Chapter 1 Overview of Financial Management

MULTIPLE CHOICE

1. Which of the following statements describes an activity which is financial management?
   a. Looking after trade payables and corporate accounting is not a responsibility of the controller.
   b. Monitoring the profit for the year which is the difference between revenue and gross profit.
   c. The treasurer raising funds.
   d. Ensuring that the cost of borrowing is greater than the return on assets.

   ANS: C PTS: 1 REF: 11 OBJ: LO 2
   BLM: Higher Order

2. Which of the following statements describes a financial management activity?
   a. Arranging internal financing is obtained from banks and investors.
   b. Ensuring liquidity by managing the payment of dividends.
   c. Operating decisions dealing with better utilization of non-current assets.
   d. The stability objective is related to the financial structure of a business.

   ANS: D PTS: 1 REF: 15 OBJ: LO 4
   BLM: Remember

3. Which of the following activities is NOT a financial management function?
   a. The treasurer is responsible for corporate accounting.
   b. External financing is obtained from investors.
   c. Internal financing is obtained from retained earnings and depreciation/amortization.
   d. Improving net profit through the use of productivity indicators and planned downsizing.

   ANS: A PTS: 1 REF: 11 OBJ: LO 3
   BLM: Remember

4. What is the ultimate objective of financial management?
   a. to ensure the ROA is higher than ROR
   b. to obtain a higher ROR than ROA
   c. to ensure that ROA is higher than the cost of financing
   d. to collect trade receivables faster than the payment of trade and other payables

   ANS: C PTS: 1 REF: 7 OBJ: LO 2
   BLM: Remember

5. Which activity is the controller responsible for?
   a. general accounting
   b. tax administration
   c. investor relations
   d. analyzing short- and long-term borrowing sources

   ANS: A PTS: 1 REF: 11 OBJ: LO 3
   BLM: Remember

6. What is considered an "efficiency" financial objective?
   a. the ability to meet short-term financial commitments
   b. the ability minimize the cost of borrowed funds
   c. the return on trade receivables
   d. the return on revenue

   ANS: D PTS: 1 REF: 13 OBJ: LO 4
   BLM: Remember

7. What does the profit for the year pay for?
   a. executive bonuses
   b. interest on debt
   c. dividends
   d. employee salaries

   ANS: C PTS: 1 REF: 17 OBJ: LO 5
   BLM: Remember

8. Which of the following is a source of internal financing?
   a. revenue
   b. depreciation/amortization
   c. mortgages
   d. long-term borrowings

   ANS: B PTS: 1 REF: 16 OBJ: LO 5
   BLM: Remember

9. What do investing decisions deal with?
   a. the cost of borrowed funds
   b. planned downsizing
   c. buying non-current assets
   d. the financing mix

   ANS: C PTS: 1 REF: 19 OBJ: LO 5
   BLM: Remember

10. What type of decision is the management of working capital?
    a. an operating decision
    b. an investing decision
    c. a financing decision
    d. a capital budgeting decision

    ANS: A PTS: 1 REF: 23 OBJ: LO 5
    BLM: Remember

11. How is gross profit determined?
    a. by deducting the cost of sales from revenue
    b. by deducting operating expenses from revenue
    c. by deducting income tax expense from profit before taxes
    d. by deducting distribution costs from operating profit

    ANS: A PTS: 1 REF: 13 OBJ: LO 4
    BLM: Remember

12. How is ROR calculated?
    a. by dividing income before taxes by revenue
    b. by dividing cost of sales by revenue
    c. by dividing revenue by cost of sales
    d. by dividing profit for the year by revenue

    ANS: D PTS: 1 REF: 14 OBJ: LO 4
    BLM: Higher Order

13. Under which of these circumstances is a company a good investment?
    a. A company is a good investment when the ROR is less than the cost of financing.
    b. A company is a good investment when the ROA is greater than the cost of financing.
    c. A company is a good investment when the ROA is less than the cost of capital.
    d. A company is a good investment when the ROR is greater than the cost of financing.

    ANS: B PTS: 1 REF: 14 OBJ: LO 4
    BLM: Higher Order

14. What term is defined as "the activity involved in raising funds and buying assets in order to obtain the highest possible return”?
    a. accounting
    b. marketing management
    c. general management
    d. financial management

    ANS: D PTS: 1 REF: 7 OBJ: LO 2
    BLM: Remember

15. Why is it important for managers to ask, "How are we doing?"
    a. It is required by their employment contract.
    b. Investors want to know about a company's financial performance.
    c. Interest groups have illegitimate and corresponding objectives.
    d. Government agencies want to know about a company's financial performance.

    ANS: B PTS: 1 REF: 8 OBJ: LO 3
    BLM: Remember

16. Who is responsible for credit and collection in a company?
    a. the bookkeeper
    b. the controller
    c. the accountant
    d. the treasurer

    ANS: B PTS: 1 REF: 11 OBJ: LO 3
    BLM: Remember

17. What term refers to the relationship between assets and profit for the year?
    a. stability
    b. efficiency
    c. liquidity
    d. prosperity

    ANS: B PTS: 1 REF: 13 OBJ: LO 4
    BLM: Remember

18. What does ROA measure?
    a. efficiency
    b. liquidity
    c. fluency
    d. prosperity

    ANS: A PTS: 1 REF: 13 OBJ: LO 4
    BLM: Remember

19. What type of decision is made when a company decides whether to arrange a mortgage, sell bonds, or issue shares?
    a. a financing decision using internal financing
    b. an operating decision using internal financing
    c. a financing decision using external financing
    d. an operating decision using external financing

    ANS: C PTS: 1 REF: 20 OBJ: LO 5
    BLM: Remember

20. Which of the following demonstrates the matching principle?
    a. paying dividends to shareholders
    b. ensuring that Assets = Liabilities + Equity
    c. selecting the most appropriate financing source when buying an asset
    d. systematically cutting overhead costs

    ANS: C PTS: 1 REF: 20 OBJ: LO 5
    BLM: Higher Order

21. What type of decisions relate to accounts on the statement of income?
    a. accounting decisions
    b. investing decisions
    c. financing decisions
    d. operating decisions

    ANS: D PTS: 1 REF: 16 OBJ: LO 5
    BLM: Remember

22. What is most likely to result from rewarding quality work instead of fast work?
    a. decreased profitability
    b. improved gross profit and bottom line
    c. higher costs
    d. decreased worker pride

    ANS: B PTS: 1 REF: 23 OBJ: LO 5
    BLM: Higher Order

23. What structure does stability refer to?
    a. the revenue structure
    b. the working capital structure
    c. the cost structure
    d. the financial structure

    ANS: D PTS: 1 REF: 15 OBJ: LO 4
    BLM: Remember

24. Which of the following activities is NOT financial management?
    a. Ensuring that a company's ROA is higher than the cost of financing.
    b. Ensuring that all operating managers participate in making investing and financing decisions.
    c. Ensuring that a company uses its resources in the most efficient and effective way.
    d. Ensuring that a company raises sufficient funds.

    ANS: B PTS: 1 REF: 8 OBJ: LO 2
    BLM: Higher Order

25. Which of the following statements concerning the role of a non-financial manager is false?
    a. The non-financial manager who is responsible for resources or budgets should be familiar with the language of finance.
    b. Business decisions made by non-financial managers do affect the financial performance of the organization.
    c. All non-financial managers are really financial managers because their actions ultimately affect the financial statements.
    d. Capital budgeting, ratio analysis, and break-even are financial tools used by non-financial managers.

    ANS: D PTS: 1 REF: 16 OBJ: LO 5
    BLM: Remember

26. What does the weighted average cost of capital address?
    a. investments made only by lenders
    b. long-term financing
    c. short-term borrowings
    d. investments made only by shareholders

    ANS: B PTS: 1 REF: 21 OBJ: LO 4
    BLM: Higher Order

27. Which of the following is used to calculate the gross profit?
    a. extraordinary expenses
    b. operating expenses
    c. revenue
    d. the cost of inventory

    ANS: C PTS: 1 REF: 23 OBJ: LO 5
    BLM: Remember

28. Who is least likely to be interested in reading a company's financial statements?
    a. investors
    b. lenders
    c. journalists
    d. suppliers

    ANS: C PTS: 1 REF: 12 OBJ: LO 3
    BLM: Higher Order

29. Who will be a user of financial statements, and what will they be used for?
    a. Lenders will use financial statements to decide whether to invest in a company.
    b. Investors will use financial statements to decide whether to lend money to a company.
    c. The marketing department is interested in the operating income figures in the financial statements.
    d. Managers will use financial statements to make decisions about their company.

    ANS: D PTS: 1 REF: 10 OBJ: LO 3
    BLM: Remember

30. What is income tax expense deducted from to determine profit for the year?
    a. revenue
    b. profit before taxes
    c. distribution expenses before taxes
    d. profit before cost of sales

    ANS: B PTS: 1 REF: 12 OBJ: LO 3
    BLM: Higher Order

31. What term refers to raising funds and buying assets to obtain the highest possible return?
    a. financial management
    b. materials management
    c. operations management
    d. asset management

    ANS: A PTS: 1 REF: 7 OBJ: LO 2
    BLM: Remember

32. Which of the following is used to calculate the weighted average cost of capital?
    a. mortgage payable
    b. accrued expenses
    c. profit for the year
    d. trade and other payables

    ANS: A PTS: 1 REF: 21 OBJ: LO 5
    BLM: Remember

33. Which of the following is a reason why financial management is important for business owners?
    a. It informs owners exactly what will happen in the coming year.
    b. It informs owners how much cash is on hand.
    c. It allows managers to determine what the operating costs are.
    d. It provides information about historical financial performance.

    ANS: B PTS: 1 REF: 6 OBJ: LO 1
    BLM: Higher Order

34. Who is responsible for raising capital dollars in a company?
    a. the manager
    b. the owner
    c. the treasurer
    d. the controller

    ANS: C PTS: 1 REF: 11 OBJ: LO 3
    BLM: Remember

35. What two items are used to measure liquidity?
    a. cash and marketable securities
    b. cash and shareholders equity
    c. total assets and total liabilities
    d. current assets and current liabilities

    ANS: D PTS: 1 REF: 14 OBJ: LO 4
    BLM: Higher Order

36. Which of the following is an investing decision?
    a. deciding if any dividends are paid
    b. deciding what capital assets to acquire
    c. deciding whether to obtain funds from shareholders and lenders
    d. deciding how much to spend on administrative expenses

    ANS: B PTS: 1 REF: 16-19 OBJ: LO 5
    BLM: Remember

37. What is the chief financial officer NOT responsible for?
    a. general accounting
    b. insurance
    c. dividend payments
    d. pension plans

    ANS: C PTS: 1 REF: 10 OBJ: LO 3
    BLM: Remember

38. Who requires skills in reading financial statements, capital budgeting and break-even and cost benefit analysis?
    a. human resources staff
    b. taxation authorities
    c. operating managers
    d. the Senior Vice President, Sales

    ANS: C PTS: 1 REF: 11-12 OBJ: LO 3
    BLM: Remember

39. What is a major goal of an operating manager?
    a. to improve relations with investors
    b. to formulate budgeting policies
    c. to raise funds from investors
    d. to improve financial performance

    ANS: D PTS: 1 REF: 11 OBJ: LO 3
    BLM: Remember

40. What must plans include if they are to be expressed in measurable terms?
    a. terms such as *good*, *medium*, and *bad*
    b. specific expressions of corporate financial objectives
    c. a reference to the firm's well-being
    d. quantities and dollar amounts

    ANS: D PTS: 1 REF: 11 OBJ: LO 3
    BLM: Higher Order

41. What do managers examine to assess the impact of their decisions on the financial well-being of their organization?
    a. general corporation correspondence
    b. statistical reports
    c. financial pages of newspapers
    d. financial statements

    ANS: D PTS: 1 REF: 12 OBJ: LO 3
    BLM: Remember

42. Which of the following is an example of an external financing source?
    a. mortgage payable
    b. profit for the year
    c. retained earnings
    d. depreciation/amortization

    ANS: A PTS: 1 REF: 17 OBJ: LO 5
    BLM: Remember

43. What is an example of "sources" of funds?
    a. land
    b. automobile
    c. share capital
    d. machinery and equipment

    ANS: C PTS: 1 REF: 17 OBJ: LO 5
    BLM: Remember

44. What is an example of an internal source of funds?
    a. mortgages
    b. retained earnings
    c. common shares
    d. bonds

    ANS: B PTS: 1 REF: 16 OBJ: LO 5
    BLM: Remember

45. What is an example of an external source of funds?
    a. mortgages
    b. decreased receivables
    c. depreciation/amortization
    d. retained earnings

    ANS: A PTS: 1 REF: 16 | 17 OBJ: LO 5
    BLM: Remember

46. Which of the following statements describes a source of funds?
    a. Operating at a loss is a source of funds.
    b. Trade credit is a source of funds.
    c. Dividends paid are a source of funds.
    d. Investments in all types of assets are sources of funds.

    ANS: B PTS: 1 REF: 18 OBJ: LO 5
    BLM: Remember

47. Which of the following is NOT an operating decision?
    a. Deciding on the amount of operating expenses.
    b. Deciding on the amount of operating revenue.
    c. Deciding on the amount of equipment to buy for the operating divisions.
    d. Deciding on the amount of equity capital to raise for operating divisions.

    ANS: A PTS: 1 REF: 23 OBJ: LO 5
    BLM: Higher Order

48. Which of the following is NOT a source of financing?
    a. equipment vendors
    b. investment bankers
    c. dividends
    d. commercial banks

    ANS: C PTS: 1 REF: 19 OBJ: LO 5
    BLM: Remember

49. Which of the following are “forms” of financing?
    a. instalment loans
    b. unsecured short-term borrowings
    c. inventories
    d. term loans

    ANS: C PTS: 1 REF: 20 OBJ: LO 5
    BLM: Remember

50. Which of the following is an example of an investing decision?
    a. buying inventory
    b. buying non-current assets
    c. selling trade receivables
    d. selling a bond

    ANS: B PTS: 1 REF: 19 OBJ: LO 5
    BLM: Remember

51. What term refers to an increase in non-current assets between two accounting periods?
    a. cash outflow
    b. source of cash
    c. cash inflow
    d. revenue

    ANS: A PTS: 1 REF: 18 OBJ: LO 5
    BLM: Remember

52. Which of the following is an example of a non-current liability?
    a. trade receivables
    b. inventories
    c. mortgage payable
    d. goodwill

    ANS: C PTS: 1 REF: 18 OBJ: LO 5
    BLM: Higher Order

53. Which of the following statements describes the effect of taxes on interest and dividends?
    a. Income taxes increase the cost of borrowing.
    b. Income taxes increase the cost of preferred dividends.
    c. Preferred share dividends are deductible for tax purposes.
    d. Finance costs are deductible for tax purposes.

    ANS: D PTS: 1 REF: 20 OBJ: LO 5
    BLM: Higher Order

54. When does cash flow increase?
    a. when inventories are reduced
    b. when trade receivables are increased
    c. when revenue is reduced
    d. when non-current assets are purchased

    ANS: A PTS: 1 REF: 18 OBJ: LO 5
    BLM: Higher Order

TRUE/FALSE

1. An important objective of financial management is to ensure that the cost of borrowed funds is higher than the return on assets.

   ANS: F PTS: 1 REF: 7

2. Efficiency means the ability of a firm to meet its short-term obligations.

   ANS: F PTS: 1 REF: 13

3. Financial management ensures that operating managers formulate accounting and financial policies that are clearly defined.

   ANS: F PTS: 1 REF: 8

4. Financial management deals with two things: raising funds and buying and utilizing assets in order to gain the highest possible return.

   ANS: T PTS: 1 REF: 8

5. The controller is the person responsible for establishing the accounting and financial reporting policies and procedures.

   ANS: T PTS: 1 REF: 11

6. The treasurer is the person responsible for budgets and analysis.

   ANS: F PTS: 1 REF: 11

7. One key function of the treasurer is "investor relations".

   ANS: T PTS: 1 REF: 11

8. Efficiency measures the relationship between profit for the year (outputs) generated and assets employed (inputs).

   ANS: T PTS: 1 REF: 13

9. Liquidity focuses on the ability of a firm to grow (i.e., revenue, profit for the year, etc.).

   ANS: F PTS: 1 REF: 14

10. Stability deals with the relationship between debt and equity.

   ANS: T PTS: 1 REF: 15

11. Funds obtained from "external financing" include depreciation/amortization and retained earnings.

ANS: F PTS: 1 REF: 16

12. Reducing working capital accounts such as trade receivables and inventories can generate funds "internally".

ANS: T PTS: 1 REF: 16

13. Capital shares can be considered an "external" source of funds.

ANS: T PTS: 1 REF: 16

14. Investing decisions relate to borrowing funds from investors.

ANS: F PTS: 1 REF: 19

15. Investing decisions has to do with the management of current assets.

ANS: F PTS: 1 REF: 19

16. Financing decisions focus on long-term borrowings.

ANS: T PTS: 1 REF: 20

17. A commercial bank is a "form" of financing.

ANS: F PTS: 1 REF: 20

18. A term loan and mortgage are considered "forms" of financing.

ANS: T PTS: 1 REF: 8

19. A component of "financing decisions" is determining the proportion of funds that should be raised from lenders versus owners.

ANS: T PTS: 1 REF: 16

20. The matching principle is the process of selecting the most appropriate financing source when selling an asset.

ANS: F PTS: 1 REF: 20

21. Financing mix is an important component of "financing decisions".

ANS: T PTS: 1 REF: 20

22. Revenue and cost of sales are accounts shown on the statement of income that deal with operating decisions.

    ANS: T PTS: 1 REF: 23

23. Planned downsizing is a recession-driven technique to add management layers in organizational charts to cut costs.

    ANS: F PTS: 1 REF: 15

24. Gross profit is the difference between revenue and cost of sales.

    ANS: T PTS: 1 REF: 14 | 23

25. Decisions affecting gross profit are found in two categories of expenses: distribution costs and cost of sales.

    ANS: F PTS: 1 REF: 24

26. Two accounts that affect profit for the year are distribution costs and administrative expenses.

    ANS: T PTS: 1 REF: 24

27. The purpose of the Sarbanes-Oxley Act was to set new standards for all public company boards, management and public accounting firm.

    ANS: T PTS: 1 REF: 25

28. Corporate governance has to do with the management of federal and provincial, or territorial, government organizations"

    ANS: F PTS: 1 REF: 26

29. Corporate culture is a management wave that appeared in the early 1980s and has to do with a shared system of values and beliefs within an organization.

    ANS: T PTS: 1 REF: 26

30. A key role of the *International Accounting Standards Committee* is to review and reinforce the convergence of global management standards for all publicly owned corporations.

    ANS: F PTS: 1 REF: 27

COMPLETION

1. Financial management is the activity that has to do with raising funds and buying ____________________ in order to obtain the highest possible return.

   ANS: assets

   PTS: 1 REF: 7

2. The ____________________ is the person responsible for establishing the accounting and financial reporting policies and procedures.

   ANS: controller

   PTS: 1 REF: 11

3. The ____________________ is the person responsible for raising funds.

   ANS: treasurer

   PTS: 1 REF: 11

4. Financial management activities are carried out by three individuals, the ____________________, the controller and managers.

   ANS: treasurer

   PTS: 1 REF: 11

5. General accounting is the responsibility of the ____________________.

   ANS: controller

   PTS: 1 REF: 11

6. ____________________ means productivity of assets, which can be measured by the relationship between profit for the year and revenue.

   ANS: Efficiency

   PTS: 1 REF: 13

7. ____________________ is a financial objective that shows if a firm has the ability to meet its short-term obligations.

   ANS: Liquidity

   PTS: 1 REF: 14

8. There are four financial objectives: efficiency, liquidity, _____________________ and stability.

   ANS: prosperity

   PTS: 1 REF: 15

9. _____________________is a financial objective that deals with the relationship between debt and equity.

   ANS: Stability

   PTS: 1 REF: 15

10. There are three types of business decisions: investing, operating and _____________________.

    ANS: financing

    PTS: 1 REF: 16

11. Funds obtained from retained earnings and depreciation/amortization are considered _____________________ financing.

    ANS: internal

    PTS: 1 REF: 16

12. Funds obtained from investors are considered _____________________ decisions.

    ANS: financing

    PTS: 1 REF: 16

13. _____________________ decisions relate to the acquisition of non-current assets.

    ANS: Investing

    PTS: 1 REF: 17

14. The acquisition of a business and the purchase of non-current assets are considered _____________________ decisions.

    ANS: investing

    PTS: 1 REF: 17

15. ____________________ assets are statement of financial position accounts such as land, buildings and equipment.

ANS: Non-current

PTS: 1 REF: 17

16. ____________________ provide funds to a business in the form of trade and other payables.

ANS: Suppliers

PTS: 1 REF: 8

17. ____________________ decisions deal with many accounts appearing on the statement of income.

ANS: Operating

PTS: 1 REF: 16

18. Gross profit is the different between revenue and ____________________.

ANS: cost of sales

PTS: 1 REF: 23

19. Profit for the year is the difference between ____________________and income tax expense.

ANS: profit before taxes

PTS: 1 REF: 24

20. ____________________ is defined as the process of decision-making and the process by which decisions are implemented (or not implemented).

ANS: Governance

PTS: 1 REF: 26

MATCHING

Match each term with the correct definition.

a. controller
b. treasurer
c. efficiency
d. liquidity
e. prosperity

1. external activities
2. internal activities
3. revenue
4. return on sales
5. meeting short-term commitments

1.	ANS:	B	PTS:	1	REF:	11
2.	ANS:	A	PTS:	1	REF:	11
3.	ANS:	E	PTS:	1	REF:	15
4.	ANS:	C	PTS:	1	REF:	13
5.	ANS:	D	PTS:	1	REF:	14

Match each term with the correct definition.

a. efficiency
b. prosperity
c. internal financing
d. external financing
e. stability

6. relationship between equity and debt
7. retained earnings
8. revenue, profit for the year, working capital
9. profit for the year ÷ revenue
10. mortgage

6.	ANS:	E	PTS:	1	REF:	15
7.	ANS:	C	PTS:	1	REF:	16
8.	ANS:	B	PTS:	1	REF:	15
9.	ANS:	A	PTS:	1	REF:	13
10.	ANS:	D	PTS:	1	REF:	17

Match each term with the correct definition.

a. investing decisions
b. efficiency
c. operating decision
d. financing decision
e. liquidity

11. machinery and equipment
12. profit for the year
13. return on revenue
14. dividends
15. working capital

11.	ANS: A	PTS: 1	REF: 19
12.	ANS: C	PTS: 1	REF: 23
13.	ANS: B	PTS: 1	REF: 13
14.	ANS: D	PTS: 1	REF: 20
15.	ANS: E	PTS: 1	REF: 14

Match each term with the correct definition.

a. accounting
b. investor relations
c. dividends
d. return on assets
e. cost of capital

16. controller
17. efficiency
18. shareholders
19. treasurer
20. investors

16.	ANS: A	PTS: 1	REF: 11
17.	ANS: D	PTS: 1	REF: 7
18.	ANS: C	PTS: 1	REF: 14
19.	ANS: B	PTS: 1	REF: 11
20.	ANS: E	PTS: 1	REF: 21

Match each term with the correct definition.

a. statement of income
b. matching principle
c. planned downsizing
d. trade receivables
e. capital asset

21. budgeting technique
22. working capital account
23. operating decision
24. equipment
25. financing

21. ANS: C	PTS: 1	REF: 11
22. ANS: D	PTS: 1	REF: 23
23. ANS: A	PTS: 1	REF: 23
24. ANS: E	PTS: 1	REF: 19
25. ANS: B	PTS: 1	REF: 20

PROBLEM

1. An individual intends to invest $100,000 in a new business. The financial projections show that during the first year of operations the business will generate $12,500 in profit for the year. Calculate the expected return on assets?

   The return on assets is __________________ .

   ANS:
   ROA is 12.5%
   Profit for the year $ 12,500 ÷
   Total assets $100,000

   PTS: 1 REF: 9

2. Using the following information, calculate the company's average daily sales:
   Revenue is $250,000
   Cost of sales is $230,000
   Trade receivables is $100,000

   The average daily sales is __________________ .

   ANS:
   Average daily sales is $684.93
   Revenue $250,000 ÷
   Number of days 365

   PTS: 1 REF: 23

3. A company invested $100,000 in a business. During the first year of operations the business generated $25,000 in profit before taxes. The company's income tax rate is 25%. Calculate the company's return on investment.

   The company's return on investment is _________________ .

   ANS:
   ROA is 18.75%.

Profit before taxes	$ 25,000	
Income tax expense	$ 6,250	($25,000 × 25%)
Profit for the year	$ 18,750 ÷	
Investment	$ 100,000	

   PTS: 1 REF: 20

4. With the following information, calculate the company's weighted cost of capital. Assume that all costs are on an after-tax basis.

		Cost
Mortgage	$400,000	6.0%
Bond	300,000	4.0%
Capital shares	300,000	
		10.0%

   The weighted average cost of capital is _________________ .

   ANS:
   The weighted average cost of capital is 6.6%.

	Proportion	Cost	Weighted	Cost
Mortgage	$400,000	0.40	6.0%	2.4%
Bond	300,000	0.30	4.0%	1.2%
Capital shares	300,000	0.40	10.0%	3.0%
		1.0		6.6%

   PTS: 1 REF: 21

5. A company wants to reinvest 60% of their $60,000 profit for the year in their business and use the rest to pay down the principal on its loan and dividends to their common shareholders. The company expects to invest 70% of their retained earnings in non-current assets and 30% in working capital. The company's revenue is $600,000.

   On the basis of this information, calculate how much the managers would keep in their business for growth reasons and how much would be used to pay off their loan and the amount that would be invested in non-current assets and in working capital.

   Retained earnings: $______________ Loan and dividends: $______________
   Non-current assets: $______________ Working capital: $______________

   ANS:
   60% of the $60,000 profit for the year is $36,000 allocated for retained earnings
   40% of the $60,000 profit for the year is $24,000 allocated to pay the loan and dividends

   70% of the $36,000 retained earnings or $25,200 will be spent on non-current assets
   30% of the $36,000 retained earnings or $10,800 will be spent on working capital

   PTS: 1 REF: 15

Statement of Income

Revenue	$ 3,000,000
Cost of sales	(2,000,000)
Gross profit	1,000,000
Operating expenses	(650,000)
Profit before taxes	350,000
Income tax expense	(150,000)
Profit for the year	$ 200,000

Statement of Financial Position

Non-current assets	$ 1,200,000	Equity	$ 800,000	
Inventories	400,000	Long-term borrowings		800,000
Trade receivable	380,000	Trade and other payables	100,000	
Cash	$ 20,000	Short-term borrowings		$ 300,000

Short-term borrowings interest rate	8 % (before tax)
Long-term borrowings interest rate	6 % (before tax)
Shareholders expected return on investment	12%

6. The company’s current assets are ________________________ .

ANS:
Current assets are $800,000.

Inventories	$ 400,000	
Trade receivables		380,000
Cash		20,000
Current assets		$ 800,000

PTS: 1 REF: 23

7. The company’s current liabilities are ________________________ .

ANS:
Current liabilities are $400,000.

Short-term borrowings	$ 300,000
Trade and other payables	100,000
Current liabilities	$ 400,000

PTS: 1 REF: 23

8. The company’s net working capital is ________________________ .

ANS:
Net working capital is $400,000.

Current assets	$ 800,000	
Current liabilities		400,000
Net working capital	$ 400,000	

PTS: 1 REF: 23

9. The company’s total assets is ________________________ .

ANS:
Total assets are $2,000,000.

Non-current assets	$ 1,200,000
Inventories	400,000
Trade receivables	380,000
Cash	20,000
Total assets	$ 2,000,000

PTS: 1 REF: 8

10. The company's total liabilities are ________________________ .

ANS:
Total liabilities are $1,200,000.

Long-term borrowings	$	800,000
Short-term borrowings		300,000
Trade and other payables		100,000
Total liabilities		$ 1,200,000

PTS: 1 REF: 8

11. The company's total equity and liabilities is ________________________ .

ANS:
Total equity and liabilities is $2,000,000.

Equity	$	800,000	
Total liabilities		1,200,000	
Total liabilities and equity			$ 2,000,000

PTS: 1 REF: 8

12. The company's return on assets is ________________________ .

ANS:
Return on assets is 10%.

Profit for the year	$ 200,000 ÷
Total assets	$2,000,000

PTS: 1 REF: 13

13. The company's return on revenue is ________________________ .

ANS:
Return on revenue is 6.7%.

Profit for the year	$ 200,000 ÷
Revenue	$3,000,000

PTS: 1 REF: 13

14. The company's after tax cost of financing is ________________________ .

ANS:
The after tax cost of financing is 7.21%.

	Sources	Proportion		After-tax cost		Weighted cost of financing
Equity	$ 800,000	42.1	×	12.0 %	=	5.05 %
Long-term borrowings	800,000	42.1	×	3.4 %	=	1.43 %
Short-term borrowings	300,000	15.8	×	4.6 %	=	.73 %
Total	$ 1,900,000	100.0				7.21 %

The company's income tax rate is 42.8% ($150,000 ÷ $350,000).

After tax cost for the short-term borrowings	4.6% (8% × 57.2)
After tax cost for the long-term borrowings	3.4% (6% × 57.2)
Shareholders expected return	12.0%

PTS: 1 REF: 22

15. If the statement of income would show a depreciation/amortization amount of $20,000, what would be the cash generated by the company?

The cash flow would be ______________________________ .

ANS:
The cash would be $220,000.

Profit for the year	$ 200,000
Depreciation/amortization	20,000
Cash flow	$ 220,000

PTS: 1 REF: 24

16. If the company's accounts receivable is lowered to $300,000, how much cash will it generate?

The additional cash would be ________________________ .

ANS:
The additional cash flow from trade receivables would be $80,000.

The existing level of trade receivables	$ 380,000
The new level of trade receivable	300,000
Additional cash flow	$ 80,000

PTS: 1 REF: 24

17. If the company improves its inventory turnover to $350,000, how much cash will it generate?

    The additional cash would be ________________________ .

    ANS:
    The additional cash flow from inventories would be $ 50,000.

The existing level of inventories		$ 400,000
The new level of inventories	350,000	
Additional cash flow	$ 50,000	

    PTS: 1 REF: 23

18. If the company's return on revenue is improved to 8.0%, how much profit for the year would be generated?

    The additional net income would be ________________________ .

    ANS:
    The additional profit for the year would be $40,000.

Existing profit for the year is	$ 200,000	
Profit for the year would be	240,000	($3,000,000 × 8.0%)
Additional profit for the year	$ 40,000	

    PTS: 1 REF: 13

19. By using the information contained in exercises 11, 12, 13, and 14, how much cash would the company generate?

    The additional cash would be ______________________________.

    ANS:
    The incremental cash would be $190,000.

From depreciation/amortization	$ 20,000	
From trade receivables	80,000	
From inventories		50,000
From additional profit for the year		40,000
Additional cash flow	$190,000	

    PTS: 1 REF: 23

20. By using the information contained in exercise 14, what is the company's new return on assets?
The new return on assets is ________________________ .

ANS:
The new return on assets is 12.0%.

New profit for the year level	$	240,000 ÷
Total assets		2,000,000

PTS: 1 REF: 9

21. The company's before tax cost of financing is ________________________ .

ANS:
The before tax cost of financing is 8.84%.

Sources financing		Proportion		Before-tax cost		Weighted cost of
Equity	$ 800,000	42.1	×	12.0 %	=	5.05 %
Long-term borrowings	800,000	42.1	×	6.0 %	=	2.53 %
Short-term borrowings	300,000	15.8	×	8.0 %	=	1.26 %
Total	$ 1,900,000	100.0				8.84 %

PTS: 1 REF: 20

Statement of Income For The Year 2010

Revenue		$ 200,000
Cost of sales		
Depreciation/amortization	(20,000)	
Other costs	(140,000)	
Total cost of sales		(160,000)
Gross profit		40,000
Operating expenses		(20,000)
Profit before taxes		20,000
Income tax expense		(10,000)
Profit for the year		$ 10,000

Statement of Financial Position Accounts

	2009	2010
Mortgage	$200,000	$180,000
Bonds	300,000	350,000
Common share	150,000	175,000
Preferred shares	70,000	75,000
Non-current assets	$500,000	$610,000

22. Cash flow for operating activities is ________________________.

ANS:
Cash flow for operating activities is $10,000.

The make-up of this cash inflow is as follows:

Profit for the year	$10,000
Depreciation/amortization	20,000
Adjustments in working capital accounts	(20,000)
Total cash flow from operating activities	$10,000

PTS: 1 REF: 23

23. Cash flow for financing activities is ________________________.

ANS:
Cash flow for financing activities is $100,000

The make-up of this cash inflow is as follows:

	2009	2010	Change
Mortgage	$200,000	$180,000	$ 20,000
Bonds	300,000	350,000	50,000
Common shares	150,000	175,000	25,000
Preferred shares	70,000	75,000	5,000
Total cash flow for financing activities			$ 100,000

PTS: 1 REF: 20

24. Cash flow for investing activities is________________________.

ANS:
Cash outflow for investing activities is $100,000.

Non-current assets	$500,000	$610,000	($110,000)

PTS: 1 REF: 19

25. Net cash flow for these three activities is ________________________,

ANS:
Cash flow for the three activities is zero.

Cash flow from operating activities	$ 10,000
Cash flow from financing activities	100,000
Cash flow for investing activities	($110,000)

PTS: 1 REF: 19-20 | 23