**Chapter 2 Solutions**

2-1 Publically-traded companies are required to provide adequate financial information to their shareholders. Information generally is provided through financial reports that a company periodically produces, which include a balance sheet, an income statement, a statement of cash flows, and a statement of retained earnings. In addition, the reports published by a company contain discussions of the firm’s operations, both present and forecasted.

2-2 (a) The balance sheet shows, at a particular point in time, the amount the firm has invested in assets and how much of those investments are financed with loans (liabilities) and how much are financed with equity (stock). (b) The income statement shows the revenues (sales) that the firm generated during a particular period and the expenses that were incurred during that same period, whether those expense were incurred as the result of normal operations or as the result of how the firm is financed. (c) The statement of cash flows shows how the firm generated cash (inflows) and how the firm used cash (outflows) during a particular accounting period. If the firm uses more cash than it generates through normal operations, it is deficit spending, and deficit spending must be financed with external funds (either stocks or debt).

2-3 The most important aspect of ratio analysis is the judgment used when interpreting the results to reach conclusions concerning a firm's current financial position and the direction in which the firm is headed in the future. The analyst should be aware of, and include in the interpretation, the fact that: (1) large firms with many different divisions are difficult to categorize in a single industry; (2) financial statements are reported at historical costs; (3) seasonal factors can distort the ratios; (4) some firms try to "window dress" their financial statements to look good; (5) firms use different accounting procedures to compute inventory values, depreciation, and so on; (6) there might not exist a single value that can be used for comparing firms' ratios (e.g., a current ratio of 2.0 might not be good for some firms); and (7) conclusions concerning the overall financial position of a firm should be based on a representative number of ratios, not a single ratio.

2-4 Shares issued = 100,000 Price per share = $7 Par value per share = $3

Common stock at par = $300,000 = $3 x 100,000

Paid-in capital = $400,000 = ($7 - $3) x 100,000 = $700,000 - $300,000

2-5 Net cash flow = Net income + Depreciation = $90,000 + $25,000 = $115,000

2-6 The income statement for HighTech Wireless with the information that is given in the problem:

Sales ?

Operating expenses, excluding depreciation $(500,000)

Depreciation (100,000)

EBIT ?

Interest 0 (HighTech has no debt)

Earnings before taxes (EBT) ?

Taxes (40%) ?

Net income (NI) $240,000

Starting with net income and working up the income statement to solve for sales, we have the following computations:

1. NI = EBT(1 – 0.4)

Thus, 

Taxes = $400,000 - $240,000 = $160,000

2. EBIT = EBT + Interest = $400,000 + 0 = $400,000

3. Sales = EBIT + Operating expenses, excluding depreciation + Depreciation

= $400,000 + $500,000 + $100,000 = $1,000,000

To show that this is the correct result, let’s start with sales equal to $1,000,000 and compute the net income:

Sales $1,000,000

Operating expenses, excluding depreciation (500,000)

Depreciation (100,000)

EBIT 400,000

Interest 0

Earnings before taxes (EBT) 400,000

Taxes (40%) (160,000)

Net income $240,000

Net cash flow = Net income + Depreciation = $240,000 + $100,000 = $340,000

2-7 a. 



b. 

Inventory = $73,500 – 3.0($21,000) = $10,500

2-8 a. 

Sales = 2.0($150,000) = $300,000

b. 

Net income = 0.06($150,000) = $9,000



2-9 a. 

Net income = 0.05($300,000) = $15,000

b. 

Alternative solution:



2-10 a. Debt ratio = 40%



Common equity = $750,000(0.6) = $450,000

b. 



Alternative solution:







2-11 a. 

Sales = 2.5($10,000) = $25,000

b. 

Net income = 0.04($10,000) = $400



Alternative solution:



2-12 (1) Current ratio: 

Current liabilities = $340,000/5.0 = $68,000

(2) Quick ratio: 

Inventories = $340,000 – 1.8($68,000) = $217,600

(3) Current assets = (Cash & Equivalents) + Accounts receivable + Inventories

$340,000 = $43,000 + Accounts receivable + $217,600

Accounts receivable = $340,000 - $43,000 - $217,600 = $79,400

(4) Inventory turnover: 

CGS = 7($217,600) = $1,523,200

(5) CGS = 0.80 (Sales), thus: 

(6) 

2-13 a. TIE = EBIT/INT, so find EBIT and INT

Interest = $200,000 x 0.06 = $12,000

Net income = $540,000 x 0.04 = $21,600

Taxable income (EBT) = $21,600/(1 - T) = $21,600/(1 – 0.4) = $36,000

EBIT = $36,000 + $12,000 = $48,000

TIE = $48,000/$12,000 = 4.0 x

b. For TIE to equal 6.0, EBIT = 6.0($12,000) = $72,000

When EBIT = $72,000, Net income = ($72,000 - $12,000)(1 – 0.40) = $36,000

Because NI = 0.04(Sales), Sales = $36,000/0.04 = $900,000

Check: When Sales = $900,000, NI = $900,000 x 0.04 = $36,000

EBT = $36,000/(1 – 0.40) = $60,000

EBIT = $60,000 + $12,000 = $72,000

TIE = $72,000/$12,000 = 6.0

2-14 We are given: Common equity = $35,000,000 Common shares outstanding = 7,000,000

Market price per share = $8 Net income = $14,000,000

a. EPS = $14,000,000/7,000,000 = $2

P/E ratio = $8/$2 = 4.0

b. Book value per share = $35,000,000/7,000,000 = $5

M/B ratio = $8/$5 = 1.6

2-15 We are given: ROE = 15% TA turnover = Sales/Total assets = 2.0x

Debt Ratio = 60%

a. From DuPont equation: ROE = ROA x Equity multiplier

0.15 = ROA x (Total assets/Common equity)

Recognize that Total assets/Common equity is simply the inverse of the proportion of the firm that is financed with equity. The proportion of the firm that is financed with equity equals 1 – Debt ratio. Thus,

 

ROA = 0.15/2.5 = 0.06 = 6.0%

b. ROA = (Net profit margin) x (Total assets turnover)

0.06 = Net profit margin x 2.0

Net profit margin = 0.06/2.0 = 0.03 = 3.0%

Alternative solution:

TA turnover = Sales/Total assets = 2.0x, thus Sales = 2.0(Total assets)

ROE = (Net income)/(Common equity) = (Net income)/[(1 – 0.6)(Total assets) = 0.15, thus,

Net income = 0.15(0.4)(Total assets) = 0.06(Total assets)



2-16 We are given: ROA = 8% Total assets = $440,000

Debt Ratio = 20%

a.  

Net income = 0.08($440,000) = $35,200

b. From DuPont equation: ROE = ROA x Equity multiplier



Thus, ROE = 0.08 x 1.25 = 0.10 = 10.0%

Alternative solution:

Common equity = $440,000(1 – 0.2) = $352,000



2-17 We are given: ROA = 4% Current assets = $260,000

Net income = $140,000 Long-term debt = $1,755,000

% assets financed with equity = 35%

(1) ; Total assets = $140,000/0.04 = $3,500,000

(2) Total liabilities = (Total assets)(Debt ratio) = $3,500,000(1 - 0.35) = $2,275,000

(3) Current liabilities = Total liabilities – Long-term debt = $2,275,000 - $1,755,000 = $520,000

(4) 

2-18 We are given: ROA = 3% ROE = 5% Total assets = $100,000

a. ; Net income = $100,000(0.03) = $3,000

b. ; CE =$3,000/0.05 = $60,000



2-19 We are given: % assets financed with equity = 60% Current ratio = 5.0

Total assets turnover = 4.0 Current assets = $150,000

Sales = $1,800,000

(1) 

Current liabilities = $150,000/5 = $30,000

(2) 

Total assets = $1,800,000/4.0 = $450,000

(3) Total liabilities = $450,000(1 – 0.60) = $180,000

(4) Long-term liabilities = $180,000 - $30,000 = $150,000

2-20 We are given: P/E ratio = 15.0 Price per share = $30

Fixed assets turnover = 8.0 Current ratio = 5.0

Current liabilities = $300,000 Net profit margin = 0.04

Shares of common = 60,000

(1) ; EPS = $30/15 = $2

Net income = 60,000($2) = $120,000

(2) ; Sales = $120,000/0.04 = $3,000,000

(3) ; Fixed assets = $3,000,000/8 = $375,000

(4) ; Current assets = $300,000(5) = $1,500,000

(5) Total assets = Fixed assets + Current assets = $375,000 + $1,500,000 = $1,875,000

a. 

b. 