Test Bank for Financial Management Theory & Practice 17th Brigham

Name:____ Class:_________________________ Date:_____________

Ch 02 Financial Statements, Cash Flow, and Taxes

1. The annual report contains four basic financial statements: the income statement, balance sheet, statement of cash flows, and statement of stockholders' equity.

a. True

b. False

ANSWER: True

2. The primary reason the annual report is important in finance is that it is used by investors when they form expectations about the firm's future earnings and dividends, and the riskiness of those cash flows.

a. True

b. False

ANSWER: True

3. Consider the balance sheet of Wilkes Industries as shown below. Because Wilkes has $800,000 of retained earnings, the company would be able to pay cash to buy an asset with a cost of $200,000.

Cash	$ 50,000	Accounts payable	$ 100,000
Inventory	200,000	Accruals	100,000
Accounts receivable	250,000	Total CL	$ 200,000
Total CA	$ 500,000	Debt	200,000
Net fixed assets	$ 900,000	Common stock	200,000
		Retained earnings	800,000
Total assets	$1,400,000	Total L & E	$1,400,000

a. True

b. False

ANSWER: False

4. On the balance sheet, total assets must always equal total liabilities and equity.

a. True

b. False

ANSWER: True

5. Assets other than cash are expected to produce cash over time, but the amount of cash they eventually produce could be higher or lower than the values at which these assets are carried on the books.

a. True

b. False

ANSWER: True

6. Which of the following statements is CORRECT?

a. A typical industrial company's balance sheet lists the firm's assets that will be converted to cash first, and then goes on down to list the firm's longest lived assets last.

b. The balance sheet for a given year is designed to give us an idea of what happened to the firm during that year.

c. The balance sheet for a given year tells us how much money the company earned during that year.

d. The difference between the total assets reported on the balance sheet and the debts reported on this statement tells us the current market value of the stockholders' equity, assuming the statements are prepared in accordance with generally accepted accounting principles (GAAP).

e. For most companies, the market value of the stock equals the book value of the stock as reported on the balance sheet.

ANSWER: a

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

ANSWER: d

8. Which of the following items is **NOT** included in current assets?
    a. Short-term, highly liquid, marketable securities.
    b. Accounts receivable.
    c. Inventory.
    d. Bonds.
    e. Cash.

ANSWER: d

9. Which of the following items cannot be found on a firm's balance sheet under current liabilities?
    a. Accrued payroll taxes.
    b. Accounts payable.
    c. Short-term notes payable to the bank.
    d. Accrued wages.
    e. Cost of goods sold.

ANSWER: e

10. Below are the year-end balance sheets for Wolken Enterprises:

Assets:	2020	2019
Cash	$ 200,000	$ 170,000
Accounts receivable	864,000	700,000
Inventories	2,000,000	1,400,000
Total current assets	$3,064,000	$2,270,000
Net fixed assets	6,000,000	5,600,000
Total assets	$9,064,000	$7,870,000
Liabilities and equity:		
Accounts payable	$1,400,000	$1,090,000
Notes payable	1,600,000	1,800,000
Total current liabilities	$3,000,000	$2,890,000
Long-term debt	2,400,000	2,400,000
Common stock	3,000,000	2,000,000
Retained earnings	664,000	580,000
Total common equity	$3,664,000	$2,580,000
Total liabilities and equity	$9,064,000	$7,870,000

Wolken has never paid a dividend on its common stock, and it issued $2,400,000 of 10-year non-callable, long-term debt in 2019. As of the end of 2020, none of the principal on this debt had been repaid. Assume that the company's sales in 2019 and 2020 were the same. Which of the following statements must be CORRECT?

a. Wolken increased its short-term bank debt in 2020.

b. Wolken issued long-term debt in 2020.

c. Wolken issued new common stock in 2020.

d. Wolken repurchased some common stock in 2020.

e. Wolken had negative net income in 2020.

ANSWER: c

11. On its 2019 balance sheet, Barngrover Books showed $510 million of retained earnings, and exactly that same amount was shown the following year in 2020. Assuming that no earnings restatements were issued, which of the following statements is CORRECT?

a. Dividends could have been paid in 2020, but they would have had to equal the earnings for the year.

b. If the company lost money in 2020, they must have paid dividends.

c. The company must have had zero net income in 2020.

d. The company must have paid out half of its earnings as dividends.

e. The company must have paid no dividends in 2020.

ANSWER: a

12. Below is the common equity section (in millions) of Fethe Industries' last two year-end balance sheets:

	2020	2019
Common stock	$2,000	$1,000
Retained earnings	2,000	2,340
Total common equity	$4,000	$3,340

The company has never paid a dividend to its common stockholders. Which of the following statements is CORRECT?

a. The company's net income in 2019 was higher than in 2020.

b. The company issued common stock in 2020.

c. The market price of the company's stock doubled in 2020.

d. The company had positive net income in both 2019 and 2020, but the company's net income in 2019 was lower than it was in 2020.

e. The company has more equity than debt on its balance sheet.

ANSWER: b

13. The income statement shows the difference between a firm's income and its costs–i.e., its profits–during a specified period of time. However, not all reported income comes in the form or cash, and reported costs likewise may not correctly reflect cash outlays. Therefore, there may be a substantial difference between a firm's reported profits and its actual cash flow for the same period.

a. True

b. False

ANSWER: True

14. The balance sheet is a financial statement that measures the flow of funds into and out of various accounts over time, while the income statement measures the firm's financial position at a point in time.

a. True

b. False

ANSWER: False

15. Which of the following statements is CORRECT?
    a. The income statement for a given year is designed to give us an idea of how much the firm earned during that year.
    b. The focal point of the income statement is the cash account, because that account cannot be manipulated by "accounting tricks."
    c. The reported income of two otherwise identical firms cannot be manipulated by different accounting procedures provided the firms follow Generally Accepted Accounting Principles (GAAP).
    d. The reported income of two otherwise identical firms must be identical if the firms are publicly owned, provided they follow procedures that are permitted by the Securities and Exchange Commission (SEC).
    e. If a firm follows Generally Accepted Accounting Principles (GAAP), then its reported net income will be identical to its reported net cash provided (used) by operating activities.

ANSWER: a

16. Which of the following statements is CORRECT?
    a. The more depreciation a firm has in a given year, the higher its EPS, other things held constant.
    b. Typically, a firm's DPS should exceed its EPS.
    c. Typically, a firm's EBIT should exceed its EBITDA.
    d. If a firm is more profitable than average (e.g., Google), we would normally expect to see its stock price exceed its book value per share.
    e. If a firm is more profitable than most other firms, we would normally expect to see its book value per share exceed its stock price, especially after several years of high inflation.

ANSWER: d

17. Companies generate income from their "regular" operations and from other sources like interest earned on the securities they hold, which is called non-operating income. Lindley Textiles recently reported $12,500 of sales, $7,250 of operating costs other than depreciation, and $1,000 of depreciation. The company had no amortization charges and no non-operating income. It had $8,000 of bonds outstanding that carry a 7.5% interest rate, and its federal-plus-state income tax rate was 25%. How much was Lindley's operating income, or EBIT?
    a. $3,462
    b. $3,644
    c. $3,836
    d. $4,038
    e. $4,250

ANSWER: e

18. Frederickson Office Supplies recently reported $12,500 of sales, $7,250 of operating costs other than depreciation, and $1,250 of depreciation. The company had no amortization charges and no non-operating income. It had $8,000 of bonds outstanding that carry a 7.5% interest rate, and its federal-plus-state income tax rate was 25%. How much was the firm's taxable income, or earnings before taxes (EBT)?
    a. $3,230.00
    b. $3,400.00
    c. $3,570.00
    d. $3,748.50
    e. $3,935.93

ANSWER: b

19. Meric Mining Inc. recently reported $15,000 of sales, $7,500 of operating costs other than depreciation, and $1,200 of depreciation. The company had no amortization charges, it had outstanding $6,500 of bonds that carry a 6.25% interest rate, and its federal-plus-state income tax rate was 25%. How much was the firm's net income after taxes? Meric uses the same depreciation expense for tax and stockholder reporting purposes.
   a. $3,789.87
   b. $3,989.33
   c. $4,199.30
   d. $4,420.31
   e. $4,641.33

ANSWER: d

20. Its retained earnings is the actual cash that the firm has generated through operations less the cash that has been paid out to stockholders as dividends. Retained earnings are kept in cash or near cash accounts and, thus, these cash accounts, when added together, will always be equal to the firm's total retained earnings.
   a. True
   b. False

ANSWER: False

21. The retained earnings account on the balance sheet does not represent cash. Rather, it represents part of stockholders' claims against the firm's existing assets. This implies that retained earnings are in fact stockholders' reinvested earnings.
   a. True
   b. False

ANSWER: True

22. On 12/31/2020, Heaton Industries Inc. reported retained earnings of $675,000 on its balance sheet, and it reported that it had $172,500 of net income during the year. On its previous balance sheet, at 12/31/2019, the company had reported $555,000 of retained earnings. No shares were repurchased during 20205. How much in dividends did Heaton pay during 2020?
   a. $47,381
   b. $49,875
   c. $52,500
   d. $55,125
   e. $57,881

ANSWER: c

23. Ullrich Printing Inc. paid out $21,750 of common dividends during the year. It ended the year with $187,500 of retained earnings versus the prior year's retained earnings of $132,250. How much net income did the firm earn during the year?
   a. $77,000
   b. $80,850
   c. $84,893
   d. $89,137
   e. $93,594

ANSWER: a

24. To estimate the cash flow from operations, depreciation must be added back to net income because it is a non-cash charge that has been deducted from revenue.
   a. True
   b. False

ANSWER: True

25. The time dimension is important in financial statement analysis. The balance sheet shows the firm's financial position at a given point in time, the income statement shows results over a period of time, and the statement of cash flows reflects <u>changes</u> in the firm's accounts over that period of time.
   a. True
   b. False

ANSWER: True

26. Which of the following statements is CORRECT?
   a. The statement of cash needs tells us how much cash the firm will require during some future period, generally a month or a year.
   b. 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.
   c. The balance sheet gives us a picture of the firm's financial position at a point in time.
   d. The income statement gives us a picture of the firm's financial position at a point in time.
   e. The statement of cash flows tells us how much cash the firm has in the form of currency and demand deposits.

ANSWER: c

27. Which of the following factors could explain why Regal Industrial Fixtures had a negative net cash flow provided (used) by operations year, even though the cash on its balance sheet increased?
   a. The company repurchased 20% of its common stock.
   b. The company sold a new issue of bonds.
   c. The company made a large investment in new plant and equipment.
   d. The company paid a large dividend.
   e. The company issued preferred stock.

ANSWER: b

28. Analysts following Armstrong Products recently noted that the company's net cash flow from operations <u>increased</u> over the prior year, yet cash as reported on the balance sheet <u>decreased</u>. Which of the following factors could explain this situation?
   a. The company issued new long-term debt.
   b. The company cut its dividend.
   c. The company made a large investment in a profitable new plant.
   d. The company sold a division and received cash in return.
   e. The company issued new common stock.

ANSWER: c

29. A security analyst obtained the following information from Prestopino Products' financial statements:

- Retained earnings at the end of the previous year were $700,000, but retained earnings at the end of the current year had declined to $320,000.
- The company does not pay dividends.
- The company's depreciation expense is its only non-cash expense; it has no amortization charges.
- The company has no non-cash revenues.
- The company's net cash provided (used) by operations for the current year was $150,000.

On the basis of this information, which of the following statements is CORRECT?

a. Prestopino had negative net income in the current year.

b. Prestopino's depreciation expense in the current year was less than $150,000.

c. Prestopino had positive net income in the current year, but its income was less than its previous year's income.

d. Prestopino's cash flow provided by operations in the current year must be higher than in the previous year.

e. Prestopino's cash on the balance sheet at the end of the current year must be lower than the cash it had on the balance sheet at the previous year.

ANSWER: a

30. Which of the following statements is CORRECT?

a. The statement of cash flows shows how much the firm's cash–the total of currency, bank deposits, and short-term liquid securities (or cash equivalents)–increased or decreased during a given year.

b. The statement of cash flows reflects cash flows from operations, but it does not reflect the effects of buying or selling fixed assets.

c. The statement of cash flows shows where the firm's cash is located; indeed, it provides a listing of all banks and brokerage houses where cash is on deposit.

d. The statement of cash flows reflects cash flows from continuing operations, but it does not reflect the effects of changes in working capital.

e. The statement of cash flows reflects cash flows from operations and from borrowings, but it does not reflect cash obtained by selling new common stock.

ANSWER: a

31. Which of the following statements is CORRECT?

a. In the statement of cash flows, a <u>decrease</u> in accounts receivable is reported as a <u>use</u> of cash.

b. Dividends do not show up in the statement of cash flows because dividends are considered to be a financing activity, not an operating activity.

c. In the statement of cash flows, a <u>decrease</u> in accounts payable is reported as a <u>use</u> of cash.

d. In the statement of cash flows, depreciation charges are reported as a use of cash.

e. In the statement of cash flows, a <u>decrease</u> in inventories is reported as a <u>use</u> of cash.

ANSWER: c

32. Lucy’s Music Emporium purchased $50 million in fixed assets in January and their accountant told them that they would have to depreciate the assets over 20 years (they use the same depreciation calculations for shareholder reporting and income tax purposes). In December they learned that their accountant did not have a college degree and fired him. They hired a new accountant with a college degree and she told them that they could depreciate the assets over 15 years. How would the new depreciation assumption affect the company's financial statements relative to the old assumption?

a. The firm's net liabilities would increase.

b. The firm's reported net fixed assets would increase.

c. The firm's EBIT would increase.

d. The firm's reported earnings per share would increase.

e. The firm's cash position would increase, all else held equal.

ANSWER: e

33. Last year Tiemann Technologies reported $10,500 of sales, $6,250 of operating costs other than depreciation, and $1,300 of depreciation. The company had no amortization charges, it had $5,000 of bonds that carry a 6.5% interest rate, and its federal-plus-state income tax rate was 25%. This year's data are expected to remain unchanged except for one item, depreciation, which is expected to increase by $750. By how much will net after-tax income change as a result of the change in depreciation? The company uses the same depreciation calculations for tax and stockholder reporting purposes.

a. -534.38

b. -562.50

c. -590.63

d. -620.16

e. -651.16

ANSWER: b

34. Which of the following statements is CORRECT?

a. If a firm reports a loss on its income statement, then the retained earnings account as shown on the balance sheet will be negative.

b. Since depreciation is a source of funds, the more depreciation a company has, the larger its retained earnings will be, other things held constant.

c. A firm can show a large amount of retained earnings on its balance sheet yet need to borrow cash to make required payments.

d. Common equity includes common stock and retained earnings, less accumulated depreciation.

e. The retained earnings account as shown on the balance sheet shows the amount of cash that is available for paying dividends.

ANSWER: c

35. Jessie's Bobcat Rentals' operations provided a <u>negative net cash flow</u> last year, yet the cash shown on its balance sheet <u>increased</u>. Which of the following statements could explain the increase in cash, assuming the company's financial statements were prepared under generally accepted accounting principles?

a. The company had high depreciation expenses.

b. The company repurchased some of its common stock.

c. The company dramatically increased its capital expenditures.

d. The company retired a large amount of its long-term debt.

e. The company sold some of its fixed assets.

ANSWER: e

36. Aubey Aircraft recently announced that its net income increased sharply from the previous year, yet its net cash flow from operations declined. Which of the following could explain this performance?

a. The company's operating income declined.

b. The company's expenditures on fixed assets declined.

c. The company's cost of goods sold increased.

d. The company's depreciation and amortization expenses declined.

e. The company's interest expense increased.

ANSWER: d

37. In accounting, emphasis is placed on determining net income in accordance with generally accepted accounting principles. In finance, the primary emphasis is also on net income because that is what investors use to value the firm. However, a secondary financial consideration is cash flow, because cash is needed to operate the business.

a. True

b. False

ANSWER: False

38. Which of the following statements is CORRECT?

a. Depreciation and amortization are not cash charges, so neither of them has an effect on a firm's reported profits.

b. The more depreciation a firm reports, the higher its tax bill, other things held constant.

c. People sometimes talk about the firm's net cash provided (used) by operations, which is shown as the lowest entry on the income statement, hence it is often called "the bottom line."

d. Depreciation reduces a firm's cash balance, so an increase in depreciation would normally lead to a reduction in the firm's net cash flow.

e. Net cash provided (used) by operations is often defined as follows:
Net cash flow provided (used) by operations = Net Income + Noncash Adjustments + Working Capital Adjustments.

ANSWER: e

39. Which of the following would be most likely to occur in the year after Congress, in an effort to increase tax revenue, passed legislation that forced companies to depreciate equipment over longer lives? Assume that sales, other operating costs, and tax rates are not affected, and assume that the same depreciation method is used for tax and stockholder reporting purposes.

a. Companies' reported net incomes would decline.

b. Companies' net operating profits after taxes (NOPAT) would decline.

c. Companies' physical stocks of fixed assets would increase.

d. Companies' free cash flows would increase.

e. Companies' cash positions would decline.

ANSWER: e

40. JBS Inc. recently reported net income of $4,750 and depreciation of $885. How much was its net cash provided (used) by operations, assuming it had no amortization expense, added $200 to inventories, sold none of its fixed assets, and had a $200 increase in accounts payable?

a. $4,831.31

b. $5,085.59

c. $5,353.25

d. $5,635.00

e. $5,916.75

ANSWER: d

41. EP Enterprises has the following income statement. How much net operating profit after taxes (NOPAT) does the firm have?

Sales	$1,800.00
Costs	1,400.00
Depreciation	250.00
EBIT	$ 150.00
Interest expense	70.00
EBT	$ 80.00
Taxes (25%)	20.00
Net income	$60.00

a. $101.53

b. $106.88

c. $112.50

d. $118.13

e. $124.03

ANSWER: c

42. Bae Inc. has the following income statement. How much net operating profit after taxes (NOPAT) does the firm have?

Sales	$2,000.00
Costs	1,200.00
Depreciation	100.00
EBIT	$ 700.00
Interest expense	200.00
EBT	$ 500.00
Taxes (25%)	125.00
Net income	$375.00

a. $427.62

b. $450.12

c. $473.81

d. $498.75

e. $525.00

ANSWER: e

43. Total net operating capital is equal to net fixed assets.

a. True

b. False

ANSWER: False

44. Net operating profit after taxes (NOPAT) is the amount of net income a company would generate from its operations if it had no interest income or interest expense.

a. True

b. False

ANSWER: True

45. The current cash flow from existing assets is highly relevant to the investor. However, since the value of the firm depends primarily upon its growth opportunities, profit projections from those opportunities are the only relevant future flows with which investors are concerned.

a. True

b. False

ANSWER: False

46. For managerial purposes, i.e., making decisions regarding the firm's operations, the standard financial statements as prepared by accountants under Generally Accepted Accounting Principles (GAAP) are often modified and used to create alternative data and metrics that provide a somewhat different picture of a firm's operations. Related to these modifications, which of the following statements is CORRECT?

a. The standard statements make adjustments to reflect the effects of inflation on asset values, and these adjustments are normally carried into any adjustment that managers make to the standard statements.

b. The standard statements focus on accounting income for the entire corporation, not cash flows, and the two can be quite different during any given accounting period. However, for valuation purposes we need to discount cash flows, not accounting income. Moreover, since many firms have a number of separate divisions, and since division managers should be compensated on their divisions' performance, not that of the entire firm, information that focuses on the divisions is needed. These factors have led to the development of information that is focused on cash flows and the operations of individual units.

c. The standard statements provide useful information on the firm's individual operating units, but management needs more information on the firm's overall operations than the standard statements provide.

d. The standard statements focus on cash flows, but managers are less concerned with cash flows than with accounting income as defined by GAAP.

e. The best feature of standard statements is that, if they are prepared under GAAP, the data are always consistent from firm to firm. Thus, under GAAP, there is no room for accountants to "adjust" the results to make earnings look better.

ANSWER: b

47. Which of the following statements is CORRECT?

a. A shortcut to calculate free cash flow (FCF) is defined as follows:
FCF = Net income + Depreciation and Amortization.

b. Changes in working capital have no effect on free cash flow.

c. Free cash flow (FCF) is defined as follows:
FCF = EBIT(1 − T)
+ Depreciation and Amortization
− Capital expenditures required to sustain operations
− Required changes in net operating working capital.

d. Free cash flow (FCF) is defined as follows:
FCF = EBIT(1 − T)+ Depreciation and Amortization + Capital expenditures.

e. Net cash provided (used) by operations is the same as free cash flow (FCF).

ANSWER: c

48. Danielle's Sushi Shop last year had (1) a negative net 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?

a. The company had a sharp increase in its depreciation and amortization expenses.

b. The company had a sharp increase in its inventories.

c. The company had a sharp increase in its accrued liabilities.

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

e. The company made a large capital investment early in the year.

ANSWER: d

Name:________________________________ Class:____________________ Date:___________

49. Swinnerton Clothing Company's balance sheet showed total current assets of $2,250, all of which were required in operations. Its current liabilities consisted of $575 of accounts payable, $300 of 6% short-term notes payable to the bank, and $145 of accrued wages and taxes. What was its net operating working capital that was financed by investors?

a. $1,454
b. $1,530
c. $1,607
d. $1,687
e. $1,771

ANSWER: b

50. NNR Inc.'s balance sheet showed total current assets of $1,875,000 plus $4,225,000 of net fixed assets. All of these assets were required in operations. The firm's current liabilities consisted of $475,000 of accounts payable, $375,000 of 6% short-term notes payable to the bank, and $150,000 of accrued wages and taxes. Its remaining capital consisted of long-term debt and common equity. What was NNR's total investor-provided operating capital?

a. $4,694,128
b. $4,941,188
c. $5,201,250
d. $5,475,000
e. $5,748,750

ANSWER: d

51. TSW Inc. had the following data for last year: Net income = $800; Net operating profit after taxes (NOPAT) = $700; Total assets = $3,000; and Total operating capital = $2,000. Information for the just-completed year is as follows: Net income = $1,000; Net operating profit after taxes (NOPAT) = $925; Total assets = $2,600; and Total operating capital = $2,500. How much free cash flow did the firm generate during the just-completed year?

a. $383
b. $425
c. $468
d. $514
e. $566

ANSWER: b

52. Rao Corporation has the following balance sheet. How much net operating working capital does the firm have?

Cash	$ 10	Accounts payable	$ 20
Short-term investments		Accruals	20
Accounts receivable	50	Notes payable	50
Inventory	40	Current liabilities	$ 90
Current assets	$130	Long-term debt	0
Net fixed assets	100	Common equity	30
		Retained earnings	50
Total assets	$230	Total liab. & equity	$230

a. $54.00
b. $60.00
c. $66.00
d. $72.60

e. $79.86

ANSWER: b

53. Tibbs Inc. had the following data for the most recent year: Net income = $300; Net operating profit after taxes (NOPAT) = $400; Total assets = $2,500; Short-term investments = $200; Stockholders' equity = $1,800; Total debt = $700; and Total operating capital = $2,300. What was its return on invested capital (ROIC)?

a. 14.91%

b. 15.70%

c. 16.52%

d. 17.39%

e. 18.26%

ANSWER: d

54. Zumbahlen Inc. has the following balance sheet. How much total operating capital does the firm have?

Cash	$ 20.00	Accounts payable	$ 30.00
Short-term investments	50.00	Accruals	50.00
Accounts receivable	20.00	Notes payable	30.00
Inventory	60.00	Current liabilities	$110.00
Current assets	$150.00	Long-term debt	70.00
Gross fixed assets	$140.00	Common stock	30.00
Accumulated deprec.	40.00	Retained earnings	40.00
Net fixed assets	$100.00	Total common equity	$ 70.00
Total assets	$250.00	Total liab. & equity	$250.00

a. $114.00

b. $120.00

c. $126.00

d. $132.30

e. $138.92

ANSWER: b

55. Wells Water Systems recently reported $8,250 of sales, $4,500 of operating costs other than depreciation, and $950 of depreciation. The company had no amortization charges, it had $3,250 of outstanding bonds that carry a 6.75% interest rate, and its federal-plus-state income tax rate was 25%. In order to sustain its operations and thus generate sales and cash flows in the future, the firm was required to spend $750 to buy new fixed assets and to invest $250 in net operating working capital. How much free cash flow did Wells generate?

a. $2,050.00

b. $2,152.50

c. $2,260.13

d. $2,373.13

e. $2,491.79

ANSWER: a

56. Last year, Michelson Manufacturing reported $10,250 of sales, $3,500 of operating costs other than depreciation, and $1,250 of depreciation. The company had no amortization charges, it had $3,500 of bonds outstanding that carry a 6.5% interest rate, and its federal-plus-state income tax rate was 25%. This year's data are expected to remain unchanged except for one item, depreciation, which is expected to increase by $725. By how much will the depreciation change cause the

firm's net after-tax income to change? Note that the company uses the same depreciation calculations for tax and stockholder reporting purposes.

a. −$442.89
b. −$466.20
c. −$490.73
d. −$516.56
e. −$543.75

ANSWER: e

57. Bartling Energy Systems recently reported $9,250 of sales, $5,750 of operating costs other than depreciation, and $700 of depreciation. The company had no amortization charges, it had $3,200 of outstanding bonds that carry a 5% interest rate, and its federal-plus-state income tax rate was 25%. In order to sustain its operations and thus generate sales and cash flows in the future, the firm was required to make $1,250 of capital expenditures on new fixed assets and to invest $300 in net operating working capital. By how much did the firm's <u>net income exceed its free cash flow</u>?

a. $658.83
b. $693.50
c. $730.00
d. $766.50
e. $804.83

ANSWER: c

58. Which of the following statements is CORRECT?

a. The primary difference between EVA and accounting net income is that when net income is calculated, a deduction is made to account for the cost of common equity, whereas EVA represents net income before deducting the cost of the equity capital the firm uses.
b. MVA gives us an idea about how much value a firm's management has added during the last year.
c. MVA stands for market value added, and it is defined as follows:
MVA = (Shares outstanding)(Stock price) + Book value of common equity.
d. EVA stands for economic value added, and it is defined as follows:
EVA = EBIT(1 − T) − (Investor-supplied op. capital) × (A − T cost of capital).
e. EVA gives us an idea about how much value a firm's management has added over the firm's life.

ANSWER: d

59. Which of the following statements is CORRECT?

a. One way to increase EVA is to achieve the same level of operating income but with more investor-supplied capital.
b. If a firm reports positive net income, its EVA must also be positive.
c. One drawback of EVA as a performance measure is that it mistakenly assumes that equity capital is free.
d. One way to increase EVA is to generate the same level of operating income but with less investor-supplied capital.
e. Actions that increase reported net income will always increase net cash flow from operations.

ANSWER: d

60. Over the years, Janjigian Corporation's stockholders have provided $15,250 of capital, part when they purchased new issues of stock and part when they allowed management to retain some of the firm's earnings. The firm now has 1,000 shares of common stock outstanding, and it sells at a price of $42.00 per share. How much value has Janjigian's

management added to stockholder wealth over the years, i.e., what is Janjigian's MVA?

a. $21,788

b. $22,935

c. $24,142

d. $25,413

e. $26,750

ANSWER: e

61. Barnes' Brothers has the following data for the year ending 12/31/2015: Net income = $600; Net operating profit after taxes (NOPAT) = $700; Total assets = $2,500; Short-term investments = $200; Stockholders' equity = $1,800; Total debt = $700; and Total operating capital = $2,100. Barnes' weighted average cost of capital is 10%. What is its economic value added (EVA)?

a. $399.11

b. $420.11

c. $442.23

d. $465.50

e. $490.00

ANSWER: e

62. HHH Inc. reported $12,500 of sales and $7,025 of operating costs (including depreciation). The company had $18,750 of investor-supplied operating assets (or capital), the weighted average cost of that capital (the WACC) was 9.5%, and the federal-plus-state income tax rate was 25%. What was HHH's Economic Value Added (EVA), i.e., how much value did management add to stockholders' wealth during the year?

a. $2,098.31

b. $2,208.75

c. $2,325.00

d. $2,441.25

e. $2,563.31

ANSWER: c

63. The fact that 50% of the interest income received by a corporation is excluded from its taxable income encourages firms to use more debt financing than they would in the absence of this tax law provision.

a. True

b. False

ANSWER: False

64. If the tax laws were changed so that $0.50 out of every $1.00 of interest paid by a corporation was allowed as a tax-deductible expense, this would probably encourage companies to use more debt financing than they presently do, other things held constant.

a. True

b. False

ANSWER: False

65. The interest and dividends paid by a corporation are considered to be deductible operating expenses, hence they decrease the firm's tax liability.

a. True

b. False

ANSWER: False

66. Interest paid by a corporation is a tax deduction for the paying corporation, but dividends paid are not deductible. This treatment, other things held constant, tends to encourage the use of debt financing by corporations.

a. True

b. False

ANSWER: True

67. Which of the following statements is CORRECT?

a. All corporations other than non-profit corporations are subject to corporate income taxes, which are 15% for the lowest amounts of income and 35% for the highest amounts of income.

b. The income of certain small corporations that qualify under the Tax Code is completely exempt from corporate income taxes. Thus, the federal government receives no tax revenue from these businesses.

c. All businesses, regardless of their legal form of organization, are taxed under the Business Tax Provisions of the Internal Revenue Code.

d. Small businesses that qualify under the Tax Code can elect not to pay corporate taxes, but then their owners must report their pro rata shares of the firm's income as personal income and pay taxes on that income.

e. Congress recently changed the tax laws to make dividend income received by individuals exempt from income taxes. Prior to the enactment of that law, corporate income was subject to double taxation, where the firm was first taxed on the income and stockholders were taxed again on the income when it was paid to them as dividends.

ANSWER: d

68. Assume that Congress recently passed a provision that will enable Barton's Rare Books (BRB) to double its depreciation expense for the upcoming year but will have no effect on its sales revenue or tax rate. Prior to the new provision, BRB's net income after taxes was forecasted to be $4 million. Which of the following best describes the impact of the new provision on BRB's financial statements versus the statements without the provision? Assume that the company uses the same depreciation method for tax and stockholder reporting purposes.

a. Net fixed assets on the balance sheet will decrease.

b. The provision will reduce the company's free cash flow.

c. The provision will increase the company's tax payments.

d. Net fixed assets on the balance sheet will increase.

e. The provision will increase the company's net income.

ANSWER: a

69. The LeMond Corporation just purchased a new production line. Assume that the firm planned to depreciate the equipment over 5 years on a straight-line basis, but Congress then passed a provision that requires the company to depreciate the equipment on a straight-line basis over 7 years. Other things held constant, which of the following will occur as a result of this Congressional action? Assume that the company uses the same depreciation method for tax and stockholder reporting purposes.

a. LeMond's tax liability for the year will be lower.

b. LeMond's taxable income will be lower.

c. LeMond's net fixed assets as shown on the balance sheet will be higher at the end of the year.

d. LeMond's cash position will improve (increase).

e. LeMond's reported net income after taxes for the year will be lower.

ANSWER: c

70. DeYoung Devices Inc., a new high-tech instrumentation firm, is building and equipping a new manufacturing facility. Assume that currently its equipment must be depreciated on a straight-line basis over 10 years, but Congress is considering legislation that would require the firm to depreciate the equipment over 7 years. If the legislation becomes law, which of the following would occur in the year following the change?

a. The firm's reported net income would increase.

b. The firm's operating income (EBIT) would increase.

c. The firm's taxable income would increase.

d. The firm's net cash flow provided (used) by operations would increase.

e. The firm's tax payments would increase.

ANSWER: d

71. Olivia Hardison, CFO of Impact United Athletic Designs, plans to have the company issue $500 million of new common stock and use the proceeds to pay off some of its outstanding bonds. Assume that the company, which does not pay any dividends, takes this action, and that total assets, operating income (EBIT), and its tax rate all remain constant. Which of the following would occur?

a. The company would have to pay less taxes.

b. The company's taxable income would fall.

c. The company's interest expense would remain constant.

d. The company would have less common equity than before.

e. The company's net income would increase.

ANSWER: e

72. Which of the following statements is CORRECT?

a. The maximum federal tax rate on personal income can exceed 50%.

b. Since companies can deduct dividends paid but not interest paid, our tax system favors the use of equity financing over debt financing, and this causes companies' debt ratios to be lower than they would be if interest and dividends were both deductible.

c. Interest paid to an individual is counted as income for tax purposes and taxed at the individual's regular tax rate, but dividends received are taxed at a maximum rate of 20%.

d. The maximum federal tax rate on corporate income is 50%.

e. Corporations obtain capital for use in their operations by borrowing and by raising equity capital, either by selling new common stock or by retaining earnings. The cost of debt capital is the interest paid on the debt, and the cost of the equity is the dividends paid on the stock. Both of these costs are deductible from income when calculating income for tax purposes.

ANSWER: c

73. Edwards Electronics recently reported $11,250 of sales, $5,500 of operating costs other than depreciation, and $1,250 of depreciation. The company had no amortization charges, it had $3,500 of bonds that carry a 6.25% interest rate, and its federal-plus-state income tax rate was 25%. How much was its net operating profit after taxes (NOPAT)?

a. $2,748.96

b. $2,893.64

c. $3,045.94

d. $3,206.25

e. $3,375.00

ANSWER: e