SSEI
Sanjay Saraf Educational Institute Pvt. Ltd.
A positive NPV Training Center

CFA LEVEL 1

MARATHON SERIES

FINANCIAL STATEMENT ANALYSIS

Question 1:

All else being equal, which of the following patent acquisition methods will most likely result in a company reporting the smallest amortization expense during the initial year of the patent?

A. Purchase a patent

B. Develop a patent internally

C. Obtain a patent through a merger

Solution:

B is correct.

Treatment for intangible assets	
Acquisition method	**Treatment of costs**
Purchased on a stand-alone basis	• Fair value of assets capitalized on balance sheet
Developed internally through research and development	• Research costs expensed immediately on income statement • Development costs capitalized on balance sheet if product is developed for internal use (US GAAP) or has demonstrated technical feasibility (IFRS)
Acquired through a business combination (eg, merger)	• Fair value of assets capitalized on balance sheet • Additional goodwill created on balance sheet

Intangible assets (eg, patents, trademarks, or software) lack physical form and grant the holder exclusive rights to future benefits. Management may obtain these assets by purchasing them, internally developing them, or merging with a company that already owns them. Valuation of an intangible asset depends on the method of acquisition.

Amortization expenses the capitalized value of an asset over its useful life. When a company develops a patent internally, it must expense research costs as incurred. Since there are no further development costs for a patent, no costs are capitalized and no amortization expense is reported over the patent's useful life.

(Choices A and C) Purchasing a patent or merging with a company that has a patent both involve capitalizing the fair value of the patent; both result in amortization expense over the patent's useful life.

Question 2:

Which of these statements is least accurate regarding the financial statement analysis framework?

A. The financial statement analysis framework provides a structured approach for analyzing financial statements, including collecting input data, processing data, and drawing conclusions.

B. The financial statement analysis framework is applicable only to equity analysis and cannot be used for other financial statement analysis projects.

C. The follow-up step of the financial statement analysis framework involves reviewing the original conclusions and recommendations to determine their ongoing relevance.

Solution:

B is correct.

Statement B is incorrect. The financial statement analysis framework is a general framework that can be applied to any financial statement analysis project, including equity analysis, credit analysis, and evaluating the performance of a company. Statements A and C are accurate. The financial statement analysis framework provides a structured approach for analyzing financial statements, and the follow-up step involves reviewing the original conclusions and recommendations to determine their ongoing relevance.

Question 3:

A company engaged an external auditor to perform an audit of its financial statements. During the audit, the auditor discovered a material misstatement that was not corrected by management. As a result, the auditor was unable to obtain sufficient evidence to determine the overall fairness of the financial statements. Which type of audit opinion should the auditor issue in this case?

A. A qualified opinion.

B. An adverse opinion.

C. A disclaimer of opinion.

Solution:

C is correct.

In this case, the auditor was unable to obtain sufficient evidence to determine the overall fairness of the financial statements. The inability to express an opinion requires the auditor to issue a disclaimer of opinion.

Option A is incorrect. A qualified opinion is issued when the auditor concludes that the financial statements are fairly presented, except for a specific matter which is disclosed in the audit report.

Option B is incorrect. An adverse opinion is issued when the financial statements are materially misstated and are not presented fairly in accordance with the applicable financial reporting framework.

Question 4:

A company sells a piece of equipment that it no longer needs. Which section of the cash flow statement should include the cash inflow from this sale?

A. Cash flow from financing.

B. Cash flow from investing.

C. Cash flow from operations.

Solution:

B is correct.

Cash flow from investing is the section of the cash flow statement that records the cash inflows and outflows related to the acquisition or sale of long-term assets, such as equipment. Since the sale of equipment is a result of investing activities, the cash inflow from the sale should be included in the cash flow from investing section.

A is incorrect. Cash flow from financing activities includes transactions that affect the company's capital structure, such as issuance of stocks or payment of dividends.

C is incorrect. Cash flow from operations includes cash inflows and outflows related to the company's primary business operations, such as revenue from sales and payment of salaries. The sale of equipment is not related to the company's operations and should not be included in this section.

Question 5:

Anne Berry, the CEO of a fruit juice manufacturing company, purchased an electric vaporizer to reduce contamination in the plant. The vendor charged $550,000 for the vaporizer, and another company charged $4,000 for installation. Anne Berry recorded the vaporizer in the company's books at $554,000. The company's accountant later discovered that a similar vaporizer model was available for purchase at $500,000, and the installation cost for this model was $3,500. Which measurement method was most likely adopted in this case?

A. Fair value.

B. Historical cost.

C. Settlement value.

Solution:

B is correct.

The company most likely adopted the historical cost measurement method, which represents the amount of cash or cash equivalent paid for the purchase of the asset, including the cost of acquisition, preparation, and installation. This is because the company recorded the vaporizer in its books at the cost of $554,000, which is the amount it paid to acquire and install the asset. The fair value measurement method would have required the company to record the vaporizer at its current market value of $500,000, which is lower than the amount paid. The settlement value measurement method is not relevant in this case, as the company is not disposing of the asset.

Question 6:

John is an investor who is considering investing in a company, ABC Corp. He is reviewing the company's financial statements to make his investment decision. Which of the following underlying assumptions of financial statements is most important for John to consider when making his investment decision?

A. Comparability and verifiability.

B. Relevance and faithful representation.

C. Going concern and accrual accounting.

Solution:

C is correct.

Going concern and accrual accounting are the two most important assumptions of financial statements. As an investor, John needs to ensure that ABC Corp is a going concern, which means that the company will continue to exist for the foreseeable future. The accrual assumption means that financial statements should reflect transactions as they occur (not necessarily when the cash is paid), which provides John with more relevant information about the company's financial position and performance.

A is incorrect. Comparability and verifiability are important characteristics of financial statements, but they are not assumptions.

B is incorrect. Relevance and faithful representation are important characteristics of financial statements, but they are not assumptions.

Question 7:

ABC Corp reported a net income of $3 million for 2018. There are currently 2 million shares outstanding, and upper management holds 200,000 share options, which are likely to be exercised.

No other potentially dilutive financial instruments ABC Corp's diluted EPS is closest to:

A. $1.36

B. $1.50

C. $1.67

Solution:

A is correct.

Diluted EPS =3,000,000/(2,000,000+200,000) =1.36

B is incorrect. Uses the outstanding share only: 3,000,000/2,000,000 =1.50

C is incorrect. Subtracts the option shares from the outstanding shares in the denominator: 3,000,000/(2,000,000-200,000) = 1.67

Question 8:

One Corp is a publicly traded company with a capital structure consisting of 50% bonds, 40% common shares, and 10% mandatorily redeemable preferred stocks. Manilla Johnson, the company's accountant, is preparing its financial statements. In which of the following ways can Johnson most accurately classify the mandatorily redeemable preferred stocks?

A. Mandatorily redeemable preferred stocks can only be classified as debt.

B. Mandatorily redeemable preferred stocks can only be classified as equity.

C. Mandatorily redeemable preferred stocks can either be classified as debt or equity.

Solution:

A is correct.

Preferred stocks can be classified either as debt or equity. However, mandatorily redeemable preferred stocks have a redemption feature that requires the issuer to redeem them for cash or other assets, which makes them more similar to debt than equity. As a result, mandatorily redeemable preferred stocks are typically classified as debt. Non-redeemable perpetual preferred stocks, on the other hand, are treated as equity. Therefore, option A is the most accurate classification for One Corp's mandatorily redeemable preferred stocks.

Question 9:

Calculate the financial leverage of a company based on the data below.

Working Capital	= $90 Million
Non-Current Assets	= $261 Million
Equity	= $220 Million
Current Ratio	= 3.0

A. 1.96

B. 1.80

C. 1.72

Solution:

B is correct.

Current ratio	= current assets/current liabilities
Working capital	= current assets - current liabilities
Current ratio	= 3
i.e. current assets	= 3×current liabilities
so working capital	= 3×current liabilities – current liabilities
90	= 2× current liabilities
Current liabilities	= 45
So current assets	= 3×45 = 135
Financial leverage	= total assets/total equity
	= (135+261)/220
	= 1.80

Question 10:

XYZ Corporation is evaluating its cash flow statement for the current fiscal year. The company had invested in purchasing preferred stocks of another company during the year. In which section of the cash flow statement should this transaction be recorded?

A. Operating activities

B. Financing activities

C. Investing activities

Solution:

C is correct.

The cash flow statement has three main sections: operating activities, investing activities, and financing activities. Investing activities section includes cash flows arising from the purchase and sale of long-term assets and other investments, including property, plant, and equipment, intangible assets, and investments in debt and equity issued by other companies.

In this case, XYZ Corporation invested in purchasing preferred stocks of another company, which is an example of investing activities. Therefore, the transaction should be recorded in the investing activities section of the cash flow statement.

Option A is incorrect because operating activities include cash flows from a company's day-to-day operations, such as sales of goods or services and payment of operating expenses.

Option B is incorrect because financing activities include cash flows from raising or repaying capital, such as issuing or buying back shares, and borrowing or repaying debt.

Question 11:

ABC Corp. is a US-based firm that reports its financial information under US GAAP. ABC is expected to receive a dividend income from its investments in a German company called XYZ Co, which follows IFRS. What is the most likely impact of the dividend on the cash flow statement of ABC Corp.?

A. An increase in cash flow from investing activities.

B. An increase in cash flow from operations activities.

C. An increase in cash flow from either operating or investing activities.

SOLUTION:

B is correct.

Under US GAAP, interest and dividend income are reported as inflow from operating activities, while IFRS allows the reporting of interest and dividend income as either operating or investing activities. Since ABC Corp. follows US GAAP, the dividend received will increase the inflow from operating activities.

Question 12:

XYZ Corp. is a manufacturing company that operates with high levels of inventory and accounts receivable. The company's management is concerned about its ability to meet daily cash requirements in case of any unexpected shortfall. They want to use the defensive interval ratio to assess the company's liquidity position. Which of the following is the most accurate description of the defensive interval ratio for XYZ Corp.?

A. The defensive interval ratio measures the duration for which the daily cash requirements can be met from the current liabilities.

B. The defensive interval ratio measures the duration for which the daily cash requirements of a period can be met from the existing liquid assets.

C. The defensive interval ratio measures the duration for which the daily cash requirements of a period can be met from the expected liquid assets at the end of the period.

Solution:

B is correct.

The defensive interval ratio measures the number of days a company can continue to operate without using any long-term assets. In the case of XYZ Corp., the ratio will measure the number of days for which the company can meet its daily cash requirements using its existing liquid assets, such as cash and cash equivalents, short-term investments, and accounts receivables.

Option A is incorrect as it refers to the current liabilities, which are the company's obligations to pay within a year, and not its ability to meet daily cash requirements.

Option C is also incorrect as it refers to the expected liquid assets at the end of the period, which is uncertain and may not reflect the company's current liquidity position

Question 13:

Company A and B are market leaders in the construction industry.

	A	B
Revenue	6,000,0000	8,000,000
Gross profit	3,400,000	5,500,000
EBIT	2,100,000	2,700,000
Net income	1,500,000	1,800,000
Total debt	6,400,000	7,200,000
Dividend per share	1	2
Share price	25	22
No of shares outstanding	500,000	600,000

Assuming that each firm's market capitalization is approximately equal to the firm's total equity, which of the following statement is most likely correct?

A. Company A's growth is higher than Company B's growth rate.

B. Company B's growth rate is higher than Company A's growth rate.

C. Company A's growth rate is the same as Company B's growth rate.

Solution:

A is correct.

Growth Rate = Return on Equity × Retention Rate

Return on Equity of Company A = 1.5/12.5 = 0.12

Retention Rate of Company A = [Net Income − (Dividend× No. of Shares)]/Net income

= [$1.5 million − ($1 × 500, 000)]/1.5 million

= 66.67%

Growth Rate of Company A = ROE × RR = 0.12 × 0.66 = 8%

Return on Equity of a Company B = 1.8/13.2 =0.136

Retention Rate of Company B =[Net Income − (Dividend× No. of Shares)]/Net income

= [1.8 million − (2 × 600, 000)]/1.8 million

= 33.33%

Growth Rate of Company B = ROE × RR = 0.136 × 0.3333 = 4.53%

Therefore, Company A's growth rate is 8%, which is higher than Company B's growth rate.

Question 14:

Company A is a manufacturing firm that sells a range of products. It wants to compare both the FIFO and LIFO methods to account for its inventory. Under which of the following economic conditions would the FIFO method's inventory value most likely exceed the inventory value of the LIFO method?

A. The company is operating in a highly competitive market, and prices are stagnant across the industry.

B. The economy is experiencing a period of high inflation, and prices are rising rapidly.

C. The economy is in recession, and prices are declining.

Solution:

B is correct.

In an inflationary environment where prices are rising, the FIFO method would result in a higher inventory value than the LIFO method because the cost of goods sold (COGS) for FIFO would be calculated using the older, lower-priced inventory while the ending inventory balance would be based on the newer, higher-priced inventory. In contrast, the LIFO method would result in a lower inventory value because the most recent, higher-priced inventory would be used to calculate the COGS, leaving lower-priced inventory in the ending balance.

A is incorrect because when prices are stagnant, both methods would result in the same inventory value and COGS.

C is incorrect because in a deflationary environment where prices are declining, the LIFO method would result in a higher inventory value than the FIFO method because the most recent, higher-priced inventory would be left in the ending balance while the COGS would be calculated using the older, lower-priced inventory.

Question 15:

Mankind Pharma is a pharmaceutical company that specializes in manufacturing and selling prescription drugs. It stores some of its finished goods under a temperature-controlled environment, which incurs a total cost of €1.2 million per year. The company is trying to determine the most appropriate accounting treatment for this cost under IFRS.

Based on the information provided, which of the following is the most appropriate method for accounting for the cost of maintaining the temperature-controlled environment under IFRS?

A. Capitalized as an asset.

B. Charged as an expense.

C. Added to the cost of inventory.

Solution:

B is correct.

The most appropriate method for accounting for the cost of maintaining the temperature-controlled environment under IFRS is option B, charged as an expense. Under IFRS, storage costs are generally excluded from the cost of inventory and are to be charged as an expense in the income statement. This applies to all types of storage costs, including costs of maintaining a temperature-controlled environment.

Option A, capitalized as an asset, is incorrect as costs that are capitalized are costs of long-lived assets, which are expected to provide economic benefits over a future period, usually greater than one year. Examples of long-lived assets include property, plant, equipment, patents and trademarks, and investments in equity and debt securities issued by other companies. Maintaining a temperature-controlled environment does not meet the criteria for capitalization as an asset.

Option C, added to the cost of inventory, is incorrect as the costs that are to be included in the cost of inventory are limited to costs of purchase, costs of conversion, and other costs incurred in bringing the inventories to their present location and condition. These costs do not include storage costs, including costs of maintaining a temperature-controlled environment.

Question 16:

An electronic appliances trading company acquires units of LCD TVs on a monthly basis. Using the data given in the following table, determine which valuation system will provide higher Ending inventory.

Date	Description	No. of Units
1-Oct	Buy LCD TVs @ $300	600
8-Oct	Buy LCD TVs @ $370	450
22-Oct	Buy LCD TVs @ $400	250
30-Oct	Sold LCD TVs	800

A. FIFO Ending Inventory of $192,500

B. LIFO Ending Inventory of $150,000

C. FIFO Ending Inventory of $150,000

SOLUTION:

A is correct.

The situation described is an inflationary environment. During a period of increasing prices, the LIFO COGS will be higher than FIFO COGS and LIFO Ending Inventory will be lower than FIFO Ending inventory. Therefore, FIFO will result in a higher inventory of $192,500 while LIFO Ending inventory will be $150,000 (Using the following table)

LIFO	No. of Units	Dollar Value
Sold @$400	250	$100,000
Sold @$370	450	$166,500
Sold @$300	100	$30,000
COGS	800	$296,500
Ending Inventory @$300	500	$150,000
FIFO	No. of Units	Dollar Value
Sold @$300	600	$180,000
Sold @$370	200	$74,000
COGS	800	$254,000
Ending Inventory @$370	250	$92,500
Ending Inventory @$400	250	$100,000
Total Ending Inventory	500	$192,500

Question 17:

Which of the following is least likely an accurate accounting treatment for recording a loss on a revaluation of a long-lived asset?

A. Reversal of revaluation surplus.

B. Expense in the income statement.

C. Creation of revaluation deficit as an asset.

Solution:

C is correct.

The creation of a revaluation deficit as an asset is not an accurate treatment for recording a loss on a revaluation of a long-lived asset.

B is incorrect. A revaluation loss is charged as an expense in the income statement.

A is incorrect. Unless it can be reversed against an opening revaluation surplus, a revaluation loss is charged as an expense in the income statement.

Question 18:

Identify which of the following statements regarding intangible assets are most likely correct.

I. An intangible asset with a finite life is amortized over its useful life.

II. An intangible asset with an indefinite life is tested for impairment.

III. If an indefinite-lived intangible asset is impaired, the loss is recognized in the income statement.

A. Statement III.

B. Statements I & II.

C. Statements I, II & III.

Solution:

C is correct.

All three statements are correct. Intangible assets are long-lived assets that lack a physical presence. These assets include patents, copyrights, brand names, etc. Finite-lived intangible assets are amortized over their useful lives, while intangible assets with indefinite lives are tested for impairment. If impaired, the loss is recognized in the income statement.

Question 19:

You are a financial analyst working for ABC Company, which is preparing its financial statements for the year ended 2018. The company's income tax expense for the year is CAD 48,000, while the tax authority demands CAD 42,000. Your task is to determine how the excess of income tax expense should be recorded on the financial statements. According to generally accepted accounting principles (GAAP), how should the excess of income tax expense be recorded on ABC Company's financial statements?

A. As a deferred tax asset.

B. As a valuation allowance.

C. As a deferred tax liability.

Solution:

C is correct.

A deferred tax liability appears on the balance sheet when financial accounting income tax expense exceeds income tax payable. In this case, the company has recognized a higher income tax expense than what it owes to the tax authority, which means that it has deferred taxes to future periods. The excess of income tax expense should be recorded as a deferred tax liability on the balance sheet. Option A is incorrect because a deferred tax asset is recorded when income tax payable exceeds income tax expense. Option B is incorrect because a valuation allowance is a contra account used to reduce the carrying value of deferred tax assets.

Question 20:

Select information from a company's financial statements is shown below.

Revenue	=$790, 000
Cost of goods sold	= $610, 000
Rent	= $100, 000
Salaries and wages	= $120, 000

If the company's tax rate for that year was 20%, which of the below statements is most likely correct?

A. The firm reported a deferred tax asset of 8,000.

B. The firm reported a deferred tax liability of 8,000.

C. The firm reported a deferred tax asset of 40,000.

Solution:

A is correct.

Earnings = Revenue-Cost of goods sold− Operating expenses

$= \$790,000 - 610,000 - (100,000 + 120,000)$

$= -40,000$

The company has a loss of 40,000. The loss will be carried forward and will result in a DTA of: $40{,}000 \times 20\% = 8,000$

Question 21:

Apple Inc., a publicly traded technology company, has outstanding bonds worth $210 million with five years left to maturity. The company decides to redeem the bonds at the call price of $200 million. What is the correct accounting treatment for the gain on redemption?

A. The gain of $10 million is to be adjusted from opening retained earnings.

B. The gain of $10 million is to be recorded as a gain in the income statement.

C. The gain of $10 million is to be recorded as a deferred expenditure in the balance sheet. This will be amortized over five years.

Solution:

B is correct.

According to IFRS, the gain or loss on extinguishment of debt is recordedin the income statement. Therefore, the correct accounting treatment for the gain on redemption of the bonds by Apple Inc. is to record the gain of $10 million as a gain in the income statement. Option B is the correct answer.

Question 22:

Which of the following is most likely the correct treatment of finance leases in the lessee's accounts?

A. A lessee will record the liability at the initiation of the lease and decrease the liability bythe amount of the periodic lease payment.

B. A lessee will not record any asset or liability; only the periodic lease payment will berecognized in the income statement as a rental expense.

C. A lessee will record the asset and liability of the same amount at the initiation of the lease.Over the time of the lease, the lessee will decrease the asset with depreciation expenses andreduce the liability with interest expenses.

Solution:

C is correct.

The lessee will record the asset and liability of the same amount at the initiation of the lease. Duringthe life of the lease, the lessee will decrease the asset with depreciation expenses and reduce theliability with interest expenses.

Question 23:

Which of the following indicate accounting manipulations in the financial statements?

A. Company E's sales are 40% lower than the sales of Company F. Both are engaged in the production of T V shows.

B. Company C operates in providing telecommunication services and does not show a transmission cost, whereas Company D is engaged in the same industry and has substantial transmission costs.

C. Company A does not show an increase in capital assets, whereas Company B operates in the same industry and has increased its capital assets by 50%. Both companies are engaged in financial consulting.

Solution:

B is correct.

Option B indicates accounting manipulation as Company C does not show a transmission cost, whereas Company D is engaged in the same industry and has substantial transmission costs. This indicates that Company C may have manipulated its financial statements to inflate its profitability by understating its costs.

Option A does not provide sufficient information to conclude accounting manipulations.

Option C indicates a difference in the financial position of the two companies but does not necessarily indicate accounting manipulations. There may be valid reasons why Company A did not increase its capital assets while Company B did.

Question 24:

If a company wants to reduce its debt, which of the following technique would the company most likely adopt?

A. Impairment of goodwill.

B. Operating lease financing.

C. Change its inventory valuation method to LIFO.

Solution:

B is correct.

Operating lease financing is considered as an off-balance-sheet financing technique. An analyst must make suitable adjustments while evaluating the financial position and performance.

A is incorrect. Goodwill is considered an asset; therefore, its impairment would reduce a company's assets but not debt.

C is incorrect. Change in inventory valuation method to LIFO would only affect the inventory value, which is an asset. This would not impact the value of a company's debt.