### Answers to Review Questions

1. The role of the FASB and PCAOB regulatory agencies in the financial reporting of businesses is highly significant. The general accepted accounting standards that firms must comply with and the procedures in monitoring those standards are referred to as GAAP and are established primarily by the FASB. The PCAOB has as one of its primary duties serving as the watchdog over the public accounting profession. Public accounting firms have reports that must be submitted to the PCAOB documenting compliance with auditing standards established by the PCAOB. Both the process of monitoring the accountants and the use of GAAP in financial reporting are necessary to restore and maintain public confidence in the financial information distributed to the public.

2. The purpose of each of the 4 major financial statements are:

   **Income Statement**—The purpose of the income statement is to provide a financial summary of the firm’s operating results during a specified time period. It includes both the sales for the firm and the costs incurred in generating those sales. Other expenses, such as taxes, are also included on this statement.

   **Balance Sheet**—The purpose of the balance sheet is to present a summary of the assets owned by the firm, the liabilities owed by the firm, and the net financial position of the owners as of a given point in time. The assets are often referred to as investments and the liabilities and owners equity as financing.

   **Statement of Retained Earnings**—This statement reconciles the net income earned during the year, and any cash dividends paid, with the change in retained earnings during the year.

   **Statement of Cash Flows**—This statement provides a summary of the cash inflows and the cash outflows experienced by the firm during the period of concern. The inflows and outflows are grouped into the cash flow areas of operations, investment, and financing.

3. The notes to the financial statements are important because they provide detailed information not directly available in the financial statements. The footnotes provide information on accounting policies, procedures, calculation, and transactions underlying entries in the financial statements.

4. *Financial Accounting Standards Board Statement No. 52* describes the rules for consolidating a company’s foreign and domestic financial statements. It requires U.S.-based companies to translate foreign-currency-denominated assets and liabilities into U.S. dollars using the current rate (translation) method. This method uses the exchange rate prevailing on the date the fiscal year ends (the current rate). Income statement items can be translated using either the current rate or an average exchange rate for the period covered by the statement. Equity accounts are converted at the exchange rate on the date of the investment. In the retained earnings account any gains and losses from currency fluctuations are stated separately in an equity reserve account—the *cumulative translation adjustment account*—and not realized until the parent company sells or closes the foreign operations.

5. Current and prospective shareholders place primary emphasis on the firm’s current and future level of risk and return as measures of profitability, while creditors are more concerned with short-term liquidity measures of debt. Stockholders are, therefore, most interested in income statement measures, and creditors are most concerned with balance sheet measures. Management is concerned with all ratio measures, since they recognize that stockholders and creditors must see good ratios in order to keep the stock price up and raise new funds.
6. Cross-sectional comparisons are made by comparing similar ratios for firms within the same industry, or to an industry average, as of some point in time. Time-series comparisons are made by comparing similar ratios for a firm measured at various points in time. Benchmarking is the term used to describe this cross-sectional comparison with competitor firms.

7. The analyst should devote primary attention to any significant deviations from the norm, whether above or below. Positive deviations from the norm are not necessarily favorable. An above-normal inventory turnover ratio may indicate highly efficient inventory management but may also reveal excessively low inventory levels resulting in stockouts. Further examination into the deviation would be required.

8. Comparing financial statements from different points in the year can result in inaccurate and misleading analysis due to the effects of seasonality. Levels of current assets can fluctuate significantly, depending on a company’s business, so statements from the same month or year end should be used in the analysis to ensure valid comparisons of performance.

9. The current ratio proves to be the better liquidity measure when all of the firm’s current assets are reasonably liquid. The quick ratio would prove to be the superior measure if the inventory of the firm is considered to lack the ability to be easily converted into cash.

10. Additional information is necessary to assess how well a firm collects receivables and meets payables. The average collection period of receivables should be compared to a firm’s own credit terms. The average payment period should be compared to the creditors’ credit terms.

11. Financial leverage is the term used to describe the magnification of risk and return introduced through the use of fixed-cost financing, such as debt and preferred stock.

12. The debt ratio and the debt-equity ratio may be used to measure the firm’s degree of indebtedness. The times-interest-earned and the fixed-payment coverage ratios can be used to assess the firm’s ability to meet fixed payments associated with debt.

13. Three ratios of profitability found on a common-size income statement are: (1) the gross profit margin, (2) the operating profit margin, and (3) the net profit margin.

14. Firms that have high gross profit margins and low net profit margins have high levels of expenses other than cost of goods sold. In this case, the high expenses more than compensate for the low cost of goods sold (i.e., high gross profit margin) thereby resulting in a low net profit margin.

15. The owners are probably most interested in the Return on Equity (ROE) since it indicates the rate of return they earn on their investment in the firm. ROE is calculated by taking earnings available to common shareholders and dividing by stockholders’ equity.

16. The price-earnings ratio (P/E) is the market price per share of common stock divided by the earnings per share. It indicates the amount the investor is willing to pay for each dollar of earnings. It is used to assess the owner’s appraisal of the value of the firm’s earnings. The level of the P/E ratio indicates the degree of confidence that investors have in the firm’s future. The market/book (M/B) ratio is the market price per of common stock divided by the firm’s book value per share. Firms with high M/B ratios are expected to perform better than firms with lower relative M/B values.
17. *Liquidity ratios* measure how well the firm can meet its current (short-term) obligations when they come due.

*Activity ratios* are used to measure the speed with which various accounts are converted (or could be converted) into cash or sales.

*Debt ratios* measure how much of the firm is financed with other people’s money and the firm’s ability to meet fixed charges.

*Profitability ratios* measure a firm’s return with respect to sales, assets, or equity (overall performance).

*Market ratios* give insight into how well investors in the marketplace feel the firm is doing in terms of return and risk.

The liquidity and debt ratios are most important to present any prospective creditors.

18. The analyst may approach a complete ratio analysis on either a cross-sectional or time-series basis by summarizing the ratios into their five key areas: liquidity, activity, debt, profitability, and market. Each of the key areas could then be summarized, highlighting specific ratios that should be investigated.

19. The *DuPont system* of analysis combines profitability (the net profit margin), asset efficiency (the total asset turnover) and leverage (the debt ratio). The division of ROE among these three ratios allows the analyst to segregate the specific factors that are contributing to the ROE into profitability, asset efficiency, or the use of debt.