Financial Accounting for Executives & MBAs
5th Edition
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PRACTICE QUIZ

Chapter 12: Using Accounting Information in Equity Valuation

Identify the answer that BEST completes the statement or answers the question.

1. Smith & Sons has a beta of 1.4. The risk-free rate of return is 3.4%, and the equity-risk premium is 4.2%.

How much is the company's cost of equity using the capital asset pricing model?
a. 5.88%
b. 9.28%
c. 10.64%
d. 8.96%

2. The Claremont Company determined its cost of equity capital to be 8.3%. The company's free cash flow to equity in its terminal year was $174,000 based on a 5-year forecast horizon. The risk-free rate of return was 3.5% and the expected rate of inflation is 2.5%.

What is the firm's terminal value?
a. $2,096,386
b. $ 870,000
c. $3,000,000
d. $6,960,000

3. The income statement for Keck Corporation appears below (amounts in millions):

Total revenue	$63,367
Cost of revenue	41,895
Gross profit	21,472
Total operating expenses	16,200
Operating income or loss	5,272
Other income/expenses	22
Earnings before interest and taxes	5,294
Interest expense	669
Income before tax	4,625
Income tax expense	1,776
Net income	$ 2,849

How much is pro forma net income for the next year if sales growth is forecasted to be 12% per year, the income tax rate is 19.2%, and all expenses except for interest vary as a function of sales?
a. $3,191 million
b. $4,250 million
c. $2,020 million
d. $4,436 million

4. The asset section of the balance sheet for Keck Corporation appears below (amounts in millions):

Assets	
Current assets	
Cash and cash equivalents	$ 2,450
Net receivables	9,207
Inventory	6,780
Other current assets	469
Total current assets	18,906
Long term investments	215
Property, plant and equipment	24,095
Intangible assets	208
Other assets	1,136
Total assets	$44,560

Assume that $2,400 million of plant assets were purchased, $1,100 million of depreciation was recorded, and cash and cash equivalents declined by 10%, while all other current assets increased by 7%.

How much are pro forma total assets if all other amounts stay the same?
a. $46,767 million
b. $21,372 million
c. $45,467 million
d. $47,867 million

5. Pomona Petroleum reported net income totaling $349,000 for the year. The average number of shares of common stock outstanding during the year totaled 2.15 million. The company's average P/E multiple is 11.6 based on identified comparable firms.

What is Anders' share price?
a. $16.23
b. $ 1.88
c. $ 1.40
d. $ 6.16

6. Below are data from the financial statements of Sound Advice:

Increase in cash account	$ 40,000
Cash flows from operations	405,000
Net income	368,000
Net cash from investing activities	45,000
Net decrease in debt	(120,000)

What is the company's free cash flow to equity?
a. $658,000
b. $290,000
c. $253,000
d. $370,000

7. Below are data from the financial statements of Drucker Corporation:

Dividends paid	$212,000
Common stock issued	66,000
Net change in common equity	167,000

What is the company's free cash flow to equity?
a. $445,000
b. $313,000
c. $ 21,000
d. $146,000

8. The following amounts were computed for Bella Enterprises:

Income before taxes:	$103,500
Net income:	$87,000
Firm's cost of debt:	4%
Firm's cost of equity:	9%
Beginning total assets:	$1,250,000
Beginning total assets:	$700,000

What is Bella's residual income?
a. $54,000
b. $37,500
c. $65,000
d. $59,000

9. Anders Petroleum reported net income totaling $500,000. The average number of shares of common stock outstanding during the year totaled 2 million. The company's average P/E multiple is 22 based on identified comparable firms.

How much is Anders' share price?
a. $5.50
b. $1.88
c. $1.40
d. $6.16

10. What does terminal value represent?
a. It is the value of a business from the present until it goes out of business
b. It is the value of the last year of its planned period of doing business operations
c. It is the value from the end of the specific forecast period until the business is sold or otherwise terminated
d. It is the value of the business during its entire functional life discounted to the present

1. b

Rationale: (3.4% + [1.4 x 4.2%])

2. c

Rationale: ($174,000 / [0.083 – 0.025])

3. b

Rationale: [($5,294 x 1.12) – $669] x (1 – 0.192)

4. a

Rationale: [$44,560 + $2,400 – $1,100 – ($2,450 x 0.1) + ($9,207 + $6,780 + $469) x 0.07]

5. b

Rationale: [($349,000 / 2,150,000) x 11.6]

6. b

Rationale: ($405,000 – $40,000 + $45,000 – $120,000)

7. d

Rationale: ($212,000 – $66,000)

8. b

Rationale: [$87,000 - (.09 x ($1,250,000 - $700,000))]

9. a

Rationale: [($500,000 / 2,000,000) x 22]

10. c