

Assignment 2:1 chapter 5 (Q. 4)

3. Book versus market return on equity.

Return on equity (ROE) can be estimated using financial statements (book value) or financial market data (market value). The book value of ROE over an accounting period is earnings after tax divided by owners' equity. The market value of ROE is the return that an investor would have experienced during the same period. It is the difference in share price plus dividend paid during the period divided by the share price at the beginning of the period. Why are the two ratios different? If the market ROE is more relevant to any investor, what is the use of the book ROE?

4. The structure of a firm's profitability.

- If a firm has a return on equity (ROE) of 15 percent, a financial multiplier of 2, and does not pay any tax, what is its return on invested capital before tax?
- If a firm has an ROE of 15 percent, a financial cost effect of 0.9, and an pre-tax ROIC of 10 percent, what is its debt-to-equity ratio (total debt divided by owners' equity)? Assume that the firm does not pay any tax.
- Under what condition(s) can a firm have, at the same time, a negative pre-tax ROIC and a positive ROE?

5. Misuse of the structure of return on equity.

Cite two cases in which a bad decision (i.e., a decision that negatively affects the market value of a firm) would increase its return on equity.

6. Financial leverage.

Under what intuitive condition will increase in debt (either short term or long term) relative to equity always increase a firm's return on equity? Can the structure of return on equity (ROE) relationship be used to determine a firm's optimal debt-to-equity ratio?

7. Industry effect on the structure of the return on equity.

Below are summarized balance sheets and income statements of three U.S. companies:

Income Statements (in millions)			
	Firm 1	Firm 2	Firm 3
Revenues	\$166,809	\$7,132	\$22,956
Earnings before interest and tax	10,105	1,419	10,937
Earnings before tax	9,083	1,114	14,275
Earnings after tax	<u>\$ 5,745</u>	<u>\$ 714</u>	<u>\$ 9,421</u>

Assignment 2.1 Chapter 4

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(in millions)	2008
Cash flows from operating activities	\$2,195
Net earnings	1,927
Adjustments to reconcile net income to net cash provided by operating activities	4,122
<i>Net cash provided by operating activities</i>	
Cash flows from investing activities	221
Proceeds from sale of short-term investments, net of sales	(154)
Purchase of long-term investments, net of sale	(56)
Increase in other long-term assets	(3,237)
Property acquired, net of disposals	(3,226)
<i>Net cash used in investing activities</i>	
Cash flows from financing activities	(57)
Net (decrease) increase in short-term borrowing	(558)
Repayment of long-term debt, net	174
Proceeds from issuance of common stock	(491)
Cash dividend payments	(8)
Repurchase of common stock	1
Excess cash benefits of share-based payments	(939)
<i>Net cash used in financing activities</i>	7
Effect of exchange rate changes on cash	(36)
Net (decrease) increase in cash and cash equivalents	281
Cash and cash equivalents, beginning of year	\$ 245
Cash and cash equivalents, end of year	

- Direct versus indirect method to cash-flow estimation.
What are the major differences between the cash-flow statement (direct method) and the statement of cash flows (indirect method according to *Standards No. 95* of the Financial Accounting Standards Board)? Which is the most relevant to financial analysis?
- Another version of the cash-flow statement.
Build a cash-flow statement for Allied Enterprises Inc. (see Review Problem 5) that measures the firm's cash flow from its operating activities in 2010 based on the cash flows the firm was legally obliged to meet that year (its *nondiscretionary* cash flows), and the cash flows that were at the discretion of the management (its *discretionary* cash flows). What would make this version of the cash-flow statement relevant?
- The effect of the management of the operating cycle on the firm's cash flows.
Following are financial statements for Sentec Inc., a distributor of electrical fixtures, for 2008, 2009, and 2010.