

Towson University
Principles of Financial Management (Fin331)
Professor M. Rhee
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Exam I

Name _____

ID# _____

1. Which of the following statements is CORRECT?
- a. One of the disadvantages of incorporating your business is that you could become subject to the firm's liabilities in the event of bankruptcy.
 - b. Sole proprietorships are subject to more regulations than corporations.
 - c. In any partnership, every partner has the same rights, privileges, and liability exposure as every other partner.
 - d. Corporations of all types are subject to the corporate income tax.
 - e. Sole proprietorships and partnerships generally have a tax advantage over corporations.

Answer: e

Some corporations (S corporations) are able to avoid the corporate income tax. Sole proprietorships and partnerships pay personal income tax, but they avoid the corporate income tax.

2. What is the sequential approach?
- a. Profit maximization
 - b. Agency conflict
 - c. Efficient management
 - d. Satisfying stakeholders to maximize shareholder wealth maximization e.
 - e. None of the above

Answer: d

3. The primary operating goal of a publicly-owned firm interested in serving its stockholders should be to
- a. Maximize its expected total corporate income.
 - b. Maximize its expected EPS.
 - c. Minimize the chances of losses.
 - d. Maximize the stock price per share over the long run
 - e. Maximize the stock price on a specific target date.

Answer: d

The primary operating goal should be to maximize the long-run stock price, or the intrinsic value.

4. Which of the following actions would be most likely to reduce potential conflicts of interest between stockholders and managers?
- a. Pay managers large cash salaries and give them no stock options.
 - b. Change the corporation's formal documents to make it easier for outside investors to acquire a controlling interest in the firm through a hostile takeover.
 - c. Beef up the restrictive covenants in the firm's debt agreements.
 - d. Eliminate a requirement that members of the board of directors must hold a high percentage of their personal wealth in the firm's stock.
 - e. For a firm that compensates managers with stock options, reduce the time before options are vested, i.e., the time before options can be exercised and the shares that are received can be sold.

Answer: b

Corporate takeovers are most likely to occur when a firm is underperforming. Managers who fear losing their jobs will try to maximize shareholder wealth.

5. Which of the following statements is CORRECT?
- a. The four most important financial statements provided in the annual report are the balance sheet, income statement, cash budget, and the statement of stockholders' equity.
 - b. The balance sheet gives us a picture of the firm's financial position at a point in time.
 - c. The income statement gives us a picture of the firm's financial position at a point in time.
 - d. The statement of cash flows tells us how much cash the firm must pay out in interest during the year.

- e. The statement of cash needs tells us how much cash the firm will require during some future period, generally a month or a year.

Answer: b

6. Other things held constant, which of the following actions would increase the amount of cash on a company's balance sheet?
- The company repurchases common stock.
 - The company pays a dividend.
 - The company issues new common stock.
 - The company gives customers more time to pay their bills.
 - The company purchases a new piece of equipment.

Answer: c

7. While preparing a pro forma B/S, you have realized that $A > L + E$, you want to balance the B/S with increased short-term debt. What is (are) the problem(s) you may run into?
- Increased debt
 - Increased liquidity
 - Decreased profit
 - Liquidity problem
 - Both increased debt and liquidity problem

Answer: e

Increasing short-term debt will worsen current ratio (CA/CL), which might cause liquidity problem. Also, increase in short-term debt means increase in total debt (short-term debt is a part of total debt).

8. On 12/31/08, Hite Industries reported retained earnings of \$525,000 on its balance sheet, and it reported that it had \$135,000 of net income during the year. On its previous balance sheet, at 12/31/07, the company had reported \$445,000 of retained earnings. No shares were repurchased during 2008. How much in dividends did the firm pay during 2008?
- \$49,638
 - \$52,250
 - \$55,000
 - \$57,750
 - \$60,638

Answer: c

12/31/08 RE	\$525,000
12/31/07 RE	<u>445,000</u>
Change in RE	\$ 80,000
Net income for 2008	\$135,000
Dividends = Net income – Change	<u>\$ 55,000</u>

or

BEG RE	\$445,000
+ NE	135,000
- DIV	<u>x</u>
END RE	<u>\$525,000</u>
Dividends =	\$ 55,000

9. Shrives Publishing recently reported \$10,750 of sales, \$5,500 of operating costs other than depreciation, and \$1,250 of depreciation. The company had \$3,500 of bonds that carry a 6.25% interest rate, and its federal-plus-state income tax rate was 35%. During the year, the firm had expenditures on **capital expenditure** and net working capital that totaled \$1,550. These expenditures were necessary for it to sustain operations and generate future sales and cash flows. What was its free cash flow?
- \$1,873
 - \$1,972
 - \$2,076
 - \$2,185
 - \$2,300

Answer: e

Bonds	\$3,500.00
Interest rate	6.25%

Tax rate	35.00%
Sales	\$10,750.00
Operating costs excluding depreciation	5,500.00
Depreciation	<u>1,250.00</u>
Operating income (EBIT)	<u>\$ 4,000.00</u>
Δ Capex + NWC =	\$1,550.00
Tax rate =	35%

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

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

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

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

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

$$FCF = \$2,600 + \$1,250 - \$1,550$$

$$\text{Free cash flow} = \$2,300$$

or

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

$$FCF = \$2,600 + \$1,250 - \$1,550$$

$$\text{Free cash flow} = \$2,300$$

10. Moose Industries faces 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
\$335,000-\$10,000,000	113,900	34
\$10,000,000-\$15,000,000	3,400,000	35

Last year the company realized \$10,000,000 in operating income (EBIT). Its annual interest expense is \$1,500,000.

What was the company's net income for the year?

- a. \$4,809,874
- b. \$5,063,025
- c. \$5,329,500
- d. \$5,610,000
- e. \$5,890,500

Answer: d

Operating income	\$10,000,000
Interest expense	\$1,500,000

$$\text{Taxable income} = \text{Operating income} - \text{Interest expense}$$

$$\text{Taxable income} = \text{Operating income} - \text{Interest expense}$$

$$\text{Taxable income} = \$8,500,000$$

<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%