material

SchweserNotes - Book 2

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Question #18 of 35

Recently, Galaxy Corporation lowered its allowance for doubtful accounts by reducing bad debt expense from 2 percent of sales to 1 percent of sales. Ignoring taxes, what are the immediate effects on Galaxy's operating income and operating cash flow?

	Operating income	Operating cash flow
A)	Lower	Lower
B)	Higher	No effect
C)	No effect	Higher

Explanation

Lower bad debt expense will result in higher operating income. Operating cash flow is not affected until Galaxy actually collects the receivables.

(Study Session 6, Module 19.5, LOS 19.e)

Related Material

SchweserNotes - Book 2

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Question #19 of 35

SnapPrints and NetPhoto Case Scenario

Josephine Howard, CFA is an equity analyst for an investment bank. She is preparing financial reports for two publicly traded digital photography companies, SnapPrints and Net Photo. Howard just attended a CFA Institute sponsored conference on detecting quality issues in financial statements and is eager to apply what she has learned.

SnapPrints provides photo prints and various other photo-related products, including calendars, T-shirts, and coffee mugs. NetPhoto is SnapPrints' largest competitor. NetPhoto has been receiving increasing attention from the analyst community due to its high sales growth rate, although NetPhoto's sales are still less than 50% of SnapPrints' sales.

During the conference, Howard learned about the importance of analyzing accruals to evaluate earnings quality. Therefore, Howard is going to analyze the accruals for each company as part of her review. Howard remembers a discussion from the conference about disaggregating income into its major components to improve earnings forecasts, but she cannot remember which component (cash or accruals) should receive a higher weighting in the forecast.

Howard gathered the following data from the income statement and statement of cash flows for SnapPrints.

Selected SnapPrints Income StatementItems (000s) Year Ended December 31, 2009	
Sales	45,000
Cost of Good Sold	(30,000)
Depreciation Expense	(3,000)
SG&A Expense	(2,000)
Interest Expense	(1,500)
Income Tax Expense	(3,000)
Net Income	**5,500**

Cash Flows for SnapPrints (000s) Year Ended December 31, 2009	
Cash from Operations	6,500
Cash from Investing	(3,500)
Cash from Financing	(1,200)
Change in Cash	**1,800**

Howard collected the following balance sheet data for NetPhoto.

Selected Balance Sheet items for NetPhoto as of December 31, in $Ms						
	2009	**2008**			**2009**	**2008**
Cash	5,500	4,500		Accounts Payable	4,500	4,300
Accounts Receivable	6,500	5,500		Short-term Notes Payable	5,800	6,500
Inventory	11,500	14,000		Long-Term Debt	28,500	29,750
Fixed Assets, Net	35,000	34,300		*Total Liabilities*	*38,800*	*40,550*
				Common Stock	15,000	12,800
				Retained Earnings	4,700	4,950
Total Assets	*58,500*	*58,300*		*Total Liabilities and Equity*	*58,500*	*58,300*

Howard has concerns about revenue recognition practices at both firms and has collected the following data.

	2009	**2008**	**2007**	**2006**
SnapPrints				
Revenue	45,000	44,000	44,400	38,500
Cash Collections	43,000	45,000	44,000	37,000
NetPhoto				
Revenue	22,000	15,000	11,500	7,500
Cash Collections	11,000	12,000	8,500	7,000

Based on the revenue and cash collections data for SnapPrints and NetPhoto, Howard would *most likely* conclude that:

A) SnapPrints is misclassifying nonrecurring and nonoperating revenue.

B) SnapPrints is accelerating revenue.

C) NetPhoto is accelerating revenue.

Explanation

Typically, the ratio of revenue to cash collections is relatively stable. If a firm's ratio is increasing significantly over time (as NetPhoto's is), the firm may be accelerating revenue recognition through aggressive accounting methods.

Comparative Revenue / Cash Collections by Firm

	2009	2008	2007	2006
SnapPrints	105%	98%	101%	104%
NetPhoto	200%	125%	135%	107%

(Study Session 6, Module 19.5, LOS 19.e)

Related Material

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Question #20 of 35

A firm has reported net income of $136 million, but the notes to financial statements includes a statement that the results "include a $27 million charge for non-insured earthquake damage" and a "gain on the sale of certain assets during restructuring of $16 million." If we assume that both of these items are given on a pre-tax basis and the effective tax rate is 36%, what would be the "normal income"?

A) $94.08 million.

B) $143.04 million.

C) $147.00 million.

Explanation

To normalize earnings you would increase it by the non-recurring charge of $27 million and decrease it by the non-recurring gain, both tax adjusted.

$136 + (27 - 16)(1 - 0.36) = $143.04.

(Study Session 6, Module 19.5, LOS 19.e)

Related Material

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Question #21 of 35

Which of the following statements regarding adjustments an analyst may make before analyzing a set of financial statements is *least* accurate?

A) Cash flow from operations may be affected by the exclusion of off-balance sheet obligations.

B) The income statement should be adjusted to reflect the liability for purchases committed to under a take-or-pay contract.

C) Income statement items that may require adjustment include accounting changes, one-time charges and restructuring charges.

Explanation

The liability for goods under take or pay contracts would be shown on the balance sheet (not income statement). Off-balance sheet obligations such as operating lease would affect Cash flow from operations (as opposed to treatment under capital lease).

(Study Session 6, Module 19.7, LOS 19.c)

Related Material

SchweserNotes - Book 2
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George Edwards is a senior analyst with The Edge Group, an independent equity research firm specializing in micro cap companies that have recently had an initial public offering, or are likely to go public within the next three years. Over the current market cycle, small company stocks have been the leading performers in the equity market, and micro cap money managers have had huge cash inflows due to their funds' strong performance. With an excess amount of cash and few good investment opportunities due to the high valuations in the marketplace, fund managers have turned to independent research firms like The Edge Group to help them discover new investment ideas.

With a large number of mutual fund managers asking them for research reports, business at The Edge Group is booming. To help handle the large amount of business, Edwards has hired two new junior analysts, Paul Kelley and Rachael Schmidt. Both Kelley and Schmidt have degrees in finance, and came highly recommended to Edwards.

In Kelley and Schmidt's orientation meeting, Edwards told them that what has made The Edge Group successful in delivering quality research to its clients is its willingness to dig into company financial statements and not take the accounting numbers at face value. Every item in the financial statements should be scrutinized and adjusted if necessary. Edwards tells the new analysts that if there is one lesson they should learn, it is that "there is a difference between accounting reality and economic reality."

For their first assignment, Edwards has asked the new analysts to put together a draft of a research report on Landesign, an architecture firm specializing in landscape design for municipalities, residential developments, and wealthy individuals. The firm also sells various kinds of stone and plastic products which are used in landscaping applications. Edwards tells the new analysts that he will help put together the report, but he would like them to do a majority of the legwork.

Since it was founded seven years ago, Landesign has grown at an annual rate exceeding 20%. Much of the growth comes from Landesign's acquisitions of regional competitors. Edwards points out to the analysts that Landesign used purchase method accounting. Kelley, looking to impress Edwards with his knowledge, tells him that when one company acquires another, assets of both companies are restated to fair market value, and that higher depreciation can lead to lower quality earnings. Not wanting to be outdone, Schmidt adds that liquidity measures such as the quick ratio and the cash ratio should improve as Landesign makes acquisitions.

Kelley decides to review Landesign's 2004 financial statements and make notes about significant accounting practices being used. His notes are shown in the exhibit below:

Exhibit 1: Kelley's Notes on Landesign's Accounting Practices

- The firm uses First In, First Out (FIFO) accounting. As a side note, the current inflation rate has remained relatively constant at an annual rate of 3%.
- Equipment and office furniture are depreciated based on the 200% declining balance method.
- Fixed assets (equipment) are generally assigned short useful life estimates.
- The expected return on defined benefit pension plan assets is 2 to 3 percentage points below the long-term rate of return for similar assets.
- Landesign reports deferred taxes of $350,000 for 2004, compared with $300,000 and $280,000 in deferred taxes for 2003 and 2002, respectively.

Schmidt notices that the footnotes to Landesign's financial statements include a reference to an agreement to receive a minimum amount of stone used to construct landscape walls from a supplier. Under the terms of the agreement, Landesign will pay for the stone whether it is used in the current accounting period or not. The agreement allows Landesign to pay a price that is significantly less than the current market price for similar quality stone.

A second footnote indicates that Landesign has an eight-year rental commitment for a greenhouse used to grow plants and store mulch that Landesign uses in the landscaping process. On the financial statements, $55,000 in rent expense for the greenhouse is listed on the income statement. The footnote also states that the $55,000 rental expense payment was agreed upon with Fred's Nursery, the owner of the greenhouse, based upon an interest rate of 7%.

A third footnote indicates that Landesign has sold its accounts receivable to Dais Enterprises for 95% of their original value of $130,000. The footnote indicates that Landesign retains the risk of noncollection of the receivables.

The final footnote on the page indicates that Landesign has a revolving line of credit at which it can borrow funds in the future at an interest rate of 6%.

After going through the information, Kelley and Schmidt discuss their findings and start to work on their report for Edwards.

Question #22 of 35

Which of the following items noted in Kelley's Notes on Landesign's Accounting Practices would *least* likely be considered indicators of high earnings quality. Landesign's use of:

A) FIFO accounting in a mildly inflationary economy. ✓

B) the 200% declining balance method of depreciation on its furniture and equipment. ✗

C) short useful life estimates for fixed assets. ✗

Explanation

High earnings quality is established by a clear and conservative approach to stating earnings. Even though inflation is relatively mild, FIFO accounting will result in lower cost of goods sold (COGS), and higher net income. This is more aggressive than the use of Last In, First Out (LIFO) method. Short useful lives for fixed assets, use of accelerated depreciation, and using a conservative estimate for returns on pension assets will all tend to increase expenses and are examples of conservative accounting practices.

(Study Session 6, Module 19.7, LOS 19.b)

Related Material

SchweserNotes - Book 2

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Question #23 of 35

Which of the following adjustments should Schmidt make to Landesign's financial statements to account for the greenhouse that Landesign uses to grow plants and store mulch?

A) Increase both liabilities and assets by $328,400.

B) Increase liabilities and decrease equity by $440,000.

C) Increase both liabilities and assets by $341,500.

Explanation

The rental agreement for the greenhouse is an operating lease and essentially represents off-balance sheet financing. To adjust Landesign's balance sheet for the operating lease, Schmidt needs to capitalize the lease by increasing both liabilities and assets by the present value of the lease payments. The interest rate used in the present value computation is the lower of the firm's financing rate or the rate implicit in the lease. We are told that the rental payments of $55,000 are based on an interest rate of 7%. However, we are told in another footnote that Landesign expects to be able to borrow funds in the future at a rate of 6%. We therefore use the lower firm financing rate of 6% in our computation. The present value of the lease payments is: N = 8; I/Y = 6%; PMT = -55,000; FV = 0; CPT PV = $341,539.

(Study Session 6, Module 19.7, LOS 19.b)

Related Material

SchweserNotes - Book 2
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Question #24 of 35

MKF Consolidated reports $500 million in goodwill on its balance sheet. The market consensus indicates that the value of MKF's intangible assets is $300 million. How should an analyst adjust MKF's balance sheet? Reduce goodwill and:

A) equity by $200 million.

B) increase liabilities by $200 million.

C) equity by $500 million while increasing liabilities by $300 million.

Explanation

If goodwill has no economic value apart from the firm, it should be eliminated from the balance sheet. If the value of the intangibles can be reliably estimated they can be substituted for accounting goodwill.

(Study Session 6, Module 19.5, LOS 19.e)

Related Material

SchweserNotes - Book 2

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Question #25 of 35

Coastal Drilling Corp (CDC) reported the following year-end data:

EBIT	$23 million
EBT	$20 million
Effective tax rate	40 percent

CDC reported in the footnotes to its financial statements that it had increased the expected return on pension plan assets assumption which resulted in an increase of EBIT of $2 million. Analyst Wanda Brunner, CFA, thinks this change in assumptions is unfounded and removes the $2 million increase in EBIT. Which of the following is *closest* to the tax burden ratio after adjustment?

A) 55.6%.

B) 60.0%.

C) 61.9%.

Explanation

Tax burden = NI/EBT or 1 - the effective tax rate. The increase in the return on pension plan assets assumption increased EBIT, EBT, Income Taxes, and Net Income from what it would have been. Removing $2 million from the reported numbers will reduce EBIT, EBT, Income Taxes, and Net Income. However, the tax burden ratio will still be 1 - the effective tax rate.

(Study Session 6, Module 19.5, LOS 19.e)

Related Material

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Question #26 of 35

An analyst is developing a framework for financial statement analysis for his firm. The primary goal of financial statement analysis is to:

A) facilitate an economic decision.

B) document portfolio changes for purposes of the Prudent Investor Rule.

C) justify trading decisions for purposes of the Statement of Code and Standards.

Explanation

The primary goal of financial statement analysis is to facilitate an economic decision. For example, the firm may use financial analysis to decide whether to recommend a stock to its clients. Documentation and justification of trading decisions may be aided by financial statement analysis, but these are not the primary purposes.

(Study Session 6, Module 19.1, LOS 19.a)

Related Material

SchweserNotes - Book 2

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Question #27 of 35

Inventories are listed on the balance sheet at $600,000, retained earnings are $1.9 Million. In the notes to financial statements, you find a LIFO reserve of $125,000. Also, the probability of a LIFO liquidation is high. Assuming a tax rate of 36%, what will be the adjusted value of retained earnings?

A) $1,855,000.00

B) $1,820,000.00

C) $1,980,000.00

Explanation

The highly probably LIFO liquidation suggests net income, income tax expense, and equity will rise. The analyst can make this adjustment now for forecasting purposes. The adjustment to retained earnings will be: $125,000 × (1 − 0.36).

(Study Session 6, Module 19.2, LOS 19.b)

Related Material

SchweserNotes - Book 2

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Question #28 of 35

What does the LIFO reserve measure?

A) The overstatement relative to the current cost of inventory.

B) The results of older inventory flowing to cost of goods sold (COGS).

C) The accumulated difference between the reported inventory balance and the cost of that inventory if first in, first out (FIFO) had been used.

Explanation

The LIFO reserve measures the accumulated difference between the reported inventory balance and the cost of that inventory if FIFO had been used.

(Study Session 6, Module 19.7, LOS 19.c)

Related Material

SchweserNotes - Book 2
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Question #29 of 35

A firm has booked as a sale, the transfer of $100 million in short-term accounts receivable to Public Finance Co., subject to recourse. The notes to the financial statements disclose that as of the end of the fiscal year, $80 million remained uncollected. In order to reflect this on the balance sheet, which of the following adjustments must be made?

A) Decrease retained earnings and increase accounts receivable.

B) Increase accounts receivable and increase current liabilities.

C) Decrease cash and increase accounts receivable.

Explanation

Since the accounts receivable were sold with recourse, the risk on uncollected accounts remains with the company.

(Study Session 6, Module 19.7, LOS 19.c)

Related Material

SchweserNotes - Book 2
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Question #30 of 35

Northern Bottling (NB) currently shows minimum expected operating lease payments over the next 5 years of $3 million, $2.5 million, $2 million, $2 million, and $1.5 million. The firm's footnotes show a present value of future capital lease payments of $10.55m discounted at a rate of 6.75%. What adjustments would an analyst make to modify the balance sheet of NB to include this off-balance sheet financing? Increase long-term:

A) assets and long-term liabilities by $9.22 million.

B) assets and long-term liabilities by $9.27 million.

C) liabilities by $9.27 million and decrease equity by $9.27 million.

Explanation

The operating lease should be capitalized at the rate used to calculate the PV of future capital lease payments in the footnotes. Therefore, the PV (operating leases) is:

$= 3 / (1 + 0.0675) + 2.5 / (1 + 0.0675)^2 + 2 / (1+ 0.0675)^3 + 2 / (1 + 0.0675)^4 + 1.5 / (1 + 0.0675)^5$

= 9.27 million

The proper adjustment is to increase both long-term assets and liabilities by the same amount.

(Study Session 6, Module 19.7, LOS 19.c)

Related Material

SchweserNotes - Book 2
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Question #31 of 35

Adjustments for off-balance-sheet items include all but which of the following?

A) Estimating the probable obligation for contingent liabilities.

B) Using the equity method in place of the proportionate consolidation to reflect the investment in affiliates.

C) Capitalizing operating leases, including this amount as an asset and a liability.

Explanation

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

(Study Session 6, Module 19.7, LOS 19.c)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #32 of 35

An analyst is analyzing TRK Construction (TRK) for possible recommendation to his firm's clients. He wants to use TRK's financial statements to answer such questions as "Is TRK suitable for firm clients?", "Is TRK priced properly relative to peers?", "What is TRK's earnings quality?" The analyst is *most likely* to begin with:

A) a review of his firm's framework for analysis of financial statements. ✓

B) a DuPont analysis. ✗

C) analysts adjustments to the financial statements. ✗

Explanation

Analysis of financial statements should be performed in the context of an overall framework for the analysis of financial statements. Specific adjustments or analysis of specific ratios is a secondary concern.

(Study Session 6, Module 19.1, LOS 19.a)

Related Material

SchweserNotes - Book 2

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Question #33 of 35

Endrun Company reported net income of $4.7 million in 1999, and $4.3 million in 2000. In reviewing the annual report an analyst notices that the Endrun took a charge of $2.4 million in 1999 for the costs of relocating its main office, and in 2000 booked a gain of $900,000 on the sale of its previous office building. What would "normalized earnings" be for 1999 and 2000 if we assume a tax rate of 36% for both years?

A) $7.1 million and $5.2 million.

B) $6.236 million and $3.724 million.

C) $3.99 million and $2.54 million.

Explanation

You will increase 1999 earnings by the tax-adjusted value of the 2.4 million one-time charge (2.4 × (1 - 0.36) = +1.536), and you would decrease Y2000 earnings by the tax-adjusted amount of the $0.9 million one-time gain (0.9 × (1 - 0.36) = -0.576).

(Study Session 6, Module 19.5, LOS 19.e)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #34 of 35

Express Delivery Inc. (EDI) reported the following year-end data:

Depreciation expense	$30 million
Net income	$30 million
Total assets	$535 million
Shareholder's equity	$150 million
Effective tax rate	35 percent

Last year EDI purchased a fleet of delivery vehicles for $140 million. For the first year, straight-line depreciation was used assuming a depreciable life of 7 years with no salvage value. However, at year-end EDI's management determined that assumptions of a useful life of 5 years with a salvage value of 10 percent of the original value were more appropriate. How would the return on assets (ROA) and return on equity (ROE) for last year change due to the change in depreciation assumptions? ROA and ROE would be *closest* to:

A) ROA 5.7% and ROE 19.5%.

B) ROA 5.3% and ROE 20.5%.

C) ROA 5.0% and ROE 18.2%.

Explanation

The reported ROA and ROE are 5.6% (30/535) and 20.0% (30/150) respectively. Under the new depreciation assumptions, depreciation expense would be (140-14)/5 = 25.2 million. Under the original assumptions depreciation of the fleet was 20 million. Therefore depreciation increases by 5.2 million. With the change in depreciation methods EDI would have reported:

Depreciation expense	$35.20 million	(30 + 5.2)
Net income	$26.62 million	(30 − (5.2 × (1-0.35)))
Total assets	$529.80 million	(535 − 5.2)
Shareholder's equity	$146.62 million	(150 − 3.38)

Note that assets would have been lower by $5.2 million due to the new depreciation assumptions and shareholder's equity by $3.38 million (5.2 × (1 − 0.35)) due to lower retained earnings. Tax liabilities would have fallen by $1.82 million to balance the $5.2 million reduction in assets. Therefore, ROA would have been 5.0% (26.62 / 529.80) and ROE would have been 18.16% (26.62 / 146.62).

(Study Session 6, Module 19.2, LOS 19.b)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #35 of 35

A firm seeking to lower current tax liability may elect to use which method of inventory valuation during an inflationary period?

A) FIFO.

B) Average cost.

C) LIFO.

Explanation

During a 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.

(Study Session 6, Module 19.2, LOS 19.b)

Related Material

SchweserNotes - Book 2

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