Questions: tax and firm finances

Business, Company

1. | Question :| (TCO D) Which of the following factors would increase the likelihood that a company would call its outstanding bonds at this time? (a) The yield to maturity on the company's outstanding bonds increases due to a weakening of the firm's financial situation. (b) A provision in the bond indenture lowers the call price on specific dates, and yesterday was one of those dates. (c) The flotation costs associated with issuing new bonds rise. (d) The firm's CFO believes that interest rates are likely to decline in the future. e) The firm's CFO believes that corporate tax rates are likely to be increased in the future. | | | Student Answer:| | (b) A provision in the bond indenture lowers the call price on specific dates, and yesterday was one of those dates. | | Instructor Explanation:| Answer is: b Chapter 20, pp. 810 - 815 | | | Points Received:| 20 of 20 | | Comments:| | | | 2. | Question :| (TCO D) The State of Idaho issued $2, 000, 000 of seven percent coupon, 20-year semiannual payment, tax-exempt bonds five years ago.

The bonds had five years of call protection, but now the state can call the bonds if it chooses to do so. The call premium would be five percent of the face amount. Today 15-year, five percent, semiannual payment bonds can be sold at par, but flotation costs on this issue would be two percent. What is the net present value of the refunding? Because these are tax-exempt bonds, taxes are not relevant. (a) $278, 606 (b) $292, 536 (c) $307, 163 (d) $322, 521 (e) $338, 647 | | Student Answer:| | (a) $278, 606 Cost of refunding: Call Premium = 5% (2mil) = 100, 000 Floatation cost = 2% (2mil) = 40, 000 Total investment outlay = 140, 000 Interest on old bond = 7%/2(2mil) = 70, 000 Interest on new bond = 5%/2(2mil) = 50, 000 Savings = 20, 000 PV of savings, 30 periods at 5%/2 = 418, 606 NPV of refunding =

PV of savings - cost of refunding = 278, 606 | | Instructor Explanation:| Answer is: a Chapter 20, pp. 810 - 815 Call premium: 5% Old rate: 7% Flotation %: 2%

New rate: 5% Amount: $2, 000, 000 Years: 15

Cost of refunding: Call premium = 5% ($2, 000, 000) $100, 000 Flotation cost = 2% ($2, 000, 000) $ 40, 000 Total investment outlay: $140, 000 Interest on old bond per 6 months: Old rate/2 ? Amount = $70, 000 Interest on new bond per 6 months: New rate/2 ? Amount = $50, 000 Savings per six months: $20, 000 PV of savings, 30 periods @ new rate/2 = $418, 606 NPV of refunding = PV of savings - Cost of refunding = $278, 606 | | | | Points Received:| 20 of 20 | | Comments:| | | 3. | Question :| (TCO D) New York Waste (NYW) is considering refunding a $50, 000, 000, annual payment, 14 percent coupon, 30-year bond issue that was issued five years ago. It has been amortizing $3 million of flotation costs on these bonds over their 30-year life. The company could sell a new issue of 25-year bonds at an annual interest rate of 11. 67 percent in today's market. A call premium of 14 percent would be required to retire the old bonds, and flotation costs on the new issue would amount to $3 million. NYW's marginal tax rate is 40 percent. The new bonds would be issued when the old bonds are called.

What will the after-tax annual interest savings for NYW be if the refunding takes place? (a) $664, 050 (b) $699, 000 (c) $768, 900 (d) $845, 790 (e) $930, 369 | | | Student Answer:| | (b) $699, 000 Old Interest: 50, 000, 000(. 14)(. 60) = 4, 200, 000 New Interest: 50, 000, 000(. 1167)(. 6) = 3, 501, 000

Difference is 699, 000 | | Instructor Explanation:| Answer is: b Chapter 20, pp. 810 - 815 Old interest: $50, 000, 000(0. 14)(0. 6) = $4, 200, 000 New interest: $50, 000, 000(0. 1167)(0. 6) = (3, 501, 000) Net annual interest savings $699, 000 | | | Points Received:| 20 of 20 | | Comments:| | | | 4. | Question :| (TCO E) Financial Accounting Standards Board (FASB) Statement #13 requires that for an unqualified audit report, financial (or capital) leases must be included in the balance sheet by reporting the: (a) residual value as a fixed asset. (b) residual value as a liability. (c) present value of future lease payments as an asset and also showing this same amount as an offsetting liability. (d) undiscounted sum of future lease payments as an asset and as an offsetting liability. e) undiscounted sum of future lease payments, less the residual value, as an asset, and as an offsetting liability. | | | Student Answer:| | (c) present value of future lease payments as an asset and also showing this same amount as an offsetting liability. | | Instructor Explanation:| Answer is: c Chapter 18, pp. 738 - 740 | | | Points Received:| 20 of 20 | | Comments:| | | | 5. | Question :| (TCO E) In the lease versus buy decision, leasing is often preferable: (a) because it has no effect on the firm's ability to borrow to make other investments. b) because, generally, no down payment is required, and there are no indirect interest costs. (c) because lease obligations do not affect the firm's risk as seen by investors. (d) because the lessee owns the property at the end of the least term. (e) because the lessee may have greater flexibility in abandoning the project in which the leased property is used than if the lessee bought and owned the asset. | | | Student Answer:| | (c) because lease obligations do not affect the firm's risk as seen

by investors. | | Instructor Explanation:| Answer is: e Chapter 18, pp. 740 - 745 | | | | Points Received:| 0 of 20 | | Comments:| | | | | |