

Inflation is assumed



Inflation is assumed Chapter 1 True / False Questions 1. Inflation is assumed to be a temporary problem that does not affect financial decisions. FALSE 2. Financial Capital is composed of long-term plant and equipment, as well as other tangible investments. FALSE 3. Real Capital is composed of long-term plant and equipment. TRUE 4. During the 1930s, financial practice revolved around such topics as the preservation of capital, maintenance of liquidity, reorganization of financially troubled corporations and bankruptcy. TRUE 5. In the mid 1950s, finance began to change to a more analytical, decision-oriented approach.

TRUE 6. Recently, the emphasis of financial management has been on the relationship between risk and return. TRUE 7. The most common partnership arrangement carries limited liability to the partners. FALSE 8. In terms of revenues and profits, the corporation is by far the most important form of business organization in the United States. TRUE 9. Dividends paid to corporate stockholders have already been taxed once as corporate income. TRUE 10. One advantage of the corporate form of organization is that income received by stockholders is not taxable since the corporation already paid taxes on the income distributed.

FALSE 11. A corporation must have more than 75 stockholders to qualify for Subchapter S designation. FALSE 12. Profits of a Subchapter S corporation are taxed at corporate tax rates. FALSE 13. Corporate governance issues have become less important to the financial community during the first decade of the new millennium. FALSE 14. Agency Theory examines the relationship between companies and their customers. FALSE 15. A major focus of the Sarbanes Oxley Act is to make sure that publicly traded

companies accurately present their assets, liabilities and income in their financial statements.

TRUE 16. The Sarbanes Oxley Act is primarily intended to increase public scrutiny of private companies that had previously been exempt from many public disclosure requirements. FALSE 17. Timing is not a particularly important consideration in financial decisions. FALSE 18. Maximizing the earnings of the firm is the goal of financial management. FALSE 19. Insider trading involves the use of information not available to the general public to make profits from trading in a company's stock. TRUE 20.

Financial markets exist as a vast global network of individuals and financial institutions that may be lenders, borrowers, or owners of public companies worldwide. TRUE 21. Moneymarkets refer to those markets dealing with short-term securities having a life of one year or less. TRUE 22. Money markets refer to markets where excess corporate cash is exchanged for foreign currencies that can earn a higher return than domestic money. FALSE 23. Capital markets refer to those markets dealing with short-term securities having a life of one year or less. FALSE 24. The primary market includes the sale of securities by way of initial public offerings.

TRUE 25. High quality initial public offerings are usually sold in a primary market, such as the New York Stock Exchange. However, low-quality stocks must usually be sold in secondary markets, such as NASDAQ. FALSE 26. Although NASDAQ is a secondary market, some of the firms traded there, such as Microsoft, are large enough to move to the primary market if they so desire. FALSE 27. The secondary market characteristically has had stable prices over the past 20 years. FALSE 28. In the United States, stocks sold on

either the New York Stock Exchange or NASDAQ are considered sold in the primary market.

FALSE 29. New issues are sold in the secondary market. FALSE 30. Existing securities are traded in the secondary market. TRUE 31. Many companies have cross-listed their stock on multiple international stock exchanges and more than several hundred foreign companies have listed their shares on the New York Stock Exchange. TRUE 32. Financial management requires both short-term activities as well as long-term planning such as raising funds. TRUE Multiple Choice Questions 33. What is the primary goal of financial management? A. Increased earnings B. Maximizing cash flow C. Maximizing shareholder wealth

D. Minimizing risk of the firm 34. In the past, the study of finance has included A. mergers and acquisitions. B. raising capital. C. bankruptcy. D. all of these. 35. Professor Merton Miller received the Nobel prize in economics for his work on A. dividend policy. B. investment theory. C. working capital management. D. capital structure theory. 36. Professors Harry Markowitz and William Sharpe received their Nobel prize in economics for their contributions to the A. options pricing model. B. theories of working capital management. C. theories of risk-return and portfolio theory. D. theories of international capital budgeting. 37. Proper risk-return management means that A. the firm should take as few risks as possible. B. the firm must determine an appropriate trade-off between risk and return. C. the firm should earn the highest return possible. D. the firm should value future profits more highly than current profits. 38. One of the major disadvantages of a sole proprietorship is A. that there is unlimited liability to the owner. B.

the simplicity of decision making. C. low organizational costs. D. low operating costs. 39. One of the major advantages of a sole proprietorship is A. that the owner has limited liability. B. that stock in the proprietorship can be easily transferred. C. that it is exempt from many tax rules that would otherwise apply when employees are hired by the firm. D. low operating costs. 40. The partnership form of an organization A. avoids the double taxation of earnings and dividends found in the corporate form of organization. B. usually provides limited liability to the partners. C. has unlimited life. D. simplifies decision making. 41. A corporation is A. owned by stockholders who enjoy the privilege of limited liability. B. easily divisible between owners.

C. a separate legal entity with perpetual life. D. all of these. 42. With a Subchapter S corporation A. income is taxed as direct income to stockholders. B. stockholders have the same liability as members of a partnership. C. the number of stockholders is unlimited. D. life of the corporation is limited. 43. A Subchapter S corporation A. is similar to a partnership in that it carries unlimited liability. B. is a separate legal entity which is treated like a normal corporation. C. has all the organizational benefits of a corporation and its income is only taxed once. D. all of these. 44.

Corporate governance is the A. relationship and exercise of oversight by the board of directors of the company. B. relationship between the chief financial officer and institutional investors. C. operation of a company by the chief executive officer (CEO) and other senior executives on the management team. D. governance of the company by the board of directors with a focus

on social responsibility. 45. Many companies such as Tyco, Enron, and WorldCom that suffered financial distress in the late 1990s and early 2000s, A. committed fraud. B. had failed corporate governance oversight. C. went bankrupt. D. II of these are true. 46. Agency theory examines the relationship between the A. shareholders of the firm and the firm's investment banker. B. owners of the firm and the managers of the firm. C. board of directors and large institutional investors. D. shareholders and the firm's transfer agent. 47. Agency theory would imply that conflicts are more likely to occur between management and shareholders when A. the company is owned and operated by the same person. B. management acts in the best interests of maximizing shareholder wealth. C. the chairman of the board is also the chief executive officer (CEO). D. the board of directors exerts strong and involved oversight of management. 48. Agency problems are least likely to arise in which organizational form? A. sole proprietorship B. limited partnership C. corporation D. subchapter S corporation 49. Institutional investors are important in today's business world because A. as large investors they have more say in how businesses are managed. B. they have a fiduciary responsibility to the workers and investors that they represent to see that the firms they own are managed in an ethical way. C. as a group they can vote large blocks of stock for the election of board members. D. all of these. 50. The increasing percentage ownership of public corporations by institutional investors has A. had no effect on corporate management. B. created higher returns for the stock market in general. C. created more pressure on public companies to manage their firms more

efficiently. D. taken away the voice of the individual investor. 51. The Sarbanes-Oxley Act was passed in an effort to A. protect small business from large corporations dominating the market. B. ensure that partnerships divide profits among partners in a fair manner. C. guarantee outside auditors can control corporate accounting practices.

D. control corrupt corporate behavior. 52. Maximization of shareholder wealth is a concept in which A. increased earnings is of primary importance. B. profits are maximized on a quarterly basis. C. virtually all earnings are paid as dividends to common stockholders. D. optimally increasing the long-term value of the firm is emphasized. 53. Which of the following is not a true statement about the goal of maximizing shareholder wealth? A. It takes into account the timing of cash-flows. B. It is a short-run point of view which takes risk into account. C. It considers risk as a factor. D. None of these. 54.

Insider trading occurs when A. someone has information not available to the public which they use to profit from trading in stocks. B. corporate officers buy stock in their company. C. lawyers, investment bankers, and others buy common stock in companies represented by their firms. D. any stock transactions occur in violation of the Federal Trade Commissions restrictions on monopolies. 55. The major difficulty in most insider-trading cases has been A. that lenient judges have simply released the guilty individuals. B. that insider trading, even though illegal, actually serves a beneficial economic and financial purpose.

C. that inside trades have not been legally well defined. D. inside trades actually have a beneficial effect on the wealth of all stockholders. 56. Money markets would include which of the following securities? A. common stock

and corporate bonds. B. treasury bills and commercial paper. C. certificates of deposit and preferred stock. D. all of these. 57. Capital markets do not include which of the following securities: A. common stock B. commercial paper C. government bonds D. preferred stock 58. When a corporation uses the financial markets to raise new funds, the sale of securities is made in the A. primary market. B. secondary market. C. on-line market. D. third market. 59. Corporate restructuring has been one result of more institutional ownership. Restructuring can cause A. changes in the assets and liabilities of the firm. B. the sale of low-profit margin divisions. C. the removal of current management and/or large reductions in the workforce. D. all of these. 60. The internationalization of the financial markets has A. allowed firms such as McDonalds to raise capital around the world. B. raised the cost of capital. C. forced companies to price everything in U. S. dollars. D. all of these. Chapter 2

True / False Questions 61. The income statement is the major device for measuring the profitability of a firm over a period of time. TRUE 62. The income statement measures the increase in the assets of a firm over a period of time. FALSE 63. Operating profit is essentially a measure of how efficient management is in generating revenues and controlling expenses. TRUE 64. Accounting income is based on verifiably completed transactions. TRUE 65. The P/E ratio is strongly related to the past performance of the firm. FALSE 66. When a firm has a sharp drop off in earnings, its P/E ratio may be artificially high. TRUE 67.

The real value of a firm is the same from an economic and accounting perspective. FALSE 68. A balance sheet represents the assets, liabilities, and

owner's equity of a company at a given point in time. TRUE 69. The investments account represents a commitment of funds of at least one year or more. TRUE 70. Asset accounts are listed in order of their liquidity. TRUE 71. Accumulated depreciation shows up in the income statement. FALSE 72. Total assets of a firm are financed with liabilities and stockholders equity. TRUE 73. Book value per share and market value per share are usually the same dollar amount. FALSE 74.

Book value per share is of greater concern to the financial manager than market value per share. FALSE 75. Book value is equal to net worth. TRUE 76. Equity is a measure of the monetary contributions that have been made directly or indirectly on behalf of the owners of the company. TRUE 77. Stockholders' equity is equal to liabilities plus assets. FALSE 78. Retained earnings shown on the balance sheet represents available cash on hand generated from prior year's earnings but not paid out in dividends. FALSE 79. Retained earnings represent the firm's cumulative earnings since inception, minus dividends and other adjustments.

TRUE 80. The statement of cash flows helps measure how the changes in a balance sheet were financed between two time periods. TRUE 81. Cash flow is equal to earnings before taxes minus depreciation. FALSE 82. An increase in an asset represents a source of funds. FALSE 83. Assume that two companies both have Net Income of \$100, 000. The firm with the highest depreciation expense will have the highest cash flow, assuming all other adjustments are equal. TRUE 84. An increase in inventory represents a source of funds. FALSE 85. An increase in a liability account represents a source of funds on the cash flow statement.

TRUE 86. An increase in accounts receivable represents a reduction in cash flows from operations. TRUE 87. An increase in accounts payable represents a reduction in cash flows from operations. FALSE 88. The purchase of a new factory would reduce the cash flows from investing activities on the statement of cash flows. TRUE 89. The sale of corporate bonds held by the firm as a long-term investment would increase cash flows from investing activities on the statement of cash flows. TRUE 90. Paying dividends to common shareholders will not affect cash flows from financing activities. FALSE 91.

The sale of a firm's securities is a source of funds, whereas the payment of dividends is a use of funds. TRUE 92. Depreciation is an accounting entry and does not involve a cash expense. TRUE 93. Free cash flow is equal to cash flow from operating activities minus necessary capital expenditures and normal dividend payments. TRUE 94. An increase in accounts receivable results in a cash inflow on the statement of cash flows. FALSE 95. A decrease in bonds payable results in a cash outflow on the statement of cash flows. TRUE 96. An increase in accrued expenses results in a cash outflow on the statement of cash flows.

FALSE Multiple Choice Questions 97. Which of the following is not one of the three basic financial statements? A. Income Statement B. Statement of Retained Earnings C. Statement of Cash Flows D. Balance Sheet 98. Which of the following is not subtracted out in arriving at operating income? A. interest expense B. cost of goods sold C. depreciation D. selling and administrative expense 99. Increasing interest expense will have what effect on EBIT? A. increase it B. decrease it C. no effect D. not enough information

to tell 100. The residual income of the firm belongs to A. creditors. B. preferred stockholders.

C. common stockholders. D. bondholders. 101. Allen Lumber Company had earnings after taxes of \$580, 000 in the year 2006 with 400, 000 shares outstanding on December 31, 2006. On January 1, 2007, the firm issued 35, 000 new shares. Because of the proceeds from these new shares and other operating improvements, 2007 earnings after taxes were 25 percent higher than in 2006. Earnings per share for the year-end 2007 was A. \$1. 67 B. \$1.

45 C. \$1. 81 D. None of these 102. Consider the following information for Ball Corp. [pic] What is the Operating Profit for Ball Corp? A. \$71, 450 B. \$90, 000

C. 120, 000 D. None of these 103. Candy Company had sales of \$240, 000 and cost of goods sold of \$108, 000. What is the gross profit margin (ratio of gross profit to sales)? A. 75% B. 55% C. 73. 3% D. None of these 104.

Density Farms, Inc. had sales of \$500, 000, cost of goods sold of \$180, 000, selling and administrative expense of \$70, 000, and operating profit of \$90, 000. What was the value of depreciation expense? A. \$170, 000 B. \$230, 000

C. Less than \$170, 000 D. None of these 105. Elgin Battery Manufacturers had sales of \$900, 000 in 2006 and their cost of goods sold represented 65 percent of sales.

Selling and administrative expenses were 9 percent of sales. Depreciation expense was \$10, 000 and interest expense for the year was \$8, 000. The firm's tax rate is 30 percent. What is the dollar amount of taxes paid? A. \$151, 200 B. \$145, 800 C. More than \$151, 800 D. None of these 106. A firm with earnings per share of \$5 and a price-earnings ratio of 15 will have a stock price of A. \$20. 00 B. \$75. 00 C. \$3. 00 D. the market assigns a stock

price of \$150. 00

107. A firm with a price-earnings ratio of 15 and a stock price of \$75. 00 will have earnings per share of A. \$5. 00 B. \$15. 00 C. \$3. 00 D. \$1. 00

108. A firm with a price-earnings ratio of 15 and a stock price of \$75. 00 will have earnings per share of A. \$5. 00 B. \$15. 00 C. \$3. 00 D. \$1. 00

109. A firm with a price-earnings ratio of 15 and a stock price of \$75. 00 will have earnings per share of A. \$5. 00 B. \$15. 00 C. \$3. 00 D. \$1. 00

110. A firm with a price-earnings ratio of 15 and a stock price of \$75. 00 will have earnings per share of A. \$5. 00 B. \$15. 00 C. \$3. 00 D. \$1. 00

111. A firm with a price-earnings ratio of 15 and a stock price of \$75. 00 will have earnings per share of A. \$5. 00 B. \$15. 00 C. \$3. 00 D. \$1. 00

112. A firm with a price-earnings ratio of 15 and a stock price of \$75. 00 will have earnings per share of A. \$5. 00 B. \$15. 00 C. \$3. 00 D. \$1. 00

113. A firm with a price-earnings ratio of 15 and a stock price of \$75. 00 will have earnings per share of A. \$5. 00 B. \$15. 00 C. \$3. 00 D. \$1. 00

114. A firm with a price-earnings ratio of 15 and a stock price of \$75. 00 will have earnings per share of A. \$5. 00 B. \$15. 00 C. \$3. 00 D. \$1. 00

115. A firm with a price-earnings ratio of 15 and a stock price of \$75. 00 will have earnings per share of A. \$5. 00 B. \$15. 00 C. \$3. 00 D. \$1. 00

116. A firm with a price-earnings ratio of 15 and a stock price of \$75. 00 will have earnings per share of A. \$5. 00 B. \$15. 00 C. \$3. 00 D. \$1. 00

117. A firm with a price-earnings ratio of 15 and a stock price of \$75. 00 will have earnings per share of A. \$5. 00 B. \$15. 00 C. \$3. 00 D. \$1. 00

118. A firm with a price-earnings ratio of 15 and a stock price of \$75. 00 will have earnings per share of A. \$5. 00 B. \$15. 00 C. \$3. 00 D. \$1. 00

price independent of EPS and the P/E ratio. 107. Earnings per share is A. operating profit divided by number of shares outstanding. B. net income divided by number of shares outstanding. C. net income divided by stockholders' equity. D. net income minus preferred dividends divided by number of shares outstanding. 108. Reinvested funds from retained earnings theoretically belong to: A. bond holders. B. common stockholders. C. employees. D. all of these. 109. The firm's price-earnings (P/E) ratio is influenced by its A. capital structure. B. earnings volatility. C. sales, profit margins, and earnings. D. all of these. 110. Which of the following factors do not influence the firm's P/E ratio: A. past earnings. B. shares outstanding. C. volatility in performance. D. none of these. 111. Which of the following would not be classified as a current asset? A. Marketable securities B. Investments C. Prepaid expenses D. Inventory 112. An item which may be converted to cash within one year or one operating cycle of the firm is classified as a A. current liability. B. long-term asset. C. current asset. D. long-term liability. 113. Which of the following would not be included in the balance sheet investment account? A. stocks of other corporations B. long term government bonds C. marketable securities D. investments in other corporations 14. Which of the following is not a primary source of capital to the firm? A. assets B. common stock C. preferred stock D. bonds 115. The major limitation of financial statements is A. in their complexity. B. in their lack of comparability. C. in their use of historical cost accounting. D. in their lack of detail. 116. Net worth is equal to stockholders' equity A. plus dividends. B. minus preferred stock. C. plus preferred stock. D. minus liabilities. 117. Book value is the same as A. stockholders' equity. B. fixed

assets minus long-term debt. C. net worth. D. current assets minus current debt. 118.

Total stockholders' equity consists of A. preferred stock and common stock. B. common stock and retained earnings. C. common stock and capital paid in excess of par. D. preferred stock, common stock, capital paid in excess of par and retained earnings. 119. The net worth of a firm A. is usually the same as the firm's market value. B. is based on current asset costs. C. is based on current liabilities. D. none of these. 120. The orientation of book value per share is _____, while the orientation of market value per share is _____. A. short term, long term B. future, historical C. historical, future D. long term, short term 121. A statement of cash flows allows a financial analyst to determine A. whether a cash dividend is affordable. B. how increases in asset accounts have been financed. C. whether long-term assets are being financed with long-term or short-term financing. D. all of these. 122. A firm's purchase of plant and equipment would be considered a A. use of cash for financing activities. B. use of cash for operating activities. C. source of cash for investment activities. D. use of cash for investment activities. 123. Depreciation is a source of cash inflow because A. it is a tax-deductible non-cash expense.

B. it supplies cash for future asset purchases. C. it is a tax-deductible cash expense. D. it is a taxable expense. 124. Depreciation tends to A. increase cash flow and decrease income. B. decrease cash flow and increase income. C. affect only cash flow. D. affect only income. 125. Given the following, what is free cash flow? [pic] A. \$115, 000. B. \$235, 000. C. \$185, 000. D. \$165, 000. 126. Assuming a tax rate of 35%, depreciation expenses of \$400, 000

will A. reduce income by \$140, 000. B. reduce taxes by \$140, 000. C. reduce taxes by \$400, 000. D. have no effect on income or taxes, since depreciation is not a cash expense.

27. Assuming a tax rate of 30%, the after-tax cost of interest expense of \$200, 000 is A. \$60, 000 B. \$140, 000 C. \$200, 000 D. \$120, 000

128. Assuming a tax rate of 40%, the after-tax cost of a \$200, 000 dividend payment is A. \$200, 000 B. \$70, 000 C. \$130, 000 D. none of these.

129. Farah Snack Co. has earnings after taxes of \$128, 750. Interest expense for the year was \$20, 000; preferred dividends paid were \$18, 750; and common dividends paid were \$30, 000. Taxes were \$15, 000. The firm has 100, 000 shares of common stock outstanding. Earnings per share on the common stock was A. \$0. 90 B. \$1. 10 C. \$0. 5 D. \$0. 80

130. Gerry Co. has a gross profit of \$880, 000 and \$360, 000 in depreciation expense. Selling and administrative expense is \$120, 000. Given that the tax rate is 40 percent, compute the cash flow for Gerry Co. A. \$456, 000 B. \$240, 000 C. \$600, 000 D. None of these

131. Hoover Inc. has current assets of \$360, 000 and fixed assets of \$640, 000. Current liabilities are \$90, 000 and long-term liabilities are \$160, 000. There is \$90, 000 in preferred stock outstanding and the firm has issued 10, 000 shares of common stock. Compute book value (net worth) per share A. \$84. 00 B. \$66. 00 C. \$75. 00 D. None of these

132. The best indication of the operational efficiency of management is A. net income. B. earnings per share. C. earnings before interest and taxes (EBIT). D. gross profit.

133. A corporation can increase their earnings per share by A. increasing tax-deductible expenses B. increasing Treasury stock C. decreasing depreciation D. decreasing retained earnings

From End of the Chapter 2 Problems 5. Given the following

information, prepare, in good form, an income statement for Goodman Software, Inc. Selling and administrative expense\$ 50, 000 Depreciation expense80, 000 Sales400, 000

Interest expense30, 000 Cost of goods sold150, 000 Taxes18, 550 2-5.

Solution: Goodman Software, Inc. Sales\$ 400, 000 Cost of goods sold 150, 000 Gross Profit250, 000 Selling and administrative expense50, 000 Depreciation expense 80, 000 Operating profit120, 000 Interest expense 30, 000 Earnings before taxes90, 000 Taxes 18, 550 Earnings after taxes\$ 71, 450

6. Given the following information prepare in good form an income statement for the Kid Rock and Gravel Company. Selling and administrative expense\$ 60, 000 Depreciation expense70, 000 Sales470, 000 Interest expense40, 000 Cost of goods sold140, 000

Taxes45, 000 2-6. Solution: Kid Rock and Gravel Co. Income Statement Sales\$ 470, 000 Cost of goods sold\$ 140, 000 Gross profit\$ 330, 000 Selling and administrative expense\$ 60, 000 Depreciation expense\$ 70, 000 Operating profit\$ 200, 000 Interest expense\$ 40, 000 Earnings before taxes\$ 160, 000 Taxes\$ 45, 000 Earnings after taxes\$ 115, 000

7. Prepare in good form an income statement for Virginia Slim Wear. Take your calculations all the way to computing earnings per share. Sales\$600, 000 Shares outstanding100, 000 Cost of goods sold200, 000 Interest expense30, 000 Selling and administrative expense40, 000

Depreciation expense20, 000 Preferred stock dividends80, 000 Taxes100, 000 2-7. Solution: Virginia Slim Wear Income Statement Sales\$600, 000 Cost of goods sold 200, 000 Gross profit400, 000 Selling and administrative expense40, 000 Depreciation expense 20, 000 Operating profit340, 000

Interest expense 30, 000 Earnings before taxes 310, 000 Taxes 100, 000
 Earnings after taxes 210, 000 Preferred stock dividends 80, 000 Earnings
 available to common stockholders 130, 000 Shares outstanding 100, 000
 Earnings per share \$ 1. 30

8. Prepare in good form an income statement for Franklin Kite Co. , Inc.

Take your calculations all the way to computing earnings per share.

Sales \$900, 000 Shares outstanding 50, 000 Cost of goods sold 400, 000
 Interest expense 40, 000 Selling and administrative expense 60, 000
 Depreciation expense 20, 000 Preferred stock dividends 80, 000 Taxes 50, 000

2-8. Solution: Franklin Kite Company Income Statement
 Sales \$900, 000 Cost of goods sold 400, 000 Gross profit 500, 000
 Selling and administrative expense 60, 000 Depreciation expense 20, 000
 Operating profit \$420, 000
 Interest expense 40, 000 Earnings before taxes \$380, 000 Taxes 50, 000
 Earnings after taxes \$330, 000 Preferred stock dividends 80, 000

Earnings available to common stockholders 250, 000 Shares outstanding 50,
 000 Earnings per share \$5. 00

9. Lasar Technology, Inc. , had sales of \$500, 000, cost of goods sold of \$180, 000, selling and administrative expense of \$70, 000, and operating profit of \$90, 000. What was the value of depreciation expense? Set this problem up as a partial income statement, and determine depreciation expenses as the plug figure.

2-9. Solution: Lasar Technology, Inc. Sales \$500, 000 Cost of goods sold \$180, 000 Gross Profit \$320, 000 Selling and administrative expense 70, 000 Depreciation Expense (plug figure) 160, 000

Operating profit \$ 90, 000

10. The Ace Book Company sold 1, 500 finance textbooks for \$185 each to High Tuition University in 2008. These books cost

Ace \$145 to produce. Ace spent \$10, 000 (selling expense) to convince the university to buy its books. In addition, Ace borrowed \$80, 000 on January 1, 2008, on which the company paid 10 percent interest. Both interest and principal of the loan were paid on December 31, 2008. Ace's tax rate is 25 percent. Depreciation expense for the year was \$15, 000. Did Ace Book Company make a profit in 2008? Please verify with an income statement presented in good form.

-10. Solution: Ace Book Company

Sales (1, 500 books at \$185 each)	277, 500
Cost of goods sold (1, 500 books at \$145 each)	217, 500
Gross Profit	60, 000
Selling expense	10, 000
Depreciation expense	15, 000
Operating profit.....	35, 000
Interest expense	8, 000
Earnings before taxes	27, 000
Taxes @ 25%	6, 750
Earnings after taxes	20, 250

11. Carr Auto Wholesalers had sales of \$900, 000 in 2004 and their cost of goods sold represented 65 percent of sales. Selling and administrative expenses were 9 percent of sales. Depreciation expense was \$10, 000 and interest expense for the year was \$8, 000.

The firm's tax rate is 30 percent. a. Compute earnings after taxes. b. Assume the firm hires Ms. Hood, an efficiency expert, as a consultant. She suggests that by increasing selling and administrative expenses to 12 percent of sales, sales can be increased to \$1, 000, 000. The extra sales effort will also reduce cost of goods sold to 60 percent of sales (there will be a larger markup in prices as a result of more aggressive selling). Depreciation expense will remain at \$10, 000. However, more automobiles will have to be carried in inventory to satisfy customers, and interest expense will go up to \$15, 000.

The firm's tax rate will remain at 30 percent. Compute revised earnings after taxes based on Ms. Hood's suggestions for Carr Auto Wholesalers. Will her

ideas increase or decrease profitability? 2-11. Solution: Carr Auto Wholesalers Income Statement a. Sales\$ 900, 000 Cost of goods sold (65% of sales) 585, 000 Gross Profit\$ 315, 000 Selling and administrative expense (9% of sales) 81, 000 Depreciation 10, 000 Operating profit 224, 000 Interest expense 8, 000 Earnings before taxes 216, 000 Taxes @ 30% 64, 800 Earnings after taxes \$ 151, 200 2-11. (Continued) b. Sales \$1, 000, 000

Cost of goods sold (60% of sales) 600, 000 Gross profit 400, 000 Selling and administrative expense (12% of sales) 120, 000 Depreciation 10, 000 Operating profit 270, 000 Interest expense 15, 000 Earnings before taxes 255, 000 Taxes @ 30% 76, 500 Earnings after taxes\$ 178, 500 Ms. Hood's

ideas will increase profits. 15. Elite Trailer Parks has an operating profit of \$200, 000. Interest expense for the year was \$10, 000; preferred dividends paid were \$18, 750; and common dividends paid were \$30, 000. The tax was \$61, 250. The firm has 20, 000 shares of common stock outstanding. .

Calculate the earnings per share and the common dividends per share for Elite Trailer Parks. b. What was the increase in retained earnings for the year? 2-15. Solution: Elite Trailor Parks a. Operating profit (EBIT)\$200, 000 Interest expense 10, 000 Earnings before taxes (EBT)\$190, 000 Taxes 61, 250 Earnings after taxes (EAT)\$128, 750 Preferred dividends 18, 750 Available to common stockholders\$110, 000 Common dividends 30, 000 Increase in retained earnings\$80, 000 [pic] Dividends per Share = $\$30,000 / 20,000 \text{ shares} = \1.50 per share b. Increase in retained earnings = \$80, 000 16.

Johnson Alarm Systems had \$800, 000 of retained earnings on December 31, 2008. The company paid common dividends of \$60, 000 in 2008 and had

retained earnings of \$640, 000 on December 31, 2007. How much did Johnson earn during 2008, and what would earnings per share be if 50, 000 shares of common stock were outstanding? 2-16. Solution: Johnson Alarm Systems Retained earnings, December 31, 2008 \$800, 000 Less: Retained earnings, December 31, 2007 640, 000 Change in retained earnings \$160, 000 Add: Common stock dividends 60, 000 Earnings available to common stockholders \$220, 000 Earnings per share [pic] 17.

Mozart Music Co. had earnings after taxes of \$560, 000 in 2008 with 200, 000 shares of stock outstanding. The stock price was \$58. 80. In 2009, earnings after taxes increased to \$650, 000 with the same 200, 000 shares outstanding. The stock price was \$78. 00 a. Compute earnings per share and the P/E ratio for 2008. The P/E ratio equals the stock price divided by earnings per share. b. Compute earnings per share and the P/E ratio for 2009. c. Give a general explanation of why the P/E changed. 2-17. Solution: Mozart Music Co. a. EPS (2008) [pic] = \$2. 80 P/E Ratio (2008) = Price/EPS = [pic] = 21X b. EPS (2009) [pic] = \$3. 5 P/E Ratio (2009) = Price/EPS = [pic] = 24X c. The stock price increased by 34% while EPS only increased 16. 1%.

20. Nova Electrics anticipated cash flow from operating activities of \$6 million in 2008. It will need to spend \$1. 2 million on capital investments in order to remain competitive within the industry. Common stock dividends are projected at \$. 4 million and preferred stock dividends at \$. 55 million. a. What is the firm's projected free cash flow for the year 2008? b. What does the concept of free cash flow represent? 2-20. Solution: Nova Electronics a. Cash flow from operations activities \$6. 0 million - Capital Expenditures 1. 20 - Common stock dividends . 40 - Preferred stock dividends . 55 Free cash

flow\$3. 85 million b. Free cash flow represents the funds that are available for special financial activities, such as a leveraged buyout, increased dividends, common stock repurchases, acquisitions, or repayment of debt.

21. The Rogers Corporation has a gross profit of \$880, 000 and \$360, 000 in depreciation expense. The Evans Corporation also has \$880, 000 in gross profit, with \$60, 000 in depreciation expense. Selling and administrative expense is \$120, 000 for each company.

Given that the tax rate is 40 percent, compute the cash flow for both companies. Explain the difference in cash flow between the two firms. 2-21.

Solution: Rogers Corporation – Evans Corporation | | Rogers | Evans | | Gross profit |\$880, 000 |\$880, 000 | | Selling and adm. expense | 120, 000 | 120, 000 | | Depreciation | 360, 000 60, 000 | | Operating profit |\$400, 000 |\$700, 000 | | Taxes (40%) | 160, 000 | 280, 000 | | Earnings after taxes |\$240, 000 |\$420, 000 | | Plus depreciation expense |\$360, 000 |\$60, 000 | | Cash Flow |\$600, 000 |\$480, 000 | | | Rogers had \$300, 000 more in depreciation which provided \$120, 000 (0. 40 (\$300, 000) more in cash flow. | | |

22. Horton Electronics has current assets of \$320, 000 and fixed assets of \$640, 000. Current liabilities are \$90, 000 and long-term liabilities are \$160, 000. There is \$90, 000 in preferred stock outstanding and the firm has issued 40, 000 shares of common stock. Compute book value (net worth) per share. 2-22.

Solution: Horton Energy Company Current assets |\$320, 000 | | Fixed assets | 640, 000 | | Total assets |\$960, 000 | | -Current liabilities | 90, 000 | | -Long-term liabilities | 160, 000 | | Stockholders' equity |\$710, 000 | | -Preferred stock obligation | 90, 000 | | Net worth assigned to common |\$620, 000 | | | | Common shares outstanding | 40, 000 | | | | Book value (net worth) per

share |\$15. 50 | 23. The Holtzman Corporation has assets of \$400, 000, current liabilities of \$50, 000, and long-term liabilities of \$100, 000. There is \$40, 000 in preferred stock outstanding; 20, 000 shares of common stock have been issued. a. Compute book value (net worth) per share. b. If there is \$22, 000 in earnings available to common stockholders and Holtzman's stock has a P/E of 18 times earnings per share, what is the current price of the stock? c. What is the ratio of market value per share to book value per share? 2-23. Solution: Holtzman Corporation | a.

Total assets |\$400, 000 | |-Current liabilities | 50, 000 | |-Long-term liabilities | 100, 000 | |-Stockholders' equity |\$250, 000 | |-Preferred stock | 40, 000 | | Net worth assigned to common |\$210, 000 | | Common shares outstanding | 20, 000 | | Book values (net worth) per share |\$10. 50 | | b. Earnings available to common |\$22, 000 | | Shares outstanding | 20, 000 | | Earnings per share |\$1. 10 | | [pic] | | c.

Market value per share (price) to book value per share $\$19.80/\$10.50 = 1.89$ | 24. Bradley Gypsum Company has assets of \$1, 900, 000, current liabilities of \$700, 000, and long-term liabilities of \$580, 000. There is \$170, 000 in preferred stock outstanding; 30, 000 shares of common stock have been issued. a. Compute book value (net worth) per share. b. If there is \$42, 000 in earnings available to common stockholders and Bradley's stock has a P/E of 15 times earnings per share, what is the current price of the stock? c. What is the ratio of market value per share to book value per share? 2-24. Solution: Bradley Gypsum Company | a.

Total assets |\$1, 900, 000 | |-Current liabilities | 700, 000 | |-Long-term liabilities | 580, 000 | | Stockholders' equity |\$ 620, 000 | |-Preferred stock |

170, 000 | | Net worth assigned to common | \$ 450, 000 | | Common shares outstanding | 30, 000 | | Book values (net worth) per share | \$ 15. 00 | | b. Earnings available to common | | | stockholders | \$ 42, 000 | | Shares outstanding | 30, 000 | | Earnings per share | \$ 1. 40 | | [pic] | | c.

Market value per share (price) to book value per share $\$21.00/\$15.00 = 1.40$ | Chapter 14 True / False Questions 148. Capital markets consist of securities having maturities greater than one year. TRUE 149. The capital structure of the firm consists of long-term debt and equity. TRUE 150. Capital markets are becoming increasingly international as investors and issuers seek out the best risk-return opportunities. TRUE 151. Upon entering the capital markets, an investor might invest in common stocks, preferred stock, negotiable certificates of deposit, and convertible securities. FALSE 152.

In the last decade, the US has invested substantially more in foreign countries than foreign countries have invested back in the US. FALSE 153. Municipal securities are called tax exempt because no federal taxes must be paid on interest received. TRUE 154. The stock market far exceeds the bond market in terms of size of new capital raised. FALSE 155. The capital markets serve as a way of allocating available capital to the most efficient user. TRUE 156. The main reason for the small amount of financing with preferred stock is that dividends on preferred stock are not tax deductible as are interest paid on bonds. TRUE 157. Retained earnings account for the majority of internally generated corporate funds. FALSE 158.

When an investor buys stock in the stock market, he is purchasing shares from a company. FALSE 159. Internal funds generated by corporations include retained earnings and non cash expenses such as depreciation and

deferred taxes. TRUE 160. Households and the government are mainly considered to be suppliers of funds while corporations are generally considered users of funds. FALSE 161. Financial intermediaries channel funds into the capital markets from the household sector. TRUE 162. Brokers on an organized stock exchange act as an agent for the person buying or selling securities. TRUE 163. Brokers actually own the securities they buy and sell on the floor of the exchange. FALSE 164.

The NASDAQ National Market is composed of large nation-wide companies that are traded in the over-the-counter market. TRUE 165. The strong form of the efficient market hypothesis states that prices reflect all public information. FALSE 166. The efficient market hypothesis is generally concerned with the impact of information on the behavior of stock prices. TRUE 167. The weak form of the efficient market hypothesis states that an investor can profit by using past price data. FALSE 168. Markets are efficient when prices adjust rapidly to new information, continuous markets exist and large dollar trades can be absorbed without large price movements. TRUE 169.

The Sarbanes-Oxley Act of 2002 holds the CEO legally accountable for the accuracy of their firm's financial statements. TRUE 170. The Sarbanes-Oxley Act of 2002 holds a firm's internal auditors legally accountable for the accuracy of their firm's financial statements. FALSE 171. The future of the NYSE is uncertain due to their unwillingness to adapt to the increase in internationalization and electronic trading in the markets. FALSE Multiple Choice Questions 172. Evidence of how global markets are linked was provided in 1997 and 1998 when international markets reacted to A. the

collapse of Asian currencies in Thailand, Indonesia, Malaysia and Korea. B. Russia's default on its sovereign debt. C. Japan's seven years of economic stagnation.

D. a and b are true. 173. When global capital markets collectively react to international events like Russia's default on its sovereign debt, it is common to find A. that there is no impact on multinational companies' ability to raise capital. B. an impact on the ability to raise capital. C. that Wall Street firms are so diversified that they are not affected by this event. D. All of these are true. 174. Which of the following is not a money market instrument? A. Treasury bills B. Commercial paper C. Negotiable certificates of deposit D. Treasury bonds 175. Global capital markets are influenced by A. interest rates. B. investor confidence. C. relative economic growth. D. all of these. 176. Companies list their stock around the globe to A. capitalize on the inefficiency inherent in foreign markets. B. increase liquidity for their stockholders. C. provide opportunities for the sale of new stock in foreign countries. D. b and c are correct. 177. Foreign investors have preferred to invest in the United States due to all but one of the following reasons: A. less stringent regulation of securities markets. B. political stability of the U. S. government. C. the U. S. dollar is the world's international currency. D. all of these are reasons that foreign investors prefer to invest in the United States. 178.

With respect to the United States and its relationship with the rest of the world, it can be said that A. the U. S. has invested more dollars in the rest of the world than foreign countries have invested in the U. S. B. the U. S. has actively helped foreign countries finance their government deficits. C.

foreign investors hold large positions in U. S. government securities. D. All of these. 179. Financial instruments in the capital markets generally fall under what category in the Balance Sheet? A. Short-term liabilities and equities. B. Long-term liabilities and equities. C. Near cash assets. D. None of these. 180. Corporations prefer bonds over preferred stock for financing their operations because A. referred stocks require a dividend. B. bond interest rates change with the economy while stock dividends remain constant. C. the after-tax cost of debt is less than the cost of preferred stock. D. none of these. 181. Federally sponsored credit agencies include all but which of the following? A. Securities Investor Protection Corporation (SIPC) B. Federal Home Loan Banks (FHLB) C. Student Loan Marketing Association (Sallie Mae) D. Federal National Mortgage Association (Fannie Mae) 182. Which of the following is an internal source of funds? A. Cash flow from depreciation (tax shield) B. Net loss C. Repurchase of debt securities D. Bank loan 183.

The major supplier of funds for investment in the whole economy is A. businesses. B. households. C. government. D. financial institutions. 184. Financial intermediaries serve which of the following purposes? A. Financial intermediaries allow for indirect investment in the capital markets by households. B. Aid in the flow of funds through the economy. C. Help provide allocation of funds to the best investments. D. All of these. 185. Which of the following are benefits of financial intermediaries? A. Increase market liquidity B. Provide a direct market for investors C. Act as agents of the government D. Only a and b 186. The purpose of secondary trading is to A. provide liquidity and competition between investments. B. provide a market to issue securities not handled in primary trading. C. provide jobs for brokers and

dealers. D. provide lower commissions than on the organized exchanges.

187. The most important capital markets in the world (in terms of dollar value) are located in A. New York. B. London. C. Toronto. D. Tokyo.

188. Which Stock Exchange is known as the most liquid? A. NASDAQ B. AMEX C. CBOT D. NYSE

189. Middle to small size companies that are centered in one city or state would most likely be found on the A. NASDAQ National Market. B. NASDAQ Small Cap Market. C. Supplemental list. D. New York Stock Exchange.

190.

The emergence of trading via ECNs has A. offer a unique advantage not offered by the NYSE B. lowered the cost of trading. C. made trading more difficult for small investors. D. all of these are true.

191. Which of the following is not a criterion for an efficient market? A. Prices adjust rapidly to new information. B. Large dollar amounts of securities can be absorbed without price destabilization. C. Each successive trade is made at a price close to the previous trade. D. Computerized handling of transactions.

192. Security markets are efficient when each of the following exist except A. security prices follow the leading indicators such as the DJIA very closely. B. the markets can absorb large dollar amounts of stock without destabilizing the price. C. prices adjust rapidly to new information. D. there is a continuous market where each successive trade is made at a price close to the previous trade.

193. The efficient market hypothesis deals primarily with A. random speculation in securities. B. the degree to which prices adjust to new information. C. degrees to which price movements are the result of past trends. D. how an investor can significantly outperform the market in general.

194. The efficient market hypothesis has several forms. The weak

form states that A. past price data is unrelated to future prices. B. prices reflect all public information. C. All information both public and private is immediately reflected in stock prices. D. none of these

195. Security markets provide liquidity A. by allowing corporations to raise funds by selling new issues. B. by creating a market in which owners may easily turn an investment into cash through its sale. C. a and b are both correct. D. neither a nor b are correct.

196. The semi-strong form of the efficient market hypothesis states that A. past price data is unrelated to future prices. B. prices reflect all public information. C. all information both public and private is immediately reflected in stock prices. D. none of these

197. The strong form of the efficient market hypothesis states that A. past price data is positively correlated to future prices. B. prices reflect all public information. C. all information both public and private is immediately reflected in stock prices. D. none of these

198. Security markets are affected by all of the following except: A. interest rates B. global crises C. book values of equity D. emotions

199. Financial intermediaries include all of the following except: A. commercial banks B. life insurance companies C. corporations D. pension plans

200. The purposes of security legislation include all of the following except: A. protect against fraud B. ensure market efficiency C. reduce insider trading D. provide a global competitive advantage