FIN 360: PRINCIPLES OF FINANCIAL MANAGEMENT
WORKING WITH FINANCIAL STATEMENTS
CRITICAL THINKING & CONCEPTUAL QUESTIONS

1. Explain the *intuition* behind why each of the following represent a source of cash:
    a. Decrease in A/R, inventory, and fixed assets
    b. Increase in A/P, current liabilities, common stock
2. Explain the *intuition* behind why each of the following represent a use of cash:
    a. Increase in A/R, inventory, and fixed assets
    b. Decrease in A/P, current liabilities, and common stock
3. Indicate whether each of the following would be found in the *operating*, *investing*, or *financing* section of a firm's statement of cash flow. Explain *why* each is found in its appropriate section.
    a. Depreciation
    b. Dividends
    c. Notes payable
    d. Accounts receivable
    e. Accounts payable
    f. Fixed assets
    g. Inventory
    h. Long term debt
    i. Common stock
4. How can we determine a firm's current year retained earning given *last* year's balance sheet, and this year's income statement and dividends?
5. Explain what positive and negative values for operating, investing, and financing activities imply for a firm. Is a positive or negative value for each considered healthy?
6. How can we verify the accuracy of the statement of cash flow using a firm's balance sheet for the current year and previous year?
7. A common question in investment banking interviews is "if you could have one (and only one) financial statement to learn about a firm, which would it be?" Which would you choose? The options are income statement, balance sheet, and statement of cash flows.
8. Another common question in investment banking interviews is "if you could only have two of a firm's financial statements, which two should they be?" Which two would you choose?
9. Describe the internal and external uses of financial statement analysis. Which is more often associated with "corporate finance" decisions? Which is more often associated with "investing"?
10. Explain how common size financial statements are useful in comparing the firm to (1) itself through time and (2) comparable companies.
11. Explain the general structure of SIC and NAICS codes, and the pros and cons of using them for comparative analysis.

12. Why would comparing company ratios for two firms in very different industries be problematic?
13. How are gross, operating, and net profit margins computed? What do each tell us?
14. Name the ratios would you use characterize the short term liquidity of the firm? What do higher and lower values of these ratios tell us?
15. What is the rationale for subtracting inventory from current assets in the quick ratio? How does this change the ratios interpretation relative to the current ratio?
16. A firm's current ratio has rapidly risen, but its quick ratio has fallen. What does this imply?
17. Explain the benefits and costs of leverage. How might an investor or manager determine whether a firm's leverage is "too high" or "too low"?
18. What does a higher equity multiplier tell us about a firm's use of leverage? Explain the rationale.
19. What does the numerator of the cash coverage ratio try to tell us about the firm? How do you interpret the cash coverage ratio?
20. Explain why an investor would be willing to pay a higher stock price for a share of a company than that company's *earnings per share*?
21. All else equal, is a lower or higher PE ratio preferable for an investor buying a stock? Why?
22. Explain the components of the Dupont analysis, and why "decomposing" ROE into components is important in the first place. Explain what higher and lower values for each component mean.
23. All else equal, which component of ROE do you think is most crucial and should remain consistently high?
24. Given your understanding of Dupont analysis, explain how a firm can manipulate and increase its ROE by its own choice of borrowing.
25. If the equity multiplier is "high", what other ratio(s) should be "low" in order to indicate that the firm has not taken on an unhealthy amount of leverage?
26. Why is the cash conversion cycle more relevant for manufacturing firms than service firms?
27. All else equal, is a longer or shorter cash conversion cycle generally preferable to a firm?
28. Explain why, all else equal, a firm would prefer a shorter A/R period but a longer A/P period.
29. Explain what a stock repurchase is, and how it adds value for a shareholder of a firm. What happens to a company's *earnings per share* after a share repurchase? Why? Given this change to EPS following a repurchase, how should we be careful when we think about comparing firms on the basis of their EPS?
30. We've discussed five categories of ratios to assess the health of a firm. If you are provided a ratio, do you know which category it would fit in?
31. Which one (or more) of the ratios that we've discussed would you use to address the following items:
    a. The firm's ability to pay its near-term liabilities
    b. The firm's liquidity
    c. The firm's ability to cover it interest expense
    d. The firm's efficiency in generating sales given the strength of its balance sheet
    e. The frequency through which a firm sells through its inventory
    f. The firm's common stock "value" relative to its accounting profitability