Valuation: Measuring and Managing the Value of Companies

Reorganizing the Financial Statements

Chapter 7 Problems

1. Exhibit 7.15 presents the income statement and balance sheet for Companies A, B, and C. Compute each company's return on assets, return on equity, and return on invested capital. Based on the three ratios, which company has the best operating performance?

2. Why does the return on assets differ between Company A and Company B? Why do companies with equity investments tend to have lower return on assets than companies with only core operations?

3. Why does the return on equity differ between Company A and Company C? Is this difference attributable to operating performance? Does return on assets better reflect operating performance than return on equity? If not, which ratio does and why?

4. Exhibit 7.16 presents the income statement and balance sheet for HealthCo, a $600 million healthcare company. Compute NOPLAT, average invested capital, and ROIC. Assume an operating tax rate of 25 percent and a marginal tax rate of 35 percent. If the weighted average cost of capital is 9 percent, is the company creating value?

5. Using the reorganized financial statements created in Question 4, what is the free cash flow for HealthCo in the current year?

6. You decide to look closer at HealthCo's tax reconciliation footnote. The table reports $35 million in statutory taxes, a $10 million credit for manufacturing investments, and a onetime tax expense of $5 million related to a past year audit. Reported taxes are therefore $30 million. What is HealthCo's statutory tax rate, operating tax rate, and effective rate? Why does computing the operating tax rate require judgment?

7. Many companies hold significant amounts of excess cash, cash above the amount required for day-to-day operations. Does including excess cash as part of invested capital distort the ROIC upwards or downwards? Why?

Exhibit 7.16 **HealthCo: Income Statement and Balance Sheet**

$ million

Income statement	Prior year	Current year
Revenues	605	665
Cost of sales	(200)	(210)
Selling costs	(300)	(320)
Depreciation	(40)	(45)
Operating income	65	90
Interest expense	(5)	(15)
Gain on sale	0	25
Earnings before taxes	60	100
Taxes	(24)	(40)
Net income	36	60

Balance sheet	Prior year	Current year
Working cash	5	5
Accounts receivable	45	55
Inventories	15	20
Current assets	65	80
Property, plant & equipment	250	260
Prepaid pension assets	10	50
Total assets	325	390
Accounts payable	10	15
Short-term debt	20	40
Restructuring reserves	20	0
Current liabilities	50	55
Long-term debt	70	70
Equity	205	265
Liabilities and equity	325	390