

Chapter 2

Introduction to Financial Statement Analysis

2-1. What four financial statements can be found in a firm’s 10-K filing? What checks are there on the accuracy of these statements?

In a firm’s 10-K filing, four financial statements can be found: the balance sheet, income statement, statement of cash flows, and statement of stockholders’ equity. Financial statements in form 10-K are required to be audited by a neutral third party, who checks and ensures that the financial statements are prepared according to GAAP and that the information contained is reliable.

2-2. Who reads financial statements? List at least three different categories of people. For each category, provide an example of the type of information they might be interested in and discuss why.

Users of financial statements include present and potential investors, financial analysts, and other interested outside parties (such as lenders, suppliers and other trade creditors, and customers). Financial managers within the firm also use the financial statements when making financial decisions.

Investors. Investors are concerned with the risk inherent in, and return provided by, their investments. Bondholders use the firm’s financial statements to assess the ability of the company to make its debt payments. Stockholders use the statements to assess the firm’s profitability and ability to make future dividend payments.

Financial analysts. Financial analysts gather financial information, analyze it, and make recommendations. They read financial statements to determine a firm’s value and project future earnings, so that they can provide guidance to businesses and individuals to help them with their investment decisions.

Managers. Managers use financial statements to look at trends in their own business, and to compare their own results with that of competitors.

2-3. Find the most recent financial statements for Starbucks’ corporation (SBUX) using the following sources:

- a. From the company’s Web page www.starbucks.com. (*Hint:* Search for “investor relations.”)
- b. From the SEC Web site www.sec.gov. (*Hint:* Search for company filings in the EDGAR database.)
- c. From the Morningstar website www.morningstar.com.
- d. From at least one other source. (*Hint:* Enter “SBUX 10K” at www.google.com.)

Each method will help find the same SEC filings. Yahoo! Finance also provides some analysis such as charts and key statistics.

- 2-4. Consider the following potential events that might have taken place at Global Conglomerate on December 30, 2022. For each one, indicate which line items in Global's balance sheet would be affected and by how much. Also indicate the change to Global's book value of equity. (In all cases, ignore any tax consequences for simplicity.)**
- Global used \$20 million of its available cash to repay \$20 million of its long-term debt.**
 - A warehouse fire destroyed \$5 million worth of uninsured inventory.**
 - Global used \$5 million in cash and \$5 million in new long-term debt to purchase a \$10 million building.**
 - A large customer owing \$3 million for products it already received declared bankruptcy, leaving no possibility that Global would ever receive payment.**
 - Global's engineers discover a new manufacturing process that will cut the cost of its flagship product by over 50%.**
 - A key competitor announces a radical new pricing policy that will drastically undercut Global's prices.**
- Long-term liabilities would decrease by \$20 million, and cash would decrease by the same amount. The book value of equity would be unchanged.
 - Inventory would decrease by \$5 million, as would the book value of equity.
 - Long-term assets would increase by \$10 million, cash would decrease by \$5 million, and long-term liabilities would increase by \$5 million. There would be no change to the book value of equity.
 - Accounts receivable would decrease by \$3 million, as would the book value of equity.
 - This event would not affect the balance sheet.
 - This event would not affect the balance sheet.

- 2-5. What was the change in Global Conglomerate's book value of equity from 2021 to 2022 according to Table 2.1? Does this imply that the market price of Global's shares increased in 2022? Explain.**

Global Conglomerate's book value of equity increased by \$1 million from 2021 to 2022. An increase in book value does not necessarily indicate an increase in Global's share price. The market value of a stock does not depend on the historical cost of the firm's assets, but on investors' expectation of the firm's future performance. There are many events that may affect Global's future profitability, and hence its share price, that do not show up on the balance sheet.

- 2-6. Use EDGAR to find Qualcomm's 10-K filing for 2021. From the balance sheet, answer the following questions:**
- How much did Qualcomm have in cash, cash equivalents, and market securities (short-term and long-term)?**
 - What were Qualcomm's total accounts receivable?**
 - What were Qualcomm's total assets?**
 - What were Qualcomm's total liabilities? How much of this was long-term debt?**
 - What was the book value of Qualcomm's equity?**
- \$12,414 million (cash, cash equivalents, and marketable securities)
 - \$3,579 million
 - \$41,240 million

- d. \$31,290 million, \$13,701 million.
- e. \$9,950 million.
- 2-7. Find online the annual 10-K report for Costco Wholesale Corporation (COST) for fiscal year 2021 (filed in October 2021). Answer the following questions from their balance sheet:**
- How much cash did Costco have at the end of the fiscal year?**
 - What were Costco's total assets?**
 - What were Costco's total liabilities? How much debt did Costco have?**
 - What was the book value of Costco's equity?**
 - At the end of the fiscal year, Costco had cash and cash equivalents of \$11,258 million.
 - Costco's total assets were \$59,268 million.
 - Costco's total liabilities were \$29,441 million, and it had \$7,491 million in debt (\$799 million as the current portion of long-term debt and \$6,692 million as long-term debt).
 - The book value of Costco's equity was \$18,078 million.
- 2-8. In early 2018, Ford Motor (F) had a book value of equity of \$34.9 billion, 4.0 billion shares outstanding, and a market price of \$12.50 per share. Ford also had cash of \$38.9 billion, and total debt of \$154.3 billion. Four years later, in early 2022, Ford had a book value of equity of \$48.5 billion, 4.0 billion shares outstanding with a market price of \$21 per share, cash of \$49.6 billion, and total debt of \$138.1 billion. Over this period, what was the change in Ford's**
- market capitalization?**
 - market-to-book ratio?**
 - enterprise value?**
 - 2018 Market Capitalization: 4 billion shares \times \$12.50/share = \$50. 2022 Market Capitalization: 4 billion shares \times \$21/share = \$84. The change over the period is $\$84 - \$50 = \$34$ billion.
 - 2018 Market-to-Book = $\$50/\$34.9 = 1.43$. 2022 Market-to-Book = $\$84/\$48.5 = 1.73$. The change over the period is: $1.73 - 1.43 = 0.30$.
 - 2018 Enterprise Value = $\$50 - \$38.9 + \$154.3 = \165.4 billion. 2022 Enterprise Value = $\$84 - \$49.6 + \$138.1 = \172.5 billion. The change over the period is: $\$172.5 - \$165.4 = \$7.1$ billion.
- 2-9. In early 2022, Abercrombie & Fitch (ANF) had a book equity of \$826 million, a price per share of \$39.00, and 50.4 million shares outstanding. At the same time, The Gap (GPS) had a book equity of \$2722 million, a share price of \$17.88, and 368 million shares outstanding.**
- What is the market-to-book ratio of each of these clothing retailers?**
 - What conclusions can you draw by comparing the two ratios?**
 - ANF's market-to-book ratio = $(\$39.00 \times 50.4)/\$826 = 2.38$.
GPS's market-to-book ratio = $(\$17.88 \times 368)/\$2,722 = 2.42$.
 - For the market, the outlook of Abercrombie and Fitch is similar to that of The Gap. For every dollar of equity invested in ANF, the market values that dollar today at \$2.38 versus \$2.42 for a dollar invested in the GPS. Equity investors are willing to pay roughly the same today for shares of ANF as they are for GPS because they expect both to perform similarly in the future.

- 2-10. See Table 2.5 showing financial statement data and stock price data for Mydeco Corp.
- What is Mydeco's market capitalization at the end of each year?
 - What is Mydeco's market-to-book ratio at the end of each year?
 - What is Mydeco's enterprise value at the end of each year?

2019–2023 Financial Statement Data and Stock Price Data for Mydeco Corp.

Table 2.5 2019-2023 Financial Statement Data and Stock Price Data for Mydeco Corp.					
(All data as of fiscal year end; \$ in millions)					
Mydeco Corp. 2019–2023	2019	2020	2021	2022	2023
Income Statement					
Revenue	404.3	363.8	424.6	510.7	604.1
Cost of Goods Sold	-188.3	-173.8	-206.2	-246.8	-293.4
Gross profit	216	190	218.4	263.9	310.7
Sales and Marketing	-66.7	-66.4	-82.8	-102.1	-120.8
Administration	-60.6	-59.1	-59.4	-66.4	-78.5
Depreciation & Amortization	-27.3	-27	-34.3	-38.4	-38.6
EBIT	61.4	37.5	41.9	57	72.8
Interest Income (Expense)	-33.7	-32.9	-32.2	-37.4	-39.4
Pretax Income	27.7	4.6	9.7	19.6	33.4
Income Tax	-9.7	-1.6	-3.4	-6.9	-11.7
Net Income	18	3	6.3	12.7	21.7
Shares outstanding (millions)	55	55	55	55	55
Earnings per share	\$0.33	\$0.05	\$0.11	\$0.23	\$0.39
Balance Sheet	2019	2020	2021	2022	2023
Assets					
Cash	48.8	68.9	86.3	77.5	85
Accounts Receivable	88.6	69.8	69.8	76.9	86.1
Inventory	33.7	30.9	28.4	31.7	35.3
Total Current Assets	171.1	169.6	184.5	186.1	206.4
Net Property, Plant & Equip.	245.3	243.3	309	345.6	347
Goodwill & Intangibles	361.7	361.7	361.7	361.7	361.7
	778.1	774.6	855.2	893.4	915.1
Liabilities & Stockholders' Equity					
Accounts Payable	18.7	17.9	22	26.8	31.7
Accrued Compensation	6.7	6.4	7	8.1	9.7
Current Liabilities	25.4	24.3	29	34.9	41.4
Long-term Debt	500	500	575	600	600
Total Liabilities	525.4	524.3	604	634.9	641.4
Stockholders' Equity	252.7	250.3	251.2	258.5	273.7
Total Liabilities & Stockholders' Equity	778.1	774.6	855.2	893.4	915.1
Statement of Cash Flows	2019	2020	2021	2022	2023
Net Income	18	3	6.3	12.7	21.7
Depreciation & Amortization	27.3	27	34.3	38.4	38.6
Chg. In Accounts Receivable	3.9	18.8	0	-7.1	-9.2
Chg. In Inventory	-2.9	2.8	2.5	-3.3	-3.6
Chg. In Payables & Accrued Com	2.2	-1.1	4.7	5.9	6.5
Cash from Operations	48.5	50.5	47.8	46.6	54
Capital Expenditures	-25	-25	-100	-75	-40
Cash from Investing Activities	-25	-25	-100	-75	-40
Dividends Paid	-5.4	-5.4	-5.4	-5.4	-6.5
Sale (or purchase) of stock	0	0	0	0	0
Debt Issuance (Pay Down)	0	0	75	25	0
Cash from Financing Activities	-5.4	-5.4	69.6	19.6	-6.5
Change in Cash	18.1	20.1	17.4	-8.8	7.5
Mydeco Stock Price	\$7.92	\$3.30	\$5.25	\$8.71	\$10.89

	2019	2020	2021	2022	2023
Stock price	\$7.92	\$3.30	\$5.25	\$8.71	\$10.89
Shares outstanding (millions)	55	55	55	55	55
Book Value of Equity	252.70	250.30	251.20	258.50	273.70
Debt	500.00	500.00	575.00	600.00	600.00
Cash	48.80	68.90	86.30	77.50	85.00
a. Market Capitalization	435.60	181.50	288.75	479.05	598.95
b. Market-to-book ratio	1.72	0.73	1.15	1.85	2.19
c. Enterprise Value	886.80	612.60	777.45	1,001.55	1,113.95

- 2-11. Suppose that in 2023, Global launches an aggressive marketing campaign that boosts sales by 15%. However, their operating margin falls from 5.57% to 4.50%. Suppose that they have no other income, interest expenses are unchanged, and taxes are the same percentage of pretax income as in 2022.

- What is Global's EBIT in 2023?

- b. **What is Global’s net income in 2023?**
- c. **If Global’s P/E ratio and number of shares outstanding remains unchanged, what is Global’s share price in 2023?**
 - a. Revenues in 2023 = $1.15 \times \$186.7 = \214.705 million.
EBIT = $4.50\% \times \$214.705 = \9.66 million (there is no other income).
 - b. Net Income = EBIT – Interest Expenses – Taxes = $(\$9.66 - \$7.7) \times (1 - 26\%) = \1.45 million.
 - c. Share price = (P/E Ratio in 20015) \times (EPS in 2016) = $25.2 \times (\$1.45/3.6) = \10.15 .

Note: Differences from spreadsheet solutions due to rounding.

- 2-12. Find online the annual 10-K report for Costco Wholesale Corporation (COST) for fiscal year 2021 (filed in October 2021). Answer the following questions from their income statement:**
- a. **What were Costco's revenues for fiscal year 2021? By what percentage did revenues grow from the prior year?**
 - b. **What was Costco's operating income for the fiscal year?**
 - c. **What was Costco's average tax rate for the year?**
 - d. **What were Costco's diluted earnings per share in fiscal year 2021? What number of shares is this EPS based on?**
 - a. Revenues = \$195,929 million. Revenue growth = $(\$195,929/\$166,761) - 1 = 17.49\%$.
 - b. Operating Income = \$6,708 million.
 - c. Average tax rate = $\$1,601/\$6,680 = 23.97\%$.
 - d. The diluted earnings per share in 2021 was \$11.27. The number of shares used in this calculation of diluted EPS was 444.35 million.

- 2-13. See Table 2.5 showing financial statement data and stock price data for Mydeco Corp.**
- a. **By what percentage did Mydeco’s revenues grow each year from 2020–2023?**
 - b. **By what percentage did net income grow each year?**
 - c. **Why might the growth rates of revenues and net income differ?**

	2020	2021	2022	2023
a. Growth rate in revenues	-10.02%	16.71%	20.28%	18.29%
b. Growth rate in net income	-83.33%	110.00%	101.59%	70.87%
c. Why are they different?	Net Income growth rate differs from revenue growth rate because cost of goods sold and other expenses can move at different rates than revenues. For example, revenues declined in 2020 by 10%, however, cost of goods sold only declined by 7%.			

- 2-14. See Table 2.5 showing financial statement data and stock price data for Mydeco Corp. Suppose Mydeco repurchases 2 million shares each year from 2020 to 2023. What would its earnings per share be in years 2020–2023? (Assume Mydeco pays for the shares using its available cash and that Mydeco earns no interest on its cash balances.)**

A repurchase does not impact earnings directly, so any change to EPS will come from a reduction in shares outstanding. 2023 shares outstanding = $55 - 4 \times 2 = 47$ million, $EPS = \frac{21.7}{47} = \0.46 .

- 2-15. See Table 2.5 showing financial statement data and stock price data for Mydeco Corp. Suppose Mydeco had purchased additional equipment for \$12 million at the end of 2020, and this equipment was depreciated by \$4 million per year in 2021, 2022, and 2023. Given Mydeco’s tax rate of 35%, what impact would this additional purchase have had on Mydeco’s net income in years 2020–2023? (Assume the equipment is paid for out of cash and that Mydeco earns no interest on its cash balances.)**

The equipment purchase does not impact net income directly, however the increased depreciation expense and tax savings changes net income.

	2020	2021	2022	2023
EBITDA	64.50	76.20	95.40	111.40
Minus new depreciation expense	-27.00	-38.30	-42.40	-42.60
New EBIT	37.50	37.90	53.00	68.80
Minus interest income	-32.90	-32.20	-37.40	-39.40
New pretax income	4.60	5.70	15.60	29.40
Minus taxes	-1.61	-2.00	-5.46	-10.29
New Net Income	3.0	3.7	10.1	19.1

- 2-16. See Table 2.5 showing financial statement data and stock price data for Mydeco Corp. Suppose Mydeco’s costs and expenses had been the same fraction of revenues in 2020–2023 as they were in 2019. What would Mydeco’s EPS have been each year in this case?**

If Mydeco’s costs and expenses had been the same fraction of revenues in 2020–2023 as they were in 2019, then their net profit margins would have been equal.

$$\text{2019 net profit margin} = \frac{18}{404.3} = 4.45\%$$

	2019	2020	2021	2022	2023
Revenues	404.30	363.80	424.60	510.70	604.10
Net profit margin from 2015	4.452%				
New Net Income	18.00	16.20	18.90	22.74	26.90
Shares outstanding (millions)	55.00	55.00	55.00	55.00	55.00
Earnings per share	\$0.33	\$0.29	\$0.34	\$0.41	\$0.49

- 2-17. Suppose a firm’s tax rate is 25%.**
- What effect would a \$10 million operating expense have on this year’s earnings? What effect would it have on next year’s earnings?**
 - What effect would a \$10 million capital expense have on this year’s earnings if the capital is depreciated at a rate of \$2 million per year for five years? What effect would it have on next year’s earnings?**
 - A \$10 million operating expense would be immediately expensed, increasing operating expenses by \$10 million. This would lead to a reduction in taxes of $25\% \times \$10 \text{ million} = \2.5 million . Thus, earnings would decline by $\$10 - \$2.5 = \$7.5 \text{ million}$. There would be no effect on next year’s earnings.
 - Capital expenses do not affect earnings directly. However, the depreciation of \$2 million would appear each year as an operating expense. With a reduction in taxes of $\$2 \times 25\% = \0.5 million , earnings would be lower by $\$2 - \$0.5 = \$1.5 \text{ million}$ for each of the next 5 years.

- 2-18. Quisco Systems has 6.5 billion shares outstanding and a share price of \$18. Quisco is considering developing a new networking product in house at a cost of \$500 million. Alternatively, Quisco can acquire a firm that already has the technology for \$900 million worth (at the current price) of Quisco stock. Suppose that absent the expense of the new technology, Quisco will have EPS of \$0.80.**
- Suppose Quisco develops the product in house. What impact would the development cost have on Quisco's EPS? Assume all costs are incurred this year and are treated as an R&D expense, Quisco's tax rate is 35%, and the number of shares outstanding is unchanged.**
 - Suppose Quisco does not develop the product in house but instead acquires the technology. What effect would the acquisition have on Quisco's EPS this year? (Note that acquisition expenses do not appear directly on the income statement. Assume the firm was acquired at the start of the year and has no revenues or expenses of its own, so that the only effect on EPS is due to the change in the number of shares outstanding.)**
 - Which method of acquiring the technology has a smaller impact on earnings? Is this method cheaper? Explain.**
 - If Quisco develops the product in-house, its earnings would fall by $\$500 \times (1 - 35\%) = \325 million. With no change to the number of shares outstanding, its EPS would decrease by to \$0.75. (Assume the new product would not change this year's revenues.)
 - If Quisco acquires the technology for \$900 million worth of its stock, it will issue $\$900/18 = 50$ million new shares. Because earnings without this transaction are $\$0.80 \times 6.5 \text{ billion} = \5.2 billion, its EPS with the purchase is $5.2/6.55 = \$0.794$.
 - Acquiring the technology would have a smaller impact on earnings, but this method is not cheaper. Developing it in-house is less costly and provides an immediate tax benefit. The earnings impact is not a good measure of the expense. In addition, note that because the acquisition permanently increases the number of shares outstanding, it will reduce Quisco's earnings per share in future years as well.
- 2-19. Find online the annual 10-K report for Costco Wholesale Corporation (COST) for fiscal year 2021 (filed in October 2021). Answer the following questions from their cash flow statement:**
- How much cash did Costco generate from operating activities in fiscal year 2017?**
 - What was Costco depreciation and amortization expense?**
 - How much cash was invested in new property and equipment (net of any sales)?**
 - How much did Costco raise from the sale of shares of its stock (net of any purchases)?**
 - Net cash provided by operating activities was \$8,958 million.
 - Depreciation and amortization expenses were \$1,781 million.
 - Net cash used in capital expenditures for property and equipment was -\$3,588 million.
 - Costco raised nothing from the sale of shares of its stock, while it spent \$496 million on the purchase of common stock. Costco raised -\$496 million from the sale of its shares of stock (net of any purchases).
- 2-20. See Table 2.5 showing financial statement data and stock price data for Mydeco Corp.**
- From 2019 to 2023, what was the total cash flow from operations that Mydeco generated?**
 - What fraction of the total in (a) was spent on capital expenditures?**
 - What fraction of the total in (a) was spent paying dividends to shareholders?**
 - What was Mydeco's total retained earnings for this period?**
 - Total cash flow from operations = $48.5 + 50.5 + 47.8 + 46.6 + 54 = \247.4 million.
 - Total fraction spent on capital expenditures = $(25 + 25 + 100 + 75 + 40)/247.4 = 107.1\%$.

- c. Total fraction spent on dividends = $(5.4 \times 4 + 6.5)/247.4 = 11.4\%$.
- d. Retained earnings = Net Income – Dividends = $(18 + 3 + 6.3 + 12.7 + 21.7) - (5.4 \times 4 + 6.5) = \33.6 million.

2-21. See Table 2.5 showing financial statement data and stock price data for Mydeco Corp.

- a. **In what year was Mydeco's net income the lowest?**
- b. **In what year did Mydeco need to reduce its cash reserves?**
- c. **Why did Mydeco need to reduce its cash reserves in a year when net income was reasonably high?**
 - a. In 2020 (net income was \$3 million).
 - b. 2022 (cash was reduced from \$86.3 to \$77.5).
 - c. Mydeco needed to reduce cash (it also issued debt) to pay for large capital expenditures in 2021 and 2022. In addition, even though net income was reasonably high, cash from operations was at the lowest amount in the five-year period due to a reduction in accounts receivable and inventories.

2-22. See Table 2.5 showing financial statement data and stock price data for Mydeco Corp. Use the data from the balance sheet and cash flow statement in 2019 to determine the following:

- a. **How much cash did Mydeco have at the end of 2018?**
- b. **What were Mydeco's accounts receivable and inventory at the end of 2018?**
- c. **What were Mydeco's total liabilities at the end of 2018?**
- d. **Assuming goodwill and intangibles were equal in 2018 and 2019, what was Mydeco's net property, plant, and equipment at the end of 2018?**
 - a. 2018 Cash = 2019 Cash – 2019 Change in Cash = $48.8 - 18.1 = \$30.7$ million.
 - b. 2018 Accounts Receivable = $88.6 + 3.9 = \$92.5$ million.
2018 Inventory = $33.7 - 2.9 = 30.8$ million
 - c. 2018 Total Liabilities = $525.4 - 2.2 = \$523.2$ million.
 - d. 2018 property, plant, and equipment = 2019 property, plant, and equipment – 2019 capital expenditures + 2019 depreciation = $245.3 - 25 + 27.3 = \$247.6$ million

2-23. Can a firm with positive net income run out of cash? Explain.

A firm can have positive net income but still run out of cash. For example, to expand its current production, a profitable company may spend more on investment activities than it generates from operating activities and financing activities. Net cash flow for that period would be negative, although its net income is positive. It could also run out of cash if it spends a lot on financing activities, perhaps by paying off other maturing long-term debt, repurchasing shares, or paying dividends.

2-24. Suppose your firm receives a \$5 million order on the last day of the year. You fill the order with \$2 million worth of inventory. The customer picks up the entire order the same day and pays \$1 million upfront in cash; you also issue a bill for the customer to pay the remaining balance of \$4 million in 30 days. Suppose your firm's tax rate is 0% (i.e., ignore taxes). Determine the consequences of this transaction for each of the following:

- a. Revenues
- b. Earnings
- c. Receivables
- d. Inventory

- e. Cash**
- Revenues: increase by \$5 million
 - Earnings: increase by \$3 million
 - Receivables: increase by \$4 million
 - Inventory: decrease by \$2 million
 - Cash: increase by \$3 million (earnings) – \$4 million (receivables) + \$2 million (inventory) = \$1 million (cash).
- 2-25. Nokela Industries purchases a \$40 million cyclo-converter. The cyclo-converter will be depreciated by \$10 million per year over four years, starting this year. Suppose Nokela's tax rate is 40%.**
- What impact will the cost of the purchase have on earnings for each of the next four years?**
 - What impact will the cost of the purchase have on the firm's cash flow for the next four years?**
 - Earnings for the next four years would have to deduct the depreciation expense. After taxes, this would lead to a decline of $10 \times (1 - 40\%) = \$6$ million each year for the next four years.
 - Cash flow for the next four years: less \$36 million ($-6 + 10 - 40$) this year, and add \$4 million ($-6 + 10$) for the three following years.
- 2-26. See Table 2.5 showing financial statement data and stock price data for Mydeco Corp.**
- What were Mydeco's retained earnings each year?**
 - Using the data from 2019, what was Mydeco's total stockholders' equity in 2018?**
 - Retained earnings = Net Income – Dividends Paid: 2019 retained earnings = $18 - 5.4 = \$12.6$, 2020 retained earnings = $3 - 5.4 = -\$2.4$, 2021 retained earnings = $6.3 - 5.4 = \$0.9$, 2022 retained earnings = $12.7 - 5.4 = \$7.3$, and 2023 retained earnings = $21.7 - 6.5 = \$15.2$.
 - 2018 stockholders' equity = 2019 stockholders' equity – 2019 retained earnings = $252.7 - 12.6 = \$240.1$ million.
- 2-27. Find online the annual 10-K report for Costco Wholesale Corporation (COST) for fiscal year 2021 (filed in October 2021). Answer the following questions from the notes to their financial statements:**
- How many stores (warehouses) did Costco open outside of the U.S. in 2021?**
 - What fraction of their warehouses do they own versus lease?**
 - What was Costco's worldwide member renewal rate for 2021?**
 - What fraction of Costco's 2021 sales came from ancillary business (gas stations and pharmacies)? What fraction came from foods, including fresh foods?**
 - Costco opened 8 stores outside of the U.S. in 2021 (4 in Canada and 4 in other countries outside the U.S.).
 - Costco owns 79% of their warehouses (644/815) and lease 21%.
 - Costco had a worldwide member renewal rate of 89% for 2021.
 - 16% percent of Costco's 2021 sales (by merchandise category) came from ancillary business (gas stations and pharmacies). 54% percent of Costco's 2021 sales came from foods, including fresh foods (40% from foods, 14% from fresh foods).
- 2-28. See Table 2.5 showing financial statement data and stock price data for Mydeco Corp.**

- a. **What were Mydeco's gross margins each year?**
- b. **Comparing Mydeco's gross margin, EBIT margin, and net profit margin in 2019 and 2023, which margins improved?**
- a. 2019: $216/404.3 = 53.43\%$, 2020: $190/363.8 = 52.23\%$, 2021: $218.4/424.6 = 51.44\%$, 2022: $263.9/510.7 = 51.67\%$, 2023: $310.7/604.1 = 51.43\%$
- b. None of the margins improved from 2019 to 2023
- 2019: Gross Margin = $216/404.3 = 53.43\%$, EBIT Margin = $61.4/403.4 = 15.19\%$, Net Profit Margin = $18/404.3 = 4.45\%$
- 2023: Gross Margin = $310.7/604.1 = 51.43\%$, EBIT Margin = $72.8/604.1 = 12.05\%$, Net Profit Margin = $21.7/604.1 = 3.59\%$
- 2-29. For fiscal year end 2021, Walmart Inc. (WMT) had revenue of \$572.8 billion, gross profit of \$143.8 billion, and net income of \$13.7 billion. Costco Wholesale Corporation (COST) had revenue of \$192.1 billion, gross profit of \$21.4 billion, and net income of \$5.0 billion.**
- a. **Compare the gross margins for Walmart and Costco.**
- b. **Compare the net profit margins for Walmart and Costco.**
- c. **Which firm was more profitable in 2021?**
- a. Walmart's gross margin = $\$143.8/\$572.8 = 25.1\%$; Costco's gross margin = $\$21.4/\$192.1 = 11.1\%$.
- b. Walmart's net margin = $\$13.7/\$572.8 = 2.4\%$; Costco's net margin = $\$5.0/\$192.1 = 2.6\%$.
- c. Walmart was had a higher gross margin, however Costco had a slightly higher net margin in 2021.
- 2-30. At the end of 2021, Apple had cash and short-term investments of \$62.64 billion, accounts receivable of \$26.28 billion, current assets of \$134.84 billion, and current liabilities of \$125.48 billion.**
- a. **What was Apple's current ratio?**
- b. **What was Apple's quick ratio?**
- c. **What is Apple's cash ratio?**
- d. **At the end of 2021, HPQ had a cash ratio of 0.15, a quick ratio of 0.34 and a current ratio of 0.76. What can you say about the asset liquidity of Apple relative to HPQ?**
- a. Apple's current ratio = $134.84/125.48 = 1.07$.
- b. Apple's quick ratio = $(62.64 + 26.28)/125.48 = 0.71$.
- c. Apple's cash ratio = $62.64/125.48 = 0.50$.
- d. Apple has more liquid assets than HPQ relative to current liabilities.
- 2-31. See Table 2.5 showing financial statement data and stock price data for Mydeco Corp.**
- a. **How did Mydeco's accounts receivable days change over this period?**
- b. **How did Mydeco's inventory days change over this period?**
- c. **Based on your analysis, has Mydeco improved its management of its working capital during this time period?**

- a. 2019 accounts receivable days. $= \frac{88.6}{404.3/365} = 80.0$
- 2023 accounts receivable days $= \frac{86.1}{604.1/365} = 52.0$.
- b. 2019 inventory days $= \frac{33.7}{188.3/365} = 65.3$.
- 2023 inventory days $= \frac{35.3}{293.4/365} = 43.9$.
- c. Between 2019 and 2023, Mydeco improved its working capital management by reducing both accounts receivable days and inventory days.
- 2-32 See Table 2.5 showing financial statement data and stock price data for Mydeco Corp.**
- a. Compare accounts payable days in 2019 and 2023.**
- b. Did this change in accounts payable days improve or worsen Mydeco's cash position in 2019?**
- a. 2019 accounts payable days $= \frac{18.7}{188.3/365} = 36.2$.
- 2023 accounts payable days $= \frac{31.7}{293.4/365} = 39.4$.
- b. Accounts payable days increased from 2019 to 2023, which improved the cash position of Mydeco
- 2-33. See Table 2.5 showing financial statement data and stock price data for Mydeco Corp.**
- a. By how much did Mydeco increase its debt from 2019 to 2023?**
- b. What was Mydeco's EBITDA/Interest coverage ratio in 2019 and 2023? Did its coverage ratio ever fall below 2?**
- c. Overall, did Mydeco's ability to meet its interest payments improve or decline over this period?**
- a. Mydeco increased its debt from \$500 million in 2019 to \$600 million in 2023 (by \$100 million).
- b. 2019 EBITDA/Interest coverage ratio $= \frac{61.4+27.3}{33.7} = 2.6$.
- 2023 EBITDA/Interest coverage ratio $= \frac{72.8+38.6}{39.4} = 2.8$.
- Mydeco's coverage ratio fell below 2 in 2020, where it was 1.96.
- c. Overall Mydeco's ability to meet its interest payments improved over this period, although it experienced a slight dip in 2020.
- 2-34. See Table 2.5 showing financial statement data and stock price data for Mydeco Corp.**
- a. How did Mydeco's book debt-equity ratio change from 2019 to 2023?**
- b. How did Mydeco's market debt-equity ratio change from 2019 to 2023?**
- c. Compute Mydeco's debt-to-enterprise value ratio to assess how the fraction of its business that is debt financed has changed over the period.**

- a. 2019 book debt-equity ratio = $\frac{500}{252.7} = 1.98$.
- 2023 book debt-equity ratio = $\frac{600}{273.7} = 2.19$.
- b. 2019 market debt-equity ratio = $\frac{500}{435.6} = 1.15$.
- 2023 market debt-equity ratio = $\frac{600}{599.0} = 1.00$.
- c. 2019 debt-enterprise value ratio = $\frac{500}{886.8} = 0.56$.
- 2023 debt-enterprise value ratio = $\frac{600}{1113} = 0.54$.

2-35. Use the data in Problem 8 to determine the change, from 2018 to 2022, in Ford's

a. book debt-equity ratio?

b. market debt-equity ratio?

- a. 2018 book debt-equity ratio = $154.3/34.9 = 4.42$.
2022 book debt-equity ratio = $138.1/48.5 = 2.85$.
- b. 2018 market debt-equity ratio = $154.3/(12.50 \times 4) = 3.09$.
2022 market debt-equity ratio = $138.1/(21 \times 4) = 1.64$.

2-36. You are analyzing the leverage of two firms and you note the following (all values in millions of dollars):

	Debt	Book Equity	Market Equity	Operating Income	Interest Expense
Firm A	500	300	400	100	50
Firm B	80	35	40	8	7

- a. What is the market debt-to-equity ratio of each firm?**
- b. What is the book debt-to-equity ratio of each firm?**
- c. What is the interest coverage ratio of each firm?**
- d. Which firm may have more difficulty meeting its debt obligations? Explain.**

- a. **Firm A:** Market debt-equity ratio = $\frac{500}{400} = 1.25$.
- Firm B:** Market debt-equity ratio = $\frac{80}{40} = 2.00$.
- b. **Firm A:** Book debt-equity ratio = $\frac{500}{300} = 1.67$.
- Firm B:** Book debt-equity ratio = $\frac{80}{35} = 2.29$.

c. **Firm A:** Interest coverage ratio = $\frac{100}{50} = 2.00$.

Firm B: Interest coverage ratio = $\frac{8}{7} = 1.14$.

Firm B has a lower coverage ratio and will have slightly more difficulty meeting its debt obligations than Firm A.

2-37. See Table 2.5 showing financial statement data and stock price data for Mydeco Corp.

- Compute Mydeco's PE ratio each year from 2019 to 2023. In which year was it the highest?
- What was Mydeco's Enterprise Value to EBITDA ratio each year? In which year was it the highest?
- What might explain the differing time pattern of the two valuation ratios?

a.

Year	2019	2020	2021	2022	2023
Price	\$7.92	\$3.30	\$5.25	\$8.71	\$10.89
Earnings per share	\$0.33	\$0.05	\$0.11	\$0.23	\$0.39
PE ratio	24.00	66.00	47.73	37.87	27.92

The PE ratio was highest in 2016.

b.

Year	2019	2020	2021	2022	2023
Enterprise Value	886.80	612.60	777.45	1,001.55	1,113.95
EBITDA	88.70	64.50	76.20	95.40	111.40
Enterprise value/EBITDA	10.00	9.50	10.20	10.50	10.00

The enterprise value/EBITDA ratio was the highest in 2022.

- The different time patterns are caused by increasing debt in 2022 and 2023 that increased the enterprise value of the Mydeco and reduced the earnings per share due to increased interest expense. In addition, very small earnings per share in 2020 increased the PE ratio even though the price decreased as well.

2-38. In early 2022, United Airlines (UAL) had a market capitalization of \$26.1 billion, debt of \$12.3 billion, and cash of \$18.4 billion. United also had annual revenues of \$24.6 billion. Southwest Airlines (LUV) had a market capitalization of \$26.1 billion, debt of \$12.3 billion, cash of \$15.5 billion, and annual revenues of \$15.8 billion.

- Compare the market capitalization-to-revenue ratio (also called the price-to-sales ratio) for United Airlines and Southwest Airlines.
- Compare the enterprise value-to-revenue ratio for United Airlines and Southwest Airlines.
- Which of these comparisons is more meaningful? Explain.
 - Market capitalization-to-revenue ratio:
 - = $14.3/24.6 = 0.58$ for United Airlines.
 - = $26.1/15.8 = 1.65$ for Southwest Airlines.

- b. Enterprise value-to-revenue ratio:
 $= (14.3 - 18.4 + 39.4)/24.6 = 1.43$ for United Airlines.
 $= (26.1 - 15.5 + 12.3)/15.8 = 1.45$ for Southwest Airlines.
- c. The market capitalization to revenue ratio cannot be meaningfully compared when the firms have different amounts of leverage, as market capitalization measures only the value of the firm's equity. The enterprise value to revenue ratio is therefore more useful when firm's leverage is quite different, as it is here.

2-39. See Table 2.5 showing financial statement data and stock price data for Mydeco Corp.

- a. Compute Mydeco's ROE each year from 2019 to 2023.
 b. Compute Mydeco's ROA each year from 2019 to 2023.
 c. Which return is more volatile? Why?

a.

Year	2019	2020	2021	2022	2023
Net Income	18.0	3.0	6.3	12.7	21.7
Stockholders' Equity	252.7	250.3	251.2	258.5	273.7
ROE	7.12%	1.20%	2.51%	4.91%	7.93%

b.

Year	2019	2020	2021	2022	2023
Net Income + Interest Expense	51.7	35.9	38.5	50.1	61.1
Book Value of Assets	778.1	775.6	855.2	893.4	915.1
ROA	6.64%	4.63%	4.50%	5.61%	6.68%

- c. ROE is more volatile. Mydeco's debt level causes a large portion of EBIT to go to interest expense. This magnifies the volatility of earnings left over for shareholders through net income. ROA adjusts net income by the interest expense, and thus is less sensitive to leverage.

Here we have calculated ROA using Net Income + Interest Expense, to reflect the total earnings of both equity and debt investors in the firm. ROA is sometimes calculated using only Net Income, or Net Income + After-tax Interest Expense. See fn. 14 in Chapter 2.

2-40. See Table 2.5 showing financial statement data and stock price data for Mydeco Corp. Was Mydeco able to improve its ROIC in 2023 relative to what it was in 2019?

$$2019 \text{ ROIC} = \frac{61.4 \times (1 - 0.35)}{252.7 + 500 - 48.8} = 5.67\%$$

$$2023 \text{ ROIC} = \frac{72.8 \times (1 - 0.35)}{273.7 + 600 - 85} = 6.00\%$$

Mydeco was able to improve its ROIC in 2023 relative to 2019.

2-41. For fiscal year 2021, Costco Wholesale Corporation had a net profit margin of 2.60%, asset turnover of 3.24, and a book equity multiplier of 3.28.

- a. Use this data to compute Costco's ROE using the DuPont Identity.

- b. If Costco's managers wanted to increase its ROE by one percentage point, how much higher would their asset turnover need to be?
- c. If Costco's net profit margin fell by one percentage point, by how much would their asset turnover need to increase to maintain their ROE?
- Costco's ROE (DuPont) = $2.60\% \times 3.24 \times 3.28 = 27.63\%$.
 - Costco's new asset turnover = $28.63\% / (2.60\% \times 3.28) = 3.36$ or an increase of $3.36 - 3.24 = 0.12$.
 - Costco's new asset turnover = $27.63\% / (1.60\% \times 3.28) = 5.26$ or an increase of $5.26 - 3.24 = 2.02$.
- 2-42. For fiscal year 2021, Walmart Inc. (WMT) had total revenues of \$572.75 billion, net income of \$13.67 billion, total assets of \$244.86 billion, and total shareholder's equity of \$83.25 billion.
- Calculate Walmart's ROE directly and using the DuPont Identity.
 - Comparing with the data for Costco in problem 41, use the DuPont Identity to understand the difference between the two firms' ROEs.
 - Walmart's ROE = $13.67/83.25 = 16.42\%$.
 Walmart's net profit margin = $13.67/572.75 = 2.39\%$.
 Walmart's asset turnover = $572.75/244.86 = 2.34$.
 Walmart's equity multiplier = $244.86/83.25 = 2.94$.
 Walmart's ROE (DuPont) = $2.39\% \times 2.34 \times 2.94 = 16.44\%$ (difference due to rounding).
 - Walmart has a lower profit margin, lower asset turnover, and a lower equity multiplier (which could represent less leverage). It has a significantly smaller ROE that is driven by its lower asset turnover and leverage.
- 2-43. Consider a retailing firm with a net profit margin of 3.5%, a total asset turnover of 1.8, total assets of \$44 million, and a book value of equity of \$18 million.
- What is the firm's current ROE?
 - If the firm increased its net profit margin to 4%, what would be its ROE?
 - If, in addition, the firm increased its revenues by 20% (while maintaining this higher profit margin and without changing its assets or liabilities), what would be its ROE?
- $3.5 \times 1.8 \times 44/18 = 15.4\%$.
 - $4 \times 1.8 \times 44/18 = 17.6\%$.
 - $4 \times (1.8 \times 1.2) \times 44/18 = 21.1\%$.
- 2-44. Find online the annual 10-K report for Costco Wholesale Corporation (COST) for fiscal year 2021 (filed in October 2021).
- Which auditing firm certified these financial statements?
 - Which officers of Costco's certified the financial statements?
 - KPMG LLP certified Costco's financial statements.
 - W. Craig Jelinek, Hamilton E. James, Richard A. Galanti, Daniel M. Hines, Susan L. Decker, Kenneth D. Denman, Sally Jewell, Charles T. Munger, Jeffrey S. Raikes, John W. Stanton, and Mary (Maggie) A. Wilderotter certified Costco's financial statements.
- 2-45. WorldCom reclassified \$3.85 billion of operating expenses as capital expenditures. Explain the effect this reclassification would have on WorldCom's cash flows. (*Hint: Consider taxes.*)

WorldCom's actions were illegal and clearly designed to deceive investors. But if a firm could legitimately choose how to classify an expense for tax purposes, which choice is truly better for the firm's investors?

By reclassifying \$3.85 billion operating expenses as capital expenditures, WorldCom increased its net income but lowered its cash flow for that period. If a firm could legitimately choose how to classify an expense, expensing as much as possible in a profitable period rather than capitalizing them will save more on taxes, which results in higher cash flows, and thus is better for the firm's investors.