# [CHAPTER 25]

# REVIEW QUESTIONS

1. Exhibit 25.9 presents tax reconciliation table for ToyCo, a $5 billion million designer and distributor of children’s toys. Convert the tax table from percent to $ millions. Separate the converted tax table into three groups: taxes attributable to domestic income, other operating taxes, nonoperating taxes. Treat “other, net” as nonoperating.
2. Exhibit 25.5 presents two approaches for estimating operating taxes. Use both methods to determine the operating taxes for ToyCo in Year 3. What are ToyCo’s statutory rate, effective tax rate, and operating tax rate (under both approaches)?
3. When a company incorporated in a country with a high tax rates does business in countries with lower tax rates, it will report an effective tax rate below its statutory rate. Is the difference sustainable into the future? What occurs if the company decides to repatriate earnings? How operating taxes should be computed in the year of repatriation? How is ROIC distorted by local taxation and repatriation?
4. Exhibit 25.9 presents deferred tax assets and liabilities for ToyCo. Using Exhibit 25.7 as a guide, reorganize the deferred tax table into three categories net operating deferred tax liabilities (net of operating deferred tax assets), nonoperating deferred tax assets, and nonoperating deferred tax liabilities. In Year 3, ToyCo generated $200.7 million in operating taxes on $673.6 million of EBITA. Using this information, what are the cash taxes in Year 3? What is percent of operating taxes that were deferred and what is the operating cash tax rate?
5. ToyCo has working capital of $400 million, fixed assets equal to $800 million, and debt equal to $600 million. Use this data and the reorganized deferred taxes in Question 4 to create invested capital and total funds invested for Year 3. Use equity as the plug to get total fund invested to reconcile.
6. One of the most common deferred tax liabilities occurs because of acceleration depreciation. When is the difference between reported taxes and cash taxes likely to be greatest? When will it be smallest? Can it reverse? i.e. cash taxes are higher than reported taxes?





# [CHAPTER 26]

# REVIEW QUESTIONS

1. Using an Internet search tool, find Procter & Gamble’s investor relations website. Under “Financial Reporting,” you will find the company’s 2009 annual report. P&G has a very simple income statement. Only cost of products sold and selling, general and administrative expenses are deducted from revenue to determine operating income. In Note 1, Summary of Significant Accounting Policies, you will find a discussion of the preceding two expenses. Does either embed nonoperating expenses? If so, adjust P&G’s “operating income” to create a clean measure of EBITA.
2. ValueCo generates $10 million in after-tax operating profit on $100 million in assets. The company has $20 million in accounts payable, $15 million in product warranty reserves, $5 million in severance reserves, and $30 in long-term debt, and $30 million in equity. What is the ValueCo’s ROIC?
3. In Year 0, SmoothCo has $50 million in cash and$ 50 million in inventory, financed by $100 million in equity. In Year 1, the company records $100 million in revenue, $80 million in operating costs, and $10 million in litigation provisions for a case yet to be resolved. Based on the preceding data, build a balance sheet for Year 1. Assume inventory remains constant and no dividends are paid. What is the return on equity in Year 1? In Year 2, the company records $100 million in revenue, $90 million in operating costs. Because management overestimated the amount of litigation charges, SmoothCo takes a $5 million gain in Year 2. What is ROE in Year 2? How is ROE distorted by the litigation expense?
4. Company’s in highly competitive industries often see a number of consecutive restructuring charges. In these cases, should restructuring be treated as operating or nonoperating? Form a valuation perspective, what are the important issues that should be considered?

# [CHAPTER 27]

# REVIEW QUESTIONS

1. Casher Industries leases a significant portion of its assets, expecting $25 million in rental expense next year. Casher Industries can borrow at 7 percent and the average life of leased asset is 7 years. Estimate the value of leased assets. If you misestimate the average life to be 10 years, how large will the valuation error be?
2. Casher Industries is expected to earn $25 million in operating profit next year. The company pays an operating tax rate of 30 percent and a marginal tax rate of 35 percent. What is the company’s after-tax operating profit before and after the adjustment?
3. Many financial analysts estimate the value of operating leases by discounting rental payments provided in the annual report at the cost of debt. Is this method likely to overestimate or underestimate the value of leased assets? Why?
4. Many companies securitize their accounts receivable. Name two ways the cost for securitizing receivables is recognized. If you decide to recapitalize securitized receivable, when for which method is an expense adjustment required?
5. Using an Internet search tool, find Procter & Gamble’s investor relations website. Under “Financial Reporting,” you will find the company’s 2009 annual report. In Note 8 of the annual report (which is titled postretirement benefits and employee stock ownership plan), P&G reports a breakout of its pension expense. Use this breakout to eliminate nonoperating income related to pensions from operating income reported in P&G’s income statement.
6. Using an Internet search tool, find Procter & Gamble’s investor relations website. Under “Financial Reporting,” you will find the company’s 2009 annual report. In the balance sheet, there is no report of prepaid pension assets or unfunded pension liabilities. Does this mean the P&G’s pension plan is fully funded?

# [CHAPTER 28]

# REVIEW QUESTIONS

1. ResearchCo is medical devices company, producing equipment for diagnosing and treating heart disease. The company currently generates $100 million in revenues and is expected to grow 10 percent per year. ResearchCo maintains cost of sales at 50 percent of revenue, research and development at 15 percent of revenue, and pays an operating tax rate of 30 percent. To generate 10 percent growth, ResearchCo will reinvest 20 percent of NOPLAT each year. Invested capital currently equals $75 million. Using the preceding data, forecast five years of NOPLAT and five years of invested capital. What is the ROIC on year-end capital by year?
2. Your colleague argues R&D for ResearchCo should be capitalized and amortized. If R&D is amortized, what is the starting R&D asset, investment in R&D, amortization of R&D, and ending R&D asset by year? Use straight-line amortization over three years, with the first amortization charge deducted the following year.
3. Use the R&D capitalization table developed in Question 2 to modify NOPLAT and invested capital from Question 1. What is the ROIC on year-end capital by year? How does this compare to the ROIC computed in Question 1?
4. Compute the annual free cash flow for ResearchCo with and without the capitalization of R&D. How do the two sets of free cash flow numbers differ? Assume no depreciation of physical assets.