Module 1

Financial Accounting for MBAs

Learning Objectives – Coverage by question		
	True/False	**Multiple Choice**
LO1 – Explain and assess the four main business activities.		
LO2 – Identify and discuss the users and suppliers of financial statement information.	1- 4	1, 2
LO3 – Describe and examine the four financial statements, and define the accounting equation.	5-10	3-19
LO4 – Explain and apply the basics of profitability analysis.	11-13	20-25
LO5 – Assess business operations within the context of a competitive environment.	14	26, 27
LO6 – Access reports filed with the SEC (Appendix 1A).		
LO7 – Describe the accounting principles and regulations that frame financial statements (Appendix 1B).	15	28-30

These questions are available to assign in ***myBusinessCourse***.

Module 1: Financial Accounting for MBAs

True/False

Topic: Users of Financial Statement Information
LO: 2

1. Shareholders demand financial information primarily to assess profitability and risk whereas bankers demand information primarily to assess cash flows to repay loan interest and principal.

Answer: True
Rationale: While both shareholders and bankers are interested in all the information companies provide, shareholders care about more about a company's profitability and bankers care more about solvency and creditworthiness.

Topic: Publicly Available Financial Reports
LO: 2

2. Publicly traded companies are required to provide quarterly financial reports directly to the public.

Answer: False
Rationale: Companies provide electronic versions of quarterly financial statements to the SEC, which posts them to the Internet for the public to access them.

Topic: Users of Financial Statement Information
LO: 2

3. Publicly traded companies provide financial information primarily to satisfy the SEC and the tax authorities (that is, the Internal Revenue Service).

Answer: False
Rationale: Demand for information extends to many users; the regulators such as the SEC and the IRS are only one class of users.

Topic: SEC Filings
LO: 2

4. Publicly traded companies must provide to the Securities Exchange Commission annual audited financial statements (10-K reports) and quarterly audited financial statements (10-Q reports).

Answer: False
Rationale: Quarterly reports do not need to be audited.

Topic: Balance Sheet
LO: 3

5. If a company reports retained earnings of $175.3 million on its balance sheet, it must also report $175.3 million in cash.

Answer: False
Rationale: The accounting equation requires total assets to equal total liabilities plus stockholders' equity. That does not imply, however, that liability and equity accounts relate directly to specific assets.

Topic: Balance Sheet
LO: 3
6. A balance sheet shows a company's position over a period of time, whereas an income statement, statement of stockholders' equity, and statement of cash flows show its position at a point in time.

Answer: False
Rationale: The statement is reversed: A balance sheet shows a company's position at a point in time, whereas an income statement, statement of equity, and statement of cash flows show its position over a period of time.

Topic: Accounting Equation
LO: 3
7. Assets must always equal liabilities plus equity.

Answer: True
Rationale: The accounting equation is Assets = Liabilities + Equity. This relation must always hold.

Topic: Income Statement
LO: 3
8. The income statement reports net income which is defined as the company's profit after all expenses and dividends have been paid.

Answer: False
Rationale: The statement contains two errors. First, net income does not include any dividends during the period; these are a distribution of profits and not part of its calculation. Second, the income statement is prepared on an accrual basis and thus includes expenses incurred (as opposed to paid).

Topic: Statement of Cash Flows
LO: 3
9. A statement of cash flows reports on cash flows for operating, investing and financing activities at a point in time.

Answer: False
Rationale: A statement of cash flows reports on cash flows for operating, investing, and financing activities over a period of time.

Topic: Statement of Stockholders' Equity
LO: 3
10. An increase in common stock would be reflected in the statement of stockholders' equity.

Answer: True
Rationale: The statement of stockholders' equity reports on changes in the accounts that make up stockholders' equity. This includes contributed capital, retained earnings, and other equity.

Topic: Return on Assets
LO: 4

11. Return on Assets (ROA) measures the profit the company makes on each dollar of total assets it uses.

Answer: True
Rationale: Return on Assets is a profitability metric that measures how much profit the company made for each dollar of assets the company holds on average during the year.

Topic: Return on Assets
LO: 4

12. Return on Assets (ROA) = (Net Income / Sales) × Asset Turnover

Answer: True
Rationale: Return on Assets = Net Income / Average Assets. This is the disaggregation of the ROA into its components

Topic: Asset Turnover
LO: 4

13. Consider two companies (A and B) with equal profit margins of 18%. Company A has an asset turnover of 1.2 and Company B has an asset turnover of 1.5. If all else is equal, Company B with its' higher asset turnover, is less profitable because it requires more revenue to turn its assets over.

Answer: False
Rationale: Asset turnover is an efficiency metric. The higher the turnover, the more efficient the company is with its assets and thus, the more profitable. Algebraically, ROA = PM × AT. Company A above is less profitable: 18% × 1.2 = 21.6% whereas Company B's ROA is 18% × 1.5 = 27.0%.

Topic: Financial Accounting and Business Analysis
LO: 5

14. Financial statements are influenced by five important forces that determine a company's competitive intensity: (A) industry competition, (B) buyer power, (C) supplier power, (D) product substitutes, and (E) threat of entry.

Answer: True
Rationale: By systematically considering these five business forces, we can gain better insights from financial statements.

Topic: Audit Report
LO: 7

15. A "clean" audit report asserts—among other things—that (a) the auditor has prepared all necessary financial statements and (b) management has expressed its opinion that they are prepared in conformity with GAAP.

Answer: False
Rationale: The statement is reversed: A "clean" audit report asserts—among other things—that (a) management has prepared all necessary financial statements and (b) the auditor has expressed its opinion that they are prepared in conformity with GAAP.

Multiple Choice

Topic: Users of Financial Statement Information
LO: 2

1. Which of the following groups would likely *not* be interested in the financial statements of a large public company such as Procter & Gamble?
   A) Shareholders
   B) Employees
   C) Competitors
   D) Taxing agencies
   E) None of these are correct

   Answer: E
   Rationale: All of these parties would use the financial statements, albeit in different ways and for different purposes.

Topic: Users of Financial Statement Information
LO: 2

2. The SEC adopted Regulation FD, to curb public companies' practice of:
   A) Routinely filing extensions for annual reports (Form 10-K)
   B) Selectively disclosing information
   C) Reporting pro forma (non-GAAP) numbers
   D) Hiring auditors for non-audit services such as consulting engagements
   E) None of these are correct

   Answer: B
   Rationale: Reg FD reads as follows: "Whenever an issuer discloses any material nonpublic information regarding that issuer, the issuer shall make public disclosure of that information . . . simultaneously, in the case of an intentional disclosure; and . . . promptly, in the case of a non-intentional disclosure."

Topic: Components of the Balance Sheet
LO: 3

3. A list of assets, liabilities and equity can be found on which of the following?
   A) Balance Sheet
   B) Income Statement
   C) Statement of Assets and Liabilities
   D) Statement of Cash Flows
   E) Statement of Stockholders' Equity

   Answer: A
   Rationale: A balance sheet lists amounts for assets, liabilities and equity at a point in time.

Topic: Balance Sheet
LO: 3

4. Which of the following items would *not* be found on a balance sheet? (Select all that apply)
- A) Stockholders' Equity
- B) Property, plant and equipment
- C) Nonowner financing
- D) Cash
- E) Dividends

Answer: E
Rationale: The balance sheet reports assets (including cash and property, plant and equipment), liabilities (including nonowner financing) and equity. Dividends are reported on statement of stockholders' equity.

Topic: Profit and Cash Flow
LO: 3

5. A company's net cash flow will equal its net income …
- A) Almost always
- B) Rarely
- C) Occasionally
- D) Only when the company has no investing cash flow for the period
- E) Only when the company has no investing or financing cash flow for the period

Answer: B
Rationale: Net income reflects the company's revenue minus expenses for the given period. Net cash flow represents the amount of money received (spent) on operating, investing and financing activities for the given period. These values are rarely the same.

Topic: Financial Statement Information
LO: 3

6. Which of the following statements are correct (*select all that apply*)?
- A) A balance sheet reports on investing and financing activities.
- B) An income statement reports on financing activities.
- C) The statement of equity reports on changes in the accounts that make up equity.
- D) The statement of cash flows reports on cash flows from operating, investing, and financing activities over a period of time.
- E) A balance sheet reports on a company's assets and liabilities over a period of time.

Answer: A, C, and D
Rationale: Statement (B) is incorrect—the statement of cash flows reports on financing activities that are reflected on the balance sheet. Statement (E) is incorrect—the balance sheet reports on a company's assets and liabilities at a point in time.

Topic: Balance Sheet—Numerical calculations required
LO: 3
7. Kelty Company's year-end financial statements reported the following (in millions):

Total assets	$41,278
Total liabilities	29,465
Total shareholders' equity	11,813
Dividends	205
Net income (loss)	3,160
Retained earnings, Jan. 1	11,425

What did Kelty Company report for retained earnings at December 31?
A) $14,380 million
B) $14,768 million
C) $14,790million
D) $14,585 million
E) There is not enough information to determine the answer.

Answer: A
Rationale:

(in millions)	
Retained earnings, Jan. 1	$11,425
Net income	3,160
Dividends	(205)
Retained earnings, Dec. 31	$14,380

Topic: Balance Sheet—Numerical calculations required
LO: 3
8. United Company's year-end balance sheet reported the following (in millions)

Total Assets	$100,228
Total Liabilities	78,713
Contributed Capital	8,933

What was United Company's total liabilities and stockholders' equity at December 31?
A) $ 87,646 million
B) $ 91,295 million
C) $100,228 million
D) $ 21,515 million

Answer: C
Rationale: Assets = Liabilities + Stockholders Equity.
Assets = $100,228 so this is the total of liabilities and equity combined.

Topic: Balance Sheet—Numerical calculations required
LO: 3

9. On December 31 Starstruck Corporation reported, on its Form 10-K, the following (in millions):

Total assets	$21,494.3
Total stockholders' equity	8,836.1
Total current liabilities	6,820.4

What did Starstruck report as total liabilities on December 31?

A) $12,658.2 million
B) $ 5,837.8 million
C) $14,673.9 million
D) $23,510.0 million
E) None of these are correct.

Answer: A
Rationale: Assets = Liabilities + Stockholders Equity.
$21,494.3 = Liabilities + $8,836.1
Therefore, total liabilities = $12,658.2 on December 31.

Topic: Balance Sheet—Numerical calculations required
LO: 3

10. In its 2019 annual report, Snap-Tite Incorporated reported the following (in millions):

Current assets	$1,884.0
Total shareholders' equity	$2,635.2
Total liabilities	$2,088.0

What did Snap-Tite report as total assets at year-end?

A) $6,607.2 million
B) $2,839.2 million
C) $3,972.0 million
D) $4,723.2 million
E) None of these are correct.

Answer: D
Rationale: Assets = Liabilities + Stockholders Equity.
Assets = $2,088.0 + $2,635.2
Therefore, Assets = $4,723.2

Topic: Balance Sheet—Numerical calculations required
LO: 3
11. In its 2016 annual report, Kehl's Corporation reported the following (in millions):

Total assets	$20,362
Total shareholders' equity	$ 7,766
Total liabilities	$12,596

What proportion of Kehl's Corporation is financed by nonowners?
A) 44.8%
B) 38.1%
C) 61.9%
D) 61.7%
E) None of these are correct.

Answer: C
Rationale: Nonowner financing for Kehl's assets is provided from liabilities (the shareholders are the owners). $12,596 / $20,362 = 61.9%

Topic: Balance Sheet—Numerical calculations required (more challenging; requires calculation of total assets before ratio can be calculated.)
LO: 3
12. In its 2016 annual report, Malibu Inc. reported the following (in millions) on its year-end balance sheet:

Total liabilities	$4,086.0
Total shareholders' equity	$2,648.6

What proportion of Malibu Inc. is financed by nonowners?
A) 60.7%
B) 39.3%
C) 64.8%
D) 78.6%
E) None of these are correct.

Answer: A
Rationale: Nonowner financing for Malibu's assets is provided from liabilities (the shareholders are the owners). Assets = Liabilities + Equity.
Assets = $4,086.0 + $2,648.6 = $6,734.6
$4,086.0 / $6,734.6 = 60.7%

Topic: Income Statement—Numerical calculations required
LO: 3
13. The Tread Company's December 31 financial statements reported the following (in millions)

Sales	$22,737
Cost of sales	$16,458
Other expenses (excluding cost of sales)	$ 4,353

What did Tread Company report for net income for the year ending December 31?
A) $ 6,279 million
B) $12,105 million
C) $10,632 million
D) $ 1,926 million
E) $43,548 million

Answer: D
Rationale: Sales – Cost of sales – Other expenses = Net income
$22,737 – $16,458 – $4,353 = $1,926

Topic: Income Statement—Numerical calculations required
LO: 3
14. Tully Corporation reported the following on its annual income statement (in millions)

Sales revenue	$118,774
Gross profit	$72,382
Total expenses	$46,634

What did Tully report for cost of goods sold during the year?
A) $31.004 million
B) $93,026 million
C) $25,748 million
D) $46,392 million
E) None of these are correct.

Answer: D
Rationale: Sales – Cost of goods sold = Gross profit
$118,774 – Cost of goods sold = $72,382
Therefore, Cost of goods sold = $46,392

Topic: Income statement—Numerical calculations required
LO: 3
15. On September 30, Star Corporation reported, in its annual report, the following (in millions):

	Year 2	Year 1
Total expenses	$27,745.5	$24,605.1
Operating income	$6,257.9	$5,401.5
Net earnings	$4,228.4	$4,139.0

What amount of revenues did Star Corporation report for the year ended September 30, Year 2 (in millions)?
A) $31.973.9
B) $34,003.4
C) $29,775.0
D) $27,834.9
E) None of these are correct.

Answer: A
Rationale: Revenues – Total expenses = Net earnings
Revenues – $27,745.5 = $4,228.4
Therefore, Revenues were $31.973.9

Topic: Income Statement—Numerical calculations required (more challenging; requires calculation of growth rate.)
LO: 3
16. On December 31, Sleek Corporation reported, on its annual report, the following (in millions):

	Year 2	Year 1
Operating income	$4,255.3	$3,673.0
Net earnings	$2,875.3	$2,759.3

Calculate year-over-year increase or (decrease) in net earnings, in percentage terms.
A) 4.2%
B) 15.9%
C) 16.8%
D) 4.0%
E) None of these are correct.

Answer: A
Rationale: During the year, net earnings increased compared to the prior year. This increase is calculated as ($2,875.3 – $2,759.3) / $2,759.3 = 4.2%.

Topic: Income Statement—Numerical calculations required (more challenging; requires calculation of gross profit and ratios for two years.)
LO: 3

17. In its year-end financial statements, Pillar Inc. reported the following (in millions):

	Year 2	Year 1
Sales	$38,537	$47,011
Cost of goods sold	$28,309	$33,546

As a percentage of sales, did Pillar's gross profit increase or decrease during the year?

A) Gross profit increased from 25.0% to 28.6%
B) Gross profit decreased from 28.6% to 25.0%
C) Gross profit increased from 71.4% to 75.0%
D) Gross profit decreased from 75.0% to 71.4%
E) There is not enough information to answer the question.

Answer: B
Rationale: Sales – Cost of goods sold = Gross profit.
In Year 1, gross profit to sales was $13,196 / $46,071 = 28.6%.
In Year 2, gross profit to sales was $9,457 / $37,766 = 25.0%.

Topic: Statement of Cash Flows—Numerical calculations required
LO: 3

18. Trio Company's December 31, Year 2, financial statements reported the following (in millions).

Cash December 31	$1,698
Cash from operating activities	$2,256
Cash from investing activities	$(1,460)
Cash from financing activities	$(1,313)

What did Trio Company report for cash on its December 31, Year 1 balance sheet?

A) $2,215 million
B) $3,422 million
C) $ 517 million
D) $1,181 million
E) None of these are correct

Answer: A
Rationale: Cash, beginning of year + Cash from operating activities + Cash from investing activities + Cash from financing activities = Cash at end of year
Cash, beginning of year + $2.256 – $1,460 – $1,313 = $1,698
Cash, beginning of year = $2,215

Topic: Statement of Cash Flows—Numerical calculations required
LO: 3
19. Page's June 30, year-end financial statements reported the following (in millions):

Cash, beginning of year	$17,090
Cash, end of year	$17,755
Cash from operating activities	$38,588
Cash from investing activities	$(13,938)

What did Page report for cash from financing activities for the year ended June 30?
A) $ 23,985 million
B) $25,315 million
C) $(23,985) million
D) $25,315 million
E) $24,650 million

Answer: C
Rationale: Cash, beginning of year + Cash from operating activities + Cash from investing activities + Cash from financing activities = Cash at end of year
$17,090 + $38.588 – $13,938 + Cash from financing = $17,755
Cash from financing = $(23,985)

Topic: Return on Assets
LO: 4
20. A company's return on assets (ROA) can be disaggregated to reveal which of the following (select all that apply):
A) Financial leverage
B) Profit margin
C) Sales growth
D) Asset growth
E) Asset turnover

Answer: B and E
Rationale: ROA can be disaggregated into profit margin and asset turnover. Financial leverage and sales growth are not components of this ratio. Asset growth affects the calculation via the denominator, but can't be disaggregated directly.

Topic: Return on Equity
LO: 4
21. The ratio of net income to equity is also known as:
A) Total net equity ratio
B) Profit margin
C) Return on equity
D) Net income ratio
E) None of these are correct.

Answer: C
Rationale: The ratio of net income to equity is called ROE, return on equity, and measures how profitable the company was given the shareholders' investment.

Topic: Return on Equity—Numerical calculations required
LO: 4

22. Sales for the year = $341,126, Net Income for the year = $38,441, Income from equity investments = $9,033, and average Equity during the year = $123,650. Return on equity (ROE) for the year is:

A) 31.1%
B) 11.3%
C) 7.3%
D) 2.6%
E) There is not enough information to answer the question.

Answer: A
Rationale: Return on equity = Net income / Average Equity
$38,441 / $123,650 = 31.1%.

Topic: Return on Assets—Numerical calculations required
LO: 4

23. Sales for the year = $296,024, Net Income for the year = $22,965, and average Assets during the year = $163,628. Return on Assets (ROA) for the year is:

A) 55.3%
B) 7.8%
C) 14.0%
D) There is not enough information to calculate ROA.
E) None of these are correct.

Answer: C
Rationale: ROA = Net Income / Average assets
Therefore ROA equals $22,965 / $163,628 = 14.0%.

Topic: Return on Assets—Numerical calculations required (more challenging because net income is not provided, must be calculated.)
LO: 4

24. Sales for the year = $997,279, Profit margin =18%, and average Assets during the year = $647,770. Return on Assets (ROA) for the year is:

A) 65.0%
B) 27.7%
C) 11.7%
D) There is not enough information to calculate ROA.
E) None of these are correct.

Answer: B
Rationale: ROA = Net Income / Average assets. We are not given Net income, but we do know that profit margin is 18%. Thus we can calculate:

Net income as Sales × PM = $997,279 x 18% = $179,510.22
ROA = $179,510.22 / $647,770 = 27.7%

Topic: Return on Assets—Numerical calculations required (more challenging because average assets are not provided; must be calculated.)
LO: 4
25. On December 31, Harper, Inc., reported, on its year-end financial statements, the following (in millions):

	Year 2	Year 1
Total assets	$11,868	$11,968
Total sales	$7,195	$7,194
Net income	$692	$902

Calculate return on assets (ROA) for Year 2.
A) 5.8%
B) 60.6%
C) 60.4%
D) 6.8%
E) None of these are correct.

Answer: A
Rationale: Return on assets = Net income / Average assets.
A simple way to calculate average assets is to take the average of the beginning and ending assets:
($11,868 + $11,968) / 2 = $911,918
ROA = $692 / $11,918 = 0.05815 = 5.8%

Topic: Five Forces of Competitive Industry
LO: 5
26. Which of the following are *not* one of the five forces that determine a company's competitive intensity? (*Select as many as apply*)
A) Bargaining power of suppliers
B) Threat of substitution
C) Ability to obtain financing
D) Threat of entry
E) Threat of regulatory intervention

Answer: C and E
Rationale: The five forces of the competitive industry include: industry competitors, bargaining power of buyers, bargaining power of suppliers, threat of substitution, and threat of entry.

Topic: Business Environment
LO: 5
27. Which of the following are relevant in an analysis of a company's business environment? (*Select as many as apply*)
A) Financing
B) Labor
C) Buyers
D) Governance
E) All of the above

Answer: E
Rationale: The components of business analysis are: life cycle, outputs, buyers, inputs, competition, financing, labor, governance, and risk.

Topic: Clean Audit Opinion
LO: 7

28. A clean audit opinion includes which of the following assertions: (*Select as many as apply*)
A) Financial statements present fairly the company's financial condition
B) The auditor certifies the financials to be error free
C) The financial statements are management's responsibility
D) Management has handled transactions efficiently in all material respects
E) All of the above

Answer: A and C
Rationale: The audit is not a certification (B is wrong) and the auditor does not provide any opinion about how management handles transactions (D is wrong).

Topic: Auditor Report
LO: 7

29. The audit report is addressed to:
A) The audit committee
B) The board of directors
C) The shareholders
D) The board of directors and the shareholders
E) The Securities and Exchange Commission (SEC)

Answer: D
Rationale: The auditors' report to the owners and the directors.

Topic: GAAP
LO: 7

30. Generally Accepted Accounting Principles (GAAP) are created by: (select all that apply)
A) The Securities and Exchange Commission
B) The Generally Accepted Accounting Principles Task Force
C) The Sarbanes Oxley Act
D) The Financial Accounting Standards Board
E) The Public Company Accounting Oversight Board

Answer: A and D
Rationale: The Sarbanes Oxley Act did not create new accounting principles but rather, rules for auditors and corporate governance mechanisms for companies. Answer B is fictional. The PCAOB was established to oversee the development of audit standards and to monitor the effectiveness of auditors.