МИНИСТЕРСТВО ОБРАЗОВАНИЯ И НАУКИ РОССИЙСКОЙ ФЕДЕРАЦИИ

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«НИЖЕГОРОДСКИЙ ГОСУДАРСТВЕННЫЙ
ЛИНГВИСТИЧЕСКИЙ УНИВЕРСИТЕТ
ИМ. Н.А. ДОБРОЛЮБОВА»

КАФЕДРА ЭКОНОМИКИ И УПРАВЛЕНИЯ

Основы финансового менеджмента

ПРАКТИЧЕСКИЕ ЗАДАНИЯ

Учебно-методические материалы

на английском языке

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Chapter 1. ACCOUNTING STATEMENTS AND CASH FLOWS

1.1. The Balance Sheet

Discussion questions

1. What is the balance-sheet equation?
2. What three things should be kept in mind when looking at a balance sheet?
3. Where is a manufacturer's inventory reported in the balance sheet?
4. What is the difference between interest expense and interest payable?
5. What is notes receivable?
6. What is the difference between notes payable and notes receivable?
7. What do Tangible fixed assets include?
8. What causes a corporation's market value to be greater than its book value?

Problem solving

DSW is a designer shoe warehouse, selling some of the most luxurious and fashionable shoes at prices that people can actually afford. Its year-end balance sheet, at January 28, 2012, contained the following items (in thousands).

Accounts payable	$ 85,820
Accounts receivable	4,088
Cash	124,709
Contributed capital	278,709
Notes payable	63,410
Other assets	282,947
Other liabilities	53,769
Property, plant, and equipment	95,921
Retained earnings	26,007
Total assets	507,715
Total assets and stockholders' equity	?

1. Prepare the balance sheet as of January 28, solving for the missing amount.
2. As of January 28, did most of the financing for assets come from creditors or stockholders?

1.2. Net Working Capital

Discussion questions

1. What is net working capital?
2. What is the change in net working capital?

3. When can Net Working Capital be negative?
4. How can working capital be improved?
5. What does the amount of working capital depend on in different businesses?

1.3. The Income Statement

Discussion questions

1. What is the income statement equation?
2. What are three things to keep in mind when looking at an income statement?
3. What are noncash expenses?
4. On December 1 a company borrowed $100,000 at 12% per year. The interest will be paid quarterly, with the first payment due on March 1. What should the company report on its income statement for December?

Problem solving

Regal Entertainment Group operates movie theaters and food concession counters throughout the United States. Its income statement for the quarter ended September 28, 2012, reported the following amounts (in thousands):

Admissions revenues	$ 450,600
Concessions expenses	27,700
Concession revenues	181,000
Film rental expenses	241,100
General and administrative expenses	65,800
Net income	?
Other expenses	230,800
Other revenues	44,100
Rent expense	81,000
Total expenses	?

1. Solve for the missing amounts and prepare an income statement for the quarter ended September 28, 2012.

TIP: First put the items in the order they would appear on the income statement and then solve for the missing values

2. What is Regal's main source of revenue and biggest expense?

1.4. Cash Flow Statement

Discussion questions

1. How is cash flow different from changes in net working capital?
2. What is the difference between operating cash flow and total cash flow of the firm?
3. How can a company have a profit but not have cash?
4. Why is an increase in inventory shown as a negative amount in the statement of cash flows?
5. What is cash from operating activities?
6. What is the purpose of the cash flow statement?

Problem solving

1. For items 1-10 indicate whether they will have a **positive** or **negative** effect on cash. A **positive effect** could also be thought of as a source of cash, an increase in cash, or a positive amount on the cash flow statement. A **negative effect** could also be thought of as a use of cash, a decrease in cash, or a negative amount on the cash flow statement.

    1. An increase in the balance of Prepaid Insurance.
    2. A decrease in Supplies on hand.
    3. The proceeds from the sale of equipment formerly used in the business.
    4. The Loss on the Sale of Equipment in the previous question.
    5. An increase in the current liability Income Taxes Payable.
    6. A decrease in Accounts Payable.
    7. An increase in Accounts Receivable.
    8. An increase in the current liability Warranty Liability.
    9. Dividends declared and paid.
    10. The Gain on the Sale of Equipment formerly used in the business.

2. For a recent year, a corporation's financial statements reported the following:

Net Income	$100,000
Depreciation Expense	10,000
Increase in Accounts Receivable	30,000
Decrease in Accounts Payable	15,000

Based on the above information, what amount will the corporation report as Cash Provided by Operating Activities on the cash flow statement?

a) $65,000 b) $125,000 c) $155,000

3. A corporation reported the following information for the past year:

Net Income	$200,000
Depreciation Expense	30,000
Gain on Sale of Truck	5,000
Proceeds from Sale of Truck	8,000
Decrease in Accounts Receivable	10,000

Assuming these are the only facts, what amount will the corporation report as the Cash Provided by Operating Activities on the cash flow statement?

a. $225,000
b. $235,000
c. $253,000

4. Using the information in Question #32, what amount will be reported under Cash From Investing Activities?

a. $3,000
b. $8,000
c. $13,000

KEY TERMS

Income statement

Cash flow

Current assets

Current liabilities

Noncash items

Cash and equivalents

Accounts receivable

Account payable

Notes payable

Accrued expenses

Deferred taxes

Long-term debt

Net property

Preferred stock

Common stock

Capital surplus

Accumulated retained earnings

Change in net working capital

Operating cash flow

Free cash flow

Net working capital

Interest expense

Dividend payments

Generally accepted accounting principles (GAAP)

Accrual accounting

Accounting liquidity

Test on Chapter 1

1. *The term Fixed Assets includes all of the following except:*
    a) furniture;
    b) franchises and patents;
    c) long term investments in Government Bonds;
    d) prepaid expenses.

2. *In finance, the term Gross Block refers to:*
   a) the written down value of total fixed assets;
   b) the original cost of total fixed assets;
   c) the total capital value of the firm;
   d) the blocks and buildings of the firm.
3. *For any firm, TA = TL + OE, where TA is Total Assets, TL is Total Liabilities and OE is Owner's Equity. Also, OE = TA – TL. The owner's Equity will increase if:*
   a) assets decrease and Liabilities remain unchanged;
   b) assets remain unchanged and Liabilities decrease;
   c) assets decrease and Liabilities increase;
   d) both assets and liabilities increase by the same amount.
4. *Revenue arises from all of the following sources except:*
   a) sale of personal jewelry of the Director or proprietor;
   b) sale of goods to customers;
   c) rendering services or supplying the firm's resources;
   d) sale of fixed assets that are not of use to the firm.
5. *In which of the following cases is the Net Working Capital affected?*
   a) issue of shares to Vendors for the purchase of Building;
   b) issue of Bills Payable to Creditors;
   c) receipt of cash on account of sale of Machinery;
   d) loss on sale of Machinery.
6. *Other things held constant, which of the following will cause an increase in working capital?*
   a) cash is used to buy marketable securities;
   b) a cash dividend is declared and paid;
   c) merchandise is sold at a profit, but the sale is on credit;
   d) missing inventory is written off against retained earnings.
7. *Which of the following would increase the Cash Flow of a firm?*
   a) Decrease in "Income in Advance";
   b) An increase in the prepaid expenses of the firm;
   c) An increase in debtors;
   d) A decrease in Inventory.
8. *An investor uses the income statement to determine:*
   a) whether the company has enough cash to pay current liabilities;
   b) if the company has invested too much cash in current assets;
   c) how much a company has earned for a given period of time;
   d) how much a company has earned cumulatively as of a given date.

9. *Revenues are technically defined as:*
   a) amounts earned from providing goods and services;
   b) amounts collected from providing goods and services;
   c) decreases in net assets;
   d) decreases in net assets as a result of day to day activities.
10. *Which of the following is not a true statement?*
   a) revenues cause an increase in net assets;
   b) expenses cause a decrease in net assets;
   c) net income and change in cash are the same thing;
   d) net income is not the same thing as retained earnings.
11. *Which of the following expenses is usually listed towards the bottom of the income statement?*
   a) cost of goods sold;
   b) rent expense;
   c) accrued expenses;
   d) tax expense.
12. *Which of the following is a condition that must be met for revenue to be recognized on the income statement?*
   a) cash must be collected;
   b) delivery of goods or services has occurred;
   c) a promise to deliver goods or services has been made;
   d) all of the above.
13. *Which of the following is a true statement?*
   a) Expenses are always recorded when cash is paid;
   b) Revenue is recognized when it is earned;
   c) Expenses are not matched against revenues in the same period;
   d) Cash received after services is provided is called unearned revenue.
14. *An accrued expense is:*
   a) an expense that has been paid for;
   b) an expense that has been incurred but not yet paid for;
   c) a revenue that has a future expense associated with it;
   d) none of the above.
15. *The principle that states that all expenses incurred in the revenue process should be recorded in the same period as the revenue generated is:*
   a) the revenue principle;
   b) the expense principle;
   c) the matching principle;
   d) the historical cost principle.

16. *Which of the following will be an expense on this period's income statement:*
    a) cash paid for the utility bill;
    b) the amount on the utility bill for services provided this period;
    c) the estimated amount for advertising for next month;
    d) amounts paid in advance for insurance coverage?
17. *Which of the following will be recorded as revenue in this period's income statement:*
    a) cash collected from customers for last months services provided;
    b) the value of services provided last month;
    c) cash collected for services to be provided next month;
    d) the value of services provided this month?
18. *When total revenues are greater than total expenses, a company has:*
    a) a net loss;
    b) a net income;
    c) a net gain;
    d) a decrease in net assets.
19. *Net Sales minus the Cost of Goods Sold equals:*
    a) gross profit;
    b) income from operations;
    c) net income;
    d) net loss.
20. *A company disposes of equipment that it no longer uses in its business. The amount received by the company is more than the amount the asset is carried at in the accounting records. The company will report a(n):*
    a) expense;
    b) gain;
    c) loss;
    d) revenue.

Chapter 2. FINANCIAL STATEMENT ANALYSIS

2.1. Short-Term Solvency (Liquidity Ratios)

Discussion questions

1. What is short-term solvency?
2. What does current ratio show?
3. What is the difference between current ratio and quick ratio?

Problem solving

1. Look at the financial information of Berry Corp.

Current assets:		*Current liabilities:*	
Inventories	$20,000	Accounts payable	$18,000
Sundry debtors	5,000	Short-term loan	15,000
Cash on hand	12,000	Bank overdraft	5,000
Cash at bank	8,000	Outstanding expenses	3,000
Accounts receivables	35,000	Provision for taxation	10,000
Short-term investments	15,000	Proposed dividends	12,000
Total:	95,000	Total:	63,000

Compute current ratio, acid test ratio the ratio of operating cash flow to current debt obligations and analyze the results.

2. On December 31, a company's records show the following information:

Cash	$ 10,000
Accounts Receivable	30,000
Inventory	80,000
Prepaid Insurance	6,000
Long-term Assets	200,000
Accounts Payable	30,000
Notes Payable due in 10 months	25,000
Wages Payable	5,000
Long-term Liabilities	70,000
Stockholders' (Owner's) Equity	196,000

Compute the company's working capital, the current ratio and the quick ratio.

2.2. Activity (Asset Management Ratios)

Discussion questions

1. What do Asset Management Ratios show?
2. What does Total Asset Turnover measure?
3. What does Accounts Receivable Turnover measure?
4. How is Inventory turnover calculated?
5. What is the debt ratio?
6. What is the debt to equity ratio?

Problem Solving

1. Pepper Corp. reported sales for 2011 of $23 million. Tater and Pepper listed $5.6 million of inventory on its balance sheet. Calculate Tater and Pepper's 2011 EBIT. Using a 365 day year, how many days did Tater and Pepper's inventory stay on the premises? How many times per year did Tater and Pepper's inventory turnover?

2. Tater Corp. ended the year 2011 with an average collection period of 32 days. The firm's credit sales for 2011 were $33 million. What is the year-end 2008 balance in accounts receivable for Tater Corp.?

2.3. Profitability

Discussion questions

1. What is the price earnings ratio?
2. What is the difference between gross profit margin and gross margin?
3. What is the book value per share of stock?
4. What is the total asset turnover ratio?
5. What is the return on assets ratio?
6. What is the working capital turnover ratio?
7. What is the free cash flow ratio?

Problem Solving

1. For its most recent year a company had Sales (all on credit) of $830,000 and Cost of Goods Sold of $525,000. At the beginning of the year its Accounts Receivable were $80,000 and its Inventory was $100,000. At the end of the year its Accounts Receivable were $86,000 and its Inventory was $110,000.

Calculate the inventory turnover ratio, the accounts receivable turnover ratio. On average how many days of sales were in Accounts Receivable during the year?

On average how many days of sales were in Inventory during the year?

2.4. Market Value Ratios

Discussion Questions

1. What is fair market value?

2. What is Price-to-Earnings (P/E) Ratio?

3. Why is Dividend Yield interesting for investors?

Problem Solving

A company's net income after tax was $400,000 for its most recent year. The company's income statement included Income Tax Expense of $140,000 and Interest Expense of $60,000. At the beginning of the year the company's stockholders' equity was $1,900,000 and at the end of the year it was $2,100,000.

1. *What is the times interest earned for the company?*
   a) 6.7
   b) 9.0
   c) 10.0
2. *What is the after-tax return on stockholder's equity for the year?*
   a) 20%
   b) 25%
   c) 30%

Test on Chapter 2

3. *Which of the following is not a current asset?*
   a) Inventory;
   b) Prepaid Insurance ;
   c) Fixtures.

4. *Current asset MINUS current liabilities is the*
   a) current ratio;
   b) net worth;
   c) working capital.
5. *Current assets DIVIDED BY current liabilities is the*
   a) current ratio;
   b) the net worth ratio;
   c) working capital.
6. *The quick ratio EXCLUDES which of the following?*
   a) Accounts Receivable;
   b) Inventory;
   c) Cash.
7. *Which of the following are likely to have the reported amounts on the balance sheet being close to their current value?*
   a) Current Assets;
   b) Long-term Assets;
   c) Stockholders' Equity.
8. *A corporation's excellent reputation will be listed among the corporation's assets on its balance sheet.*
   a) True
   b) False
9. *The current market value of a corporation is approximately the amount reported on the balance sheet as stockholders' equity.*
   a) True
   b) False
10. *Free cash flow is the cash provided by operating activities minus the cash used by financing activities.*
   a) True
   b) False
11. *Which ratio is a test of liquidity?*
   a) Net profit margin;
   b) Inventory turnover;
   c) Times interest earned;
   d) Debt-to-assets.
12. *Which ratio is not a test of profitability?*
   a) Gross profit margin;
   b) Fixed asset turnover;

c) Earnings per share;
d) Current ratio.

13. *If a company increases the selling price of the product it sells and all other data on the financial statements remains the same, which of the following ratios will be unaffected?*
a) Fixed asset turnover;
b) Net profit margin;
c) Inventory turnover;
d) Earnings per share.

14. *Listed below are four companies with their respective current ratios. Based on these current ratios, which company is in the most liquid position?*
a) A, 2.0
b) B, 1.8
c) C, 2.5
d) D, 2.1

15. *Which of the following ratios uses information that comes only from the balance sheet?*
a) Debt-to-assets
b) Earnings per share
c) Inventory turnover
d) Accounts receivable turnover

16. *Which of the following ratios uses information that comes only from the income statement?*
a) Earnings per share
b) Debt-to-assets
c) Gross profit percentage
d) Return on equity

17. *If an analyst wants to examine a company's short-run ability to survive, which of the following would best be considered?*
a) Liquidity
b) Market share
c) Profitability
d) Solvency

18. *Although the inventory turnover ratio is an important analytical tool for many companies, it would be most crucial for a company that*
a) provides legal services
b) sells cell phones and electronic organizers

c) manufactures steel
d) sells paint

19. *A company has $72,500 of inventory at the beginning of the year and $65,500 at the end of the year. Sales revenue is $986,400, cost of goods sold is $572,700, and net income is $124,200 for the year. The inventory turnover ratio is:*
a) 1.8.
b) 8.3.
c) 6.0.
d) 14.3.

20. *An increase in the inventory turnover rate is indicative of:*
a) a reduction in the cost of goods sold.
b) a decrease in the supply of inventory.
c) an increase in the supply of inventory.
d) an increase in sales revenue.

Word Scramble for Financial Ratios

	Word Clue	**Scrambled Answer**	**Unscrambled Answer**
1.	Current assets minus current liabilities is __________ capital.	GRNOKWI	
2.	Current assets divided by current liabilities is the ___________ ratio.	RTUCENR	
3.	Cost of goods sold divided by average inventory is the inventory _______________.	RRETNVOU	
4.	Net ______ sales divided by accounts receivable is the receivables turnover ratio.	RDEICT	
5.	Days sales in accounts receivable is 365 divided by the _____________ turnover ratio.	BESVEELARIC	
6.	This is excluded from the current assets when calculating the quick ratio.	TRNEYOVNI	

7.	Another name for the quick ratio is the _______ test ratio.	CADI	
8.	__________ analysis results in all income statement amounts expressed as a percentage of net sales.	TREILAVC	
9.	___________-size balance sheets show all amounts as a percentage of total assets.	OMCNOM	
10.	_____________ analysis results in amounts expressed as a percentage of an earlier, base year.	LAOOTHINZR	
11.	The debt to equity ratio is the ratio of _____________ to stockholders' equity.	BIISETIIALL	
12.	When dividing income statement amounts by balance sheet amounts, it is logical to use an ____________ of the balance sheet amounts.	GERVAAE	
13.	Financial ratios are part of financial statement ____________.	SNYIASLA	
14.	The current ratio and the quick ratio are indicators of a company's __________.	IIUDTYIQL	
15.	The profit margin ratio and the return on assets are indicators of a company's _____________.	IYITATLOIRBPF	
16.	A very large amount of debt in relation to the amount of assets indicates that a company is highly _________________.	DEARGEEVL	
17.	Vertical analysis is associated with ___________-size financial statements.	OOCMMN	
18.	Horizontal analysis is associated with ________ analysis.	DETRN	
19.	The receivables _______________	NVRUORET	

	ratio is net credit sales divided by the average amount of accounts receivable.		
20.	Accountants calculate the inventory turnover ratio by dividing the _______ of goods sold by the average inventory.	SOTC	

KEY TERMS

Financial distress

Insolvency

Shelf life

Operating Cycle

Turnover

Debt Ratio

Debt to Equity Ratio

Return on Equity, Profit Margin

EBIT

Return on Assets (ROA)

Return on Equity (ROE)

Payout Ratio

Sustainable Growth Rate

Price-to-Earnings (P/E) Ratio

Dividend Yield

Chapter 3. CAPITAL BUDGETING ANALYSIS

3.1. Stages of capital budgeting analysis

Discussion questions

1. Share your opinion on the following idea: “How we spend our money today determines what our value will be tomorrow”.
2. What are sources of options of capital projects?
3. What reasons make financial management recognize time value of money?
4. How much do you have to invest today to receive $200 next year? The interest rate is 10%.
5. If the interest rate were 10% per period, what would $200 in two periods be worth today?
6. Should a company focus on cash flow or accounting profit when making a capital expenditure decision?
7. Should capital decisions be based on cash flow or revenues and expenses?
8. What do opportunity costs mean?

3.2. Calculating the Discounted Cash Flow

Discussion questions

1. What is relevant to project cash flow?
2. What does overhead mean? Give examples.
3. What is the difference between the initial and terminal cash flows?
4. What is the difference between proceeds and net proceeds?
5. Is depreciation a cash item?
6. What is a straight-line method of depreciation?
7. We plan to invest in a three-year project and assume that it will generate the following cash flows: year 1 – 100, year 2 – 200, year 3 – 250. The interest rate is 12%. Calculate the total present value of the project.
8. Why are net proceeds from sale called “net”?

3.3. Criteria of Projects Evaluating

Discussion questions

1. What are the criteria for evaluating a project?
2. How should the investor proceed if the NPV of the project is negative? And if NPV =0? Explain your point of view.
3. What is the internal rate of return?

4. You may invest $450 in the project in #7 from previous Discussion Questions. What would your decision? (PV has been already calculated).
5. Why does the IRR equate to a NPV of zero?
6. How do you calculate a payback period?
7. What is the difference between payback period and discounted payback period?
8. What is disinvestment?

Test on Chapter 3

1. *Making the proper investment decision depends on:*
   a) Individual's preference for consumption;
   b) Individual's patience or impatience;
   c) Alternatives in the financial markets;
   d) Project returns.
2. *The time value of money is important for three reasons. These three reasons are:*
   a) Inflation, uncertainty, and opportunity costs.
   b) Relevancy, stability, and consistency.
   c) Project returns, costs, and timing.
   d) Project options, positions, and variables.
3. *Which of the following is relevant in determining the cash flows of a project?*
   a) Sunk costs
   b) Depreciation
   c) Payback period
   d) Net Present Value
4. *You are about to invest $ 15,000 into a project that will generate $ 5,500 of cash flows each year for the next 3 years. If your cost of capital is 11%, then the present value of future cash flows is:*
   a) $ 23,218
   b) $ 13,442
   c) $ 11,612
   d) $ 10,808
5. *Referring back to question 4, the Net Present Value of the project is:*
   a) $ 6,418
   b) $ 8,218
   c) $ (1,558)
   d) $ (4,192)

6. *You are considering investing in a new cotton-bailing machine. The purchase price of new bailer is $ 10,000. It will cost $ 750 to transport the bailer to your location. The old bailer will be sold for $ 2,000 and your tax rate is 40%. The net investment for this project is:*
   a) $ 11,950
   b) $ 10,750
   c) $ 9,550
   d) $ 8,950
7. *One method for managing project risk is to use:*
   a) Sensitivity Analysis
   b) Discounted Payback
   c) Net Investment
   d) Project Turnover
8. *Discounting means*
   a) Converting the present amount into its equivalent future value amount:
   b) Calculating the payback period of a project;
   c) Converting the future amount into its equivalent present value amount;
   d) Comparing the project with alternatives in the financial markets.
9. *A company used the net present value method for evaluating a project. The project requires an immediate cash outlay of $450,000. The company discounted the cash flows by 16% and determined that the net present value of the project was a negative $300. From this information it is likely that the project*
   a) had an internal rate of return that was slightly GREATER than 16%
   b) had an internal rate of return that was slightly LESS than 16%
   c) had a negative internal rate of return
10. *A company is planning to invest $100,000 in order to receive $50,000 one year later, $40,000 two years later, and $60,000 three years later. Using the present value of 1 factors for 16% (see above), the net present value of this investment is*
   a) ($11,000)
   b) $11,000
   c) $100,000
   d) $111,000
11. *A $100,000 investment will be made on January 1. The cash generated from this investment is expected to be received uniformly during each year. The yearly amounts are: $50,000 in the first year; $40,000 in the second year; $60,000 in the third year. What is the expected payback period?*
   a) 2 years
   b) 2.1 years

c) 2.17 years
d) 3 years

12. *Depreciation Expense is a negative cash flow that needs to be discounted* (true/false).
13. *While depreciation does not result in a payment of cash, tax depreciation does reduce the cash payments for income taxes* (true/false).
14. *Depreciation Expense can be ignored when computing the accounting rate of return* (true/false).
15. *If the net present value of a project is $0, the project should be rejected* (true/false).
16. *A project whose future cash flows are discounted by 10% will have a larger net present value than the same cash flows discounted by 8%* (true/false).
17. *What amount would you invest today in return for a one-time $10,000 receipt one year from today, if you want to earn 8%?*
    a) $9,200
    b) $9,300
    c) $9,920
18. *If you invest $15,900 today and receive $10,000 at the end of one year plus $10,000 at the end of four years, what is the internal rate of return on your investment?*
    a) 6%
    b) 8%
    c) 10%
    d) 12%
    e) 16%
19. *If you invest $15,300 today and receive $10,000 at the end of one year and $10,000 at the end of four years, what is the internal rate of return on your investment?*
    a) 6%
    b) 8%
    c) 10%
    d) 12%
    e) 16%
20. *You invest $10,000 immediately plus an additional $100,000 at the end of one year. If the time value of money is 10%, what is the present value of your investment?*
    a) $100,000
    b) $101,000
    c) $110,000

KEY TERMS

Decision tree

Discounted cash flows

Discount rate

Net Present Value

Net proceeds

Opportunity costs

Overhead

Payback period

Rate of return

Salvage value

Sunk costs

Uncertainty

Chapter 4. MANAGEMENT OF CAPITAL

4.1. The Economics of Capital

Discussion questions

1. What are the sources of funds for business?
2. What is the cost of capital?
3. What do people base on while investing?
4. What should investors adjust their returns for?
5. How does the rate of return on capital influence investment spending?
6. If the business earns more than its cost of capital, what will happen to market value of business?
7. How does taxation influence the cost of capital?
8. Why is the management of capital so important?

4.2. Managing the capital

Discussion questions

1. What is optimal capital structure?
2. What issues do we have when we raise capital?
3. What is the difference between stakeholder and stockholder?
4. What are advantages to using stocks?
5. What are advantages to using debt?
6. What conditions affect how we raise capital?
7. What is financial leverage?
8. What is operating leverage?

Problem solving

1. A software company has invested $10 million into development and marketing for its latest application program, which sells for $45 per copy. Each copy costs the company $5 to sell. Sales volume reaches one million copies. Compute the degree of operational leverage and explain the result.

2. Mean Corp sells 5,000 units of its products at $10.00 each. Variable Cost per unit = $ 6.00, Fixed Costs = $12,000. Compute DOL and make a conclusion.

3. Voltar Company manufactures and sells a telephone answering machine. The company's income statement is given below.

	Total	Per Unit
Sales	$1,200,000	$60
Less variable expenses	$900,000	$45
Contribution margin		
Less fixed expenses	$240,000	
Net operating income		

Fill in the necessary data and calculate DOL.

4.3. Approaches to Managing the Capital

Discussion questions

1. What is Net Operating Income Approach?
2. What is Net Income Approach?
3. What did Modigliani and Miller conclude on the capital structure?
4. According to them, what gives rise to values?

5. According to M. Jensen, what signal does a company send to investors whenever it makes a change in its capital structure?
6. What is pecking order?
7. What is free cash flow?

4.4. Calculating the Cost of Capital

Discussion Questions

1. Why do we have to know the overall cost of capital?
2. What are components of capital?
3. What is WACC and how is it calculated?
4. What is CAPM?
5. Why is 30-year US Treasury Bonds good benchmark for the risk free rate?
6. What is retained earnings?
7. What is the difference between business risk and financial risk?
8. Why does the cost of capital grow if we invest in a long-term project?

Test on Chapter 4

1. *The cost a business must pay for the use of long-term funds is called the:*
   a) Indifference Point
   b) Cost of Capital
   c) Prime Lending Rate
   d) Risk Free Rate of Return
2. *One of the advantages of issuing debt over equity is that debt:*
   a) Has no maturity date.
   b) Reduces risk.
   c) Requires no fixed payments.
   d) Has a tax deduction for interest payments.
3. *When a company uses increased fixed costs for production, this is an example of what type of leverage?*
   a) Operating Leverage
   b) Financial Leverage
   c) Variable Cost Leverage
   d) Money Market Leverage
4. *According to the pecking order, which of the following sources of capital would managers use first?*
   a) Bonds (Debt)
   b) Common Stock
   c) Preferred Stock

d) Retained Earnings

5. *Delphi Corporation has common stock with a listed beta coefficient of 1.40. U.S. Treasury. Bonds are paying 6.2% and the overall market rate according to Standard and Poor's is 13.5%. Using the Capital Asset Pricing Model (CAPM), the cost of common stock is:*
   a) 10.22%
   b) 13.50%
   c) 16.44%
   d) 18.33%
6. *Gemini Corporation has summarized its capital structure as follows: Component Cost of Capital Market Value, Long-term Bonds 5.8% after tax $ 150,000, Common Stock 12.5% $ 450,000. Based on the above information, Gemini's weighted average cost of capital is:*
   a) 10.83%
   b) 11.50%
   c) 16.70%
   d) 12.50%
7. *Fleming Corporation has plans to raise $2 million in capital by issuing 50,000 shares of $ 20.00 common stock and by issuing $1 million in bonds 12% interest. Fleming's tax rate is 40%. Fleming expects EBIT (Earnings Before Interest Taxes) of $ 4.5 million and its current capital structure consists only of common stock - 250,000 shares outstanding. What will EPS (Earnings per Share) be after the financing plan?*
   a) $ 6.67
   b) $ 7.97
   c) $ 8.76
   d) $ 9.00
8. *A common method for assessing risk associated with financing plans is to calculate:*
   a) Beta Coefficient
   b) Marginal Cost of Capital
   c) Breakeven EPS
   d) Coverage Ratios
9. *When a privately held company decides to "go public", it must go through a process known as:*
   a) Initial Public Offering
   b) Debt for Equity Swap
   c) Stock Buyback Program
   d) Option Selling

10. *The overall (weighted average) cost of capital is composed of a weighted average of _*
    a) The cost of common equity and the cost of debt
    b) The cost of common equity and the cost of preferred stock
    c) The cost of preferred stock and the cost of debt
    d) The cost of common equity, the cost of preferred stock, and the cost of debt
11. *The beta coefficient measures:*
    a) The return relative to the risk-free rate
    b) The return relative to the market return
    c) The historical volatility relative to the market's volatility
    d) The required return on a financial asset
12. *One assumption underlying the use of the cost of capital to analyze capital projects is that:*
    a) Current costs will remain the same
    b) Capital structure will vary with the type of financing
    c) Different risk projects are required to diversify the firm
    d) The analyzed projects are of comparable risk to existing projects
13. *The cost of capital is:*
    a) Used as an evaluation tool
    b) Based on the present cost obligation's of the firm
    c) The cost of long-term investment
    d) The cost of maintaining the bureaucrats in Ottawa
14. *The formula for the Capital Asset Pricing Model (CAPM) is:*
    a) $K_j = R_f + b\ (R_f - R_m)$
    b) $K_j = R_f + b\ (R_m - R_f)$
    c) $K = R + b\ (R - M)$
    d) $K = R + b\ (R - R)$
15. *The cost of retained earnings is equal to:*
    a) The return on new common stock
    b) The return on preferred stock
    c) The return on existing common stock
    d) It does not have a cost.
16. *The least expensive form of financing for the firm is:*
    a) Existing common stock
    b) Preferred stock
    c) Debt
    d) New common stock
17. *In determining the appropriate capital mix, the starting point for the firm is:*
    a) The cost of common equity

b) The optimum capital structure
c) The present capital structure
d) The after-tax cost of debt

18. *Financial capital:*
a) Appears under liabilities and equity on the corporate income statement
b) And the optimum capital structure are the same
c) Consists of common stock, preferred stock and retained earnings only
d) Consists of stocks, bonds and retained earnings

19. *Regardless of the type of asset being acquired, the appropriate discount rate is:*
a) The aftertax cost of debt
b) The required rate of return
c) The weighted average cost of capital
d) The cost of equity capital

20. *The cost of debt is measured by:*
a) The yield to maturity on the firm's bonds
b) The coupon rate on the firm's bonds
c) The weighted average cost of capital
d) The marginal cost of capital

KEY TERMS

cost of capital

preferred stock,

common stock,

retained earnings

taxation

bonds

maturity date

outstanding debt

leverage

EBIT (earnings before interest taxes).

WACC

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