

Towson University
Department of Finance
Principles of Financial Management (FIN331)
Spring 2010
Exam I

Name _____

ID# _____

1. Which of the following statements is CORRECT?
- a. One of the advantages of the corporate form of organization is that it avoids double taxation.
 - b. It is easier to transfer one's ownership interest in a partnership than in a corporation.
 - c. One of the disadvantages of a sole proprietorship is that the proprietor is exposed to unlimited liability.
 - d. One of the advantages of a corporation from a social standpoint is that every stockholder has equal voting rights, i.e., "one person, one vote."
 - e. Corporations of all types are subject to the corporate income tax.

Answer: c

2. Which of the following is NOT to address the agency conflict between shareholders and managers?
- a. Maximize sales
 - b. Monitor managers' activities
 - c. Give incentives based on performance
 - d. Offer stock shares or stock options
 - e. Hostile takeover threat

Answer: a

3. What is the main advantage of S-corp relative to C-corp?
- a. Profit margin
 - b. Single taxation
 - c. Limited liability
 - d. Dividend policy
 - e. Capital structure

Answer: b

S-corp Distribution is taxed only once at personal income tax rate. In other words, a single taxation

4. Which of the following mechanisms would be most likely to help motivate managers to act in the best interests of shareholders?
- a. Decrease the use of restrictive covenants in bond agreements.
 - b. Take actions that reduce the possibility of a hostile takeover.
 - c. Elect a board of directors that allows managers greater freedom of action.
 - d. Increase the proportion of executive compensation that comes from stock options and reduce the proportion that is paid as cash salaries.
 - e. Eliminate a requirement that members of the board of directors have a substantial investment in the firm's stock.

Answer: d

5. If the projected net earnings is \$5m and the dividend payout ratio is 60%, what is the projected retained earnings at the end of the next year if the retained earnings at the end of this year is \$10m?
- a. \$6m
 - b. \$9m
 - c. \$10m
 - d. \$11m
 - e. \$12m

Answer: e

60% dividend payout ratio => 40% retention ratio => $\$5m \times 0.4 = \$2m$ addition to retained earnings => \$10m retained earnings you already have + \$2m = \$12m

6. Which of the following items is NOI normally considered to be a current asset?
- a. Accounts receivable.
 - b. Inventory.

- c. Bonds.
- d. Cash.
- e. Short-term, highly-liquid, marketable securities.

Answer: c

7. The following information for Towsontown, Inc. is provided:

Net Sales:	\$88,000
Operating Costs:	\$72,000 (doesn't include depreciation)
Depreciation Expense:	\$ 7,200 (no amortization charges occurred)
Debt:	\$40,000
Interest Rates:	10% Annual
Tax Rate:	34%

How much net cash flow did Woodley generate over the past year?

- a. \$3,168
- b. \$3,268
- c. \$10,168
- d. \$10,368
- e. \$11,368

Answer: d

$NCF = NI + Dep$, From I/S, $NI = \$3,168 (=Sales - Op. Costs - Dep - INT - Tax)$, Thus, $\$3,168 + \$7,200 = \$10,368$

8. Houston Pumps recently reported \$185,250 of sales, \$140,500 of operating costs other than depreciation, and \$9,250 of depreciation. The company had \$35,250 of outstanding bonds that carry a 6.75% interest rate, and its income tax rate was 35%. In order to sustain its operations and thus generate future sales and cash flows, the firm was required to spend \$15,250 to buy new **capital expenditure** and to invest \$6,850 in net working capital. What was the firm's free cash flow?

- a. \$10,225
- b. \$10,736
- c. \$11,273
- d. \$11,837
- e. \$12,429

Answer: a

Tax rate	35%
Required addition to net working capital	\$6,850
Required capital expenditures (fixed assets)	\$15,250
Sales	\$185,250
Operating costs excluding depreciation	140,500
Depreciation	<u>9,250</u>
Operating income (EBIT)	<u>\$ 35,500</u>

$$FCF = EBIT * (1 - T) - \Delta NFA - \Delta CA + \Delta CL$$

$$\Delta NFA = \Delta Capex - Deprec, \Delta NWC = (\Delta CA - \Delta CL)$$

$$FCF = EBIT * (1-T) - (\Delta Capex - Deprec) - (\Delta CA - \Delta CL) = EBIT * (1-T) - \Delta Capex + Deprec - \Delta NWC$$

$$FCF = EBIT*(1 - T) + Deprec. - \Delta Capex - \Delta NWC$$

$$FCF = \$23,075.00 + \$9,250 - \$15,250 - \$6,850$$

$$FCF = \$10,225$$

$$FCF = EBIT(1 - T) + Deprec. - \Delta CapEx - \Delta Net WC$$

$$FCF = \$23,075.00 + \$9,250 - \$15,250 - \$6,850$$

$$FCF = \$10,225$$

9. Corporations face the following tax schedule:

<u>Taxable Income</u>	<u>Tax on Base of Bracket</u>	<u>Percentage on Excess above Base</u>
Up to \$50,000	\$0	15%
\$50,000-\$75,000	7,500	25

\$75,000-\$100,000	13,750	34
\$100,000-\$335,000	22,250	39

Company Z has \$80,000 of taxable income from its operations, \$5,000 of interest income, and \$30,000 of dividend income from preferred stock it holds in other corporations. What is Company Z's tax liability (For dividend, 70% is excluded from the taxable income. Taxable income for dividend is $\text{Dividend income} \times (1 - \text{Dividend exclusion \%})$)?

- a. \$17,328
- b. \$18,240
- c. \$19,200
- d. \$20,210
- e. \$21,221

Answer: d

Taxable income	\$80,000
Interest income	\$5,000
Dividend income	\$30,000
Dividend exclusion %	70%

Total taxable income = Taxable income + Interest income + Taxable dividend income

Total taxable income = Taxable income + Interest income + Dividend income (1 – Dividend exclusion %)

Total taxable income = \$94,000

<u>Taxable Income</u>	<u>Tax on Base of Bracket</u>	<u>% on Excess above Base</u>
\$0	\$0	15%
\$50,000	7,500	25%
\$75,000	13,750	34%
\$100,000	22,250	39%
\$335,000	113,900	34%
\$10,000,000	3,400,000	35%
\$15,000,000	5,150,000	38%
\$18,333,333	6,416,667	35%

Tax on base = \$13,750

Tax on excess base = \$6,460

Tax liability = \$20,210

10. A company expects sales to increase during the coming year, and it is using the AFN equation to forecast the additional capital that it must raise. Which of the following conditions would cause the AFN to increase?
- a. The company previously thought its fixed assets were being operated at full capacity, but now it learns that it actually has excess capacity.
 - b. The company increases its dividend payout ratio.
 - c. The company begins to pay employees monthly rather than weekly.
 - d. The company's profit margin increases.
 - e. The company decides to stop taking discounts on purchased materials.

Answer: b

11. Chua Chang & Wu Inc. is planning its operations for next year, and the CEO wants you to forecast the firm's additional funds needed (AFN). Data for use in your forecast are shown below. Based on the AFN equation, what is the AFN for the coming year?

Last year's sales = S0	\$200,000	Last year's accounts payable	\$50,000
Sales growth rate = g	40%	Last year's notes payable	\$15,000
Last year's total assets = A*0	\$135,000	Last year's accruals	\$20,000
Last year's profit margin = M	20.0%	Target payout ratio	25.0%

- a. -\$14,440
- b. -\$15,200
- c. -\$16,000
- d. -\$16,800