

**Questions/Problems:**

1. Which of the following actions would be likely to reduce conflicts of interest between stockholders and managers?

**The composition of the board of directors is changed from all inside directors to all outside directors, and the directors are compensated with stock rather than cash.**

2. Which of the following could explain why a business might choose to operate as a corporation rather than as a sole proprietorship or a partnership?

**Corporations generally find it easier to raise large amounts of capital.**

3. Which of the following actions would be most likely to reduce potential conflicts of interest between stockholders and managers?

**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.**

4. Which of the following actions would be most likely to reduce conflicts between stockholders and bondholders?

**Including restrictive covenants in the company's bond indenture (which is the contract between the company and its bondholders).**

5. Relaxant Inc. operates as a partnership. Now the partners have decided to convert the business to a corporation. Which is correct?

**Relaxant's shareholders (ex partners) will now be exposed to less liability.**

6. Which of the following actions would be most likely to reduce conflicts of interest between stockholders and bondholders?

**If someone deliberately understates costs and thereby causes reported profits to increase, then this can cause the price of the stock to rise above its intrinsic value. The stock will probably fall in the future. Both those who participated in the fraud and the firm itself can be prosecuted.**

7. Which of the following statements would most people in business agree with?

**Although people's moral characters are probably developed before they get into a business school, it is still useful for business schools to cover ethics, including giving students an idea about the adverse consequences of unethical behavior to themselves, their firms, and the nation.**

8. Chang Corp. has \$375,000 of assets, and it uses only common equity capital (zero debt). Its sales last year were \$520,000, and its net income was \$25,000. Stockholders recently voted in a new management team that has promised to lower costs and get the return on equity up to 15.0%. What profit margin would the firm need in order to achieve the 15% ROE, holding everything constant?

$15\% \text{ (target ROE)} \times \$375,000 \text{ (Equity because 0 debt)} = \$56,250 \text{ NI needed to get target ROE}$   
 $\$56,250 \text{ (NI)} / \$520,000 \text{ (Sales)} =$   
**10.82%**

9. If a bank loan officer were considering a company's loan request, which of the following statements would you consider to be correct?

**Other things held constant, the lower the debt ratio, the lower the interest rate the bank would charge.**

10. Which of the following factors could explain why Michigan Energy's cash balance increased even though it had a negative cash flow last year?

**The company sold a new issue of bonds.**

11. Last year Ann Arbor Corp had \$300,000 of assets, \$305,000 of sales, \$20,000 of net income, and a debt-to-total-assets ratio of 37.5%. The new CFO believes a new computer program will enable it to reduce costs and thus raise net income to \$33,000. Assets, sales, and the debt ratio would not be affected. By how much would the cost reduction improve the ROE?

**6.93%**

12. A firm's new president wants to strengthen the company's financial position. Which of the following actions would make it Financially Stronger?

**Increase EBIT while holding sales and assets constant.**


13. River Corp's total assets at the end of last year were \$380,000 and its net income was \$32,750. What was its return on total assets?

**8.62%**  $(32,750/380,000)$

14.

Faldo Corp sells on terms that allow customers 45 days to pay for merchandise. Its sales last year were \$435,000, and its year-end receivables were \$60,000. If its DSO is less than the 45-day credit period, then customers are paying on time. Otherwise, they are paying late. By how much are customers paying early or late? Base your answer on this equation:  $\text{DSO} - \text{Credit Period} = \text{Days early or late}$ , and use a 365-day year when calculating the DSO. A positive answer indicates late payments, while a negative answer indicates early payments.

Answer

Selected   
Answer: **5.  
34**

Sale/day  $(435,000/365) = 1,191.78$  then Receivables/sales per day =  
 $60,000/1,191.78 =$   
 $50.34$ -credit period (45) = 5.34

15. Other things held constant, which of the following actions would increase the amount of cash on a company's balance sheet?

**The company issues new common stock.**

16. Ryngard Corp's sales last year were \$27,000, and its total assets were \$16,000. What was its total assets turnover ratio (TATO)?

**1.69**  $(27,000/16,000)$


17. Last year, Delip Industries had (1) negative cash flow from operations, (2) a negative free cash flow, and (3) an increase in cash as reported on its balance sheet. Which of the following factors could explain this situation?

**The company sold a new issue of common stock.**

18.

HD Corp and LD Corp have identical assets, sales, interest rates paid on their debt, tax rates, and EBIT. However, HD uses more debt than LD. Which of the following statements is CORRECT?

Answer

Selected   
Answer: **HD would have the lower net income as shown on the income statement.**

19. Barenek Corp has \$665,000 of assets, and it uses no debt – it is financed only with common equity. The new CFO wants to employ enough debt to raise the debt/assets ratio to 40%, using the proceeds from borrowing to buy back common stock at its book value. How much must the firm borrow to achieve the target debt ratio?

**\$266,000**  $(665,000 \times .4)$

20. You observe that a firm's ROE is above the industry average, but its profit margin and debt ratio are both below the industry average. Which of the following statements is correct?

**Its total assets turnover must be above the industry average.**