True/False

Indicate whether the statement is true or false.

____ 1. There are three primary advantages of a regular partnership: (1) unlimited liability, (2) limited life of the organization, and (3) difficulty of transferring ownership. These combine to make it difficult for partnerships to attract large amounts of capital and thus to grow to a very large size.

____ 2. If an individual investor buys shares of stock from a corporation that is issuing shares to raise funds for the first time, then this is a primary market transaction.

____ 3. Recently, Cadbury Corporation announced the sale of 2.5 million newly issued shares of its stock at a price of $21 per share. Hale sold the stock to an investment banker, who in turn sold it to individual and institutional investors. This is a primary market transaction.

____ 4. The annual report contains four basic financial statements: the income statement, balance sheet, statement of cash flows, and an actuarial report on the company pension plan.

____ 5. To estimate the cash flow from operations, depreciation must be subtracted from net income because it is a non-cash charge that has been deducted from revenue.

____ 6. 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.

____ 7. The retained earnings is derived by the firm from what it generates in cash savings over the course of its existence. It is the company’s last source of funding in that it does not involve the use of an investment banker to generate financing to the firm.

____ 8. The interest and dividends paid by a corporation are considered to be deductible operating expenses, hence they decrease the firm's tax liability.

Multiple Choice

Identify the choice that best completes the statement or answers the question.

____ 9. Macro economic financial factors that may impact the operation of a company such as AT&T are:
   a. the input costs for AT&T in offering its products and services
   b. Inflation
   c. Demand for AT&T products and services
   d. The price of AT&T products and services
   e. Only A and B

____ 10. Judy Chen, who has substantial personal wealth and income, is considering the possibility of starting a new business in the Chinese restaurant business. She will be the sole owner, and she has enough funds to finance the operation. The business will have a relatively high degree of risk, and it is expected that the firm will incur losses for the first few years. However, the prospects for growth and positive future income look good, and Judy plans to have the firm pay out all of its income as dividends to her once it is well established. Which of the legal forms of business organization would probably best suit her needs?
   a. Proprietorship, because of ease of entry.
   b. S corporation, to gain some tax advantages and also to obtain limited liability.
   c. Partnership, but only if she needs additional capital.
   d. Regular corporation, because of the limited liability.
11. A publicly traded firm interested in serving its shareholders, long term should be:
   a. Focused on using the lowest cost sources of funding to invest in projects that will maximize earnings long term
   b. Seeking to hire a CEO who can smooze federal regulators into overlooking any legal business restrictions and is adept at obscuring financial results in the annual report.
   c. Seeking to minimize the amount of taxes the company is required to pay, thereby increasing the amount of earnings for the firm.
   d. A and B.
   e. A and C.

12. Suppose the U.S. Treasury announces plans to issue $50 billion of new bonds in an open market operation designed to impact the money supply, short term interest rates and bond prices. Assuming the announcement was not expected, what effect, other things held constant, would that move have on bond prices and interest rates in the short run?
   a. Bond prices, interest rates and the money supply would all rise.
   b. Bond prices would rise and interest rates would decline.
   c. Bond prices and interest rates would both decline.
   d. There would be no changes in either bond prices or interest rates.
   e. Bond prices would decline, interest rates would rise, while the money supply would contract.

13. You are considering the purchase of a $1,000 Disney bond that yields 5.5%. However, you want to compare the after tax yield on this investment in relation to your other holdings. What will be the after tax yield on this Disney bond if you buy it? [Assume you are in the 30% tax bracket]
   a. 7.85%
   b. 5.5%
   c. 3.85%
   d. 5%
   e. 4.58%

14. You are considering two different types of investments (1) purchase of a GE bond that yields 8% versus (2) purchase of the UNI Redecker Expansion General Obligation [tax exempt] yielding 6%. What tax rate would you have to have in order for you to be indifferent between these two types of investments?
   a. 15%
   b. 20%
   c. 25%
   d. 30%
   e. 50%

15. TSX Corporation had a taxable income of $375,000 from operations after all operating costs, but before (1) interest expenses of $60,000 (2) dividends received of $30,000 (3) dividends paid of $15,000 and (4) income taxes. What is the firm’s taxable income?
   a. $319,500.
   b. $324,000
   c. $306,000
   d. $405,000
   e. $465,000

16. Which of the following statements is CORRECT?
   a. The four most important financial statements provided in the annual report are the balance sheet, income statement, profit and loss statement, and the statement of retained earnings.
   b. The balance sheet gives us a picture of the firm's financial position at a point in time.
   c. The income statement gives us a picture of the firm's financial position at a point in time.
   d. The statement of cash flows tells us how much cash the firm has in the form of currency.
and demand deposits.

e. The statement of cash needs tells us how much cash the firm will require during some future period, generally a month or a year.

17. MMM is considering a $1,000,000 investment in either one of two investments (1) the purchase of a $1 million GE bond with an yield rate of 10% or (2) the purchase of $1,000,000 in GE preferred stock with a dividend yield 9 %. If MMM’s corporate tax rate is 25%, which of these two investments should they invest in on the basis of highest after tax return?

a. 3M should purchase the GE Bonds to earn a 10% rate of return.

b. 3M should purchase preferred stock even though the dividend rate of 9% is below the GE bond interest rate of 10%, because of the 70% exclusion of dividends it receives from taxes.

c. At 3M’s present tax rate of 25% it is indifferent between purchasing the GE bonds or the preferred stock.

d. 3M should purchase the GE bonds because they are less risky than the preferred stock.

e. There is not enough information given in this problem to tell which investment might be superior on the basis of highest after tax return.
TRUE/FALSE

1. ANS: F
   These are disadvantages of a regular partnership -

2. ANS: T
   Shares that are sold for the first time by a corporation seeking to raise new funds is called a primary market transaction. Secondary market transactions are where shares are bought and sold between investors after a corporation has issued shares in a primary market transaction.

3. ANS: T

4. ANS: F
   The fourth statement in the annual report is the statement of retained earnings -- showing how net income was distributed back to the company. Most company’s no longer have defined benefit plans so they would not be generating an actuarial report on their pension plan.

5. ANS: F
   Depreciation has to be added back to net income because it was used to reduce income to determine after tax earnings.

6. ANS: T

7. ANS: F
   This statement is true -- retained earnings as the name implies represents earnings that the firm retains out of net income. The use of retained earnings is what the company owns from its operations and does not involve the use of an investment banker to obtain this type of financing.

8. ANS: F Dividends that are paid by a corporation are not considered to be expenses in terms of calculating taxable income --- dividends are paid out of net income once taxes have been paid by the corporation.

MULTIPLE CHOICE

9. ANS: B
   Macro economic factors would include ==> interest rates, inflation, employment/aggregate demand for goods and services. The other factors listed here are micro economic financial factors that relate to issues within the purview of AT&T’s management - pricing, costs, and demand for products and services.

10. ANS: B
    The S corporation would allow her to take early losses as deductions against her other income, hence save some taxes. Then, when the firm became profitable, she would receive dividends and pay taxes on them, but the firm itself would avoid corporate taxes and double taxation.

11. ANS: E

12. ANS: E
13. ANS: C
14. ANS: C
15. ANS: B
   Operating Income: $375,000
   Less: Interest Expense ( 60,000)
   Less: Taxable Dividends
     30% x $30,000 = 9,000
   Taxable Income $324,000

16. ANS: B
17. ANS: B
   GE Bond Yield: 10%
   After Tax GE Bond Yield = 10% x [1-.25] = 7.5%

   GE Preferred:
   Dividend Income ===> $1,000,000 x .09 = $90,000
   30% Taxable Dividends: $27,000
   Less: Tax on taxable dividends ===> (6,750)
   After Tax Dividend Income ===> $ 83,250
   After Tax Rate of Return = $83,250/$1,000,000 = .08325