LOYOLA COLLEGE (AUTONOMOUS), CHENNAI – 600 034

B.Com. DEGREE EXAMINATION – **ACCOUNTING AND FINANCE**

THIRD SEMESTER – **APRIL 2022**

UAF 3502 – STRATEGIC FINANCIAL MANAGEMENT - I

Date: 24-06-2022 Dept. No. Max. : 100 Marks
Time: 09:00 AM - 12:00 NOON

SECTION – A

Answer all the Questions **(70x 1 =70 Marks)**

1. Shown below are components of a company's financial statements.

Sales revenue	$600,000
Cost of goods sold	300,000
Total assets	2,400,000
Total equity	1,500,000
Net income	120,000

What percentage value would net income be on a common size financial statement?

a. 5%.
b. 8%.
c. 20%.
d. 40%.

2. In analyzing the short-term liquidity of a firm, many analysts prefer to use the quick (or acid test) ratio rather than the current ratio. The primary reason for this preference is that the

a. quick ratio excludes account receivables.
b. current ratio includes marketable securities which may be mispriced.
c. pro-forma cash flow statements focus on cash only.
d. Conversion of inventory into cash is less reliable.

3. All of the following are affected when merchandise is purchased on credit **except**
a. total current assets.
b. net working capital.
c. total current liabilities.
d. current ratio.

4. Davis Retail Inc. has current assets of $7,500,000 and a current ratio of 2.3 times before purchasing $750,000 of merchandise on credit for resale. After this purchase, the current ratio will
a. remain at 2.3 times.
b. be higher than 2.3 times.
c. be lower than 2.3 times.
d. be exactly 2.53 times.

5. Garstka Auto Parts must increase its acid test ratio above the current 0.9 level in order to comply with the terms of a loan agreement. Which one of the following actions is **most** likely to produce the desired results?
a. Expediting collection of accounts receivable.
b. Selling auto parts on account.
c. Making a payment to trade accounts payable.
d. Purchasing marketable securities for cash.

6. The owner of a chain of grocery stores has bought a large supply of mangoes and paid for the fruit with cash. This purchase will adversely impact which one of the following?
a. Working capital.
b. Current ratio.
c. Quick or acid test ratio.
d. Price earnings ratio.

7. When reviewing a credit application, the credit manager should be **most** concerned with the applicant's
a. profit margin and return on assets.
b. price-earnings ratio and current ratio.
c. working capital and return on equity.
d. working capital and current ratio.

8. Both the current ratio and the quick ratio for Spartan Corporation have been slowly decreasing. For the past two years, the current ratio has been 2.3 to 1 and 2.0 to 1. During the same time period, the quick ratio has decreased from 1.2 to 1 to 1.0 to 1. The disparity between the current and quick ratios can be explained by which one of the following?
a. The current portion of long-term debt has been steadily increasing.
b. The cash balance is unusually low.
c. The accounts receivable balance has decreased.
d. The inventory balance is unusually high.

9. The acid test ratio shows the ability of a company to pay its current liabilities without having to
a. reduce its cash balance.
b. borrow additional funds.
c. collect its receivables.
d. liquidate its inventory.

10. All of the following are included when calculating the acid test ratio **except**
a. six-month treasury bills.
b. prepaid insurance.
c. accounts receivable.
d. 60-day certificates of deposit.

11. If a company has a current ratio of 2.1 and pays off a portion of its accounts payable with cash, the current ratio will
a. decrease.
b. increase.
c. remain unchanged.
d. move closer to the quick ratio.

12. An accountant has determined that last year a company had earnings before interest and tax of $750,000, interest expense of $125,000, and an income tax rate of 40%. What was the company's degree of financial leverage last year?
a. 0.80.
b. 1.20.
c. 1.67.
d. 2.00.

13. A degree of operating leverage of 3 at 5,000 units means that a
a. 3% change in earnings before interest and taxes will cause a 3% change in sales.
b. 3% change in sales will cause a 3% change in earnings before interest and taxes.
c. 1% change in sales will cause a 3% change in earnings before interest and taxes.
d. 1% change in earnings before interest and taxes will cause a 3% change in sales.

14. Firms with high degrees of financial leverage would be **best** characterized as having
a. high debt-to-equity ratios.
b. zero coupon bonds in their capital structures.
c. low current ratios.
d. high fixed-charge coverage.

15. The use of debt in the capital structure of a firm
a. increases its financial leverage.
b. increases its operating leverage.
c. decreases its financial leverage.
d. decreases its operating leverage.

16. A financial analyst with Mineral Inc. calculated the company's degree of financial leverage as 1.5. If net income before interest increases by 5%, earnings to shareholders will increase by
a. 1.50%.
b. 3.33%.
c. 5.00%.
d. 7.50%.

17. Which one of the following is the **best** indicator of long-term debt paying ability?
a. Working capital turnover.
b. Asset turnover.
c. Current ratio.
d. Debt-to-total assets ratio.

18. Maydale Inc.'s financial statements show the following information.

Accounts receivable, end of Year 1	$ 320,000
Credit sales for Year 2	3,600,000
Accounts receivable, end of Year 2	400,000

Maydale's accounts receivable turnover ratio is
a. 0.10.
b. 9.00.
c. 10.00.
d. 11.25.

19. Globetrade is a retailer that buys virtually all of its merchandise from manufacturers in a country experiencing significant inflation. Globetrade is considering changing its method of inventory costing from first-in, first-out (FIFO) to last-in, first-out (LIFO). What effect would the change from FIFO to LIFO have on Globetrade's current ratio and inventory turnover ratio?

a. Both the current ratio and the inventory turnover ratio would increase.
b. The current ratio would increase but the inventory turnover ratio would decrease.
c. The current ratio would decrease but the inventory turnover ratio would increase.
d. Both the current ratio and the inventory turnover ratio would decrease.

20. Lancaster Inc. had net accounts receivable of $168,000 and $147,000 at the beginning and end of the year, respectively. The company's net income for the year was $204,000 on $1,700,000 in total sales. Cash sales were 6% of total sales. Lancaster's average accounts receivable turnover ratio for the year is
a. 9.51.
b. 10.15.
c. 10.79.
d. 10.87.

21. On its year-end financial statements, Caper Corporation showed sales of $3,000,000, net fixed assets of $1,300,000, and total assets of $2,000,000. The company's fixed asset turnover is
a. 1.5 times.
b. 43.3%.
c. 2.3 times.
d. 65%.

22. Douglas Company purchased 10,000 shares of its common stock at the beginning of the year for cash. This transaction will affect all of the following **except** the
a. debt-to-equity ratio.
b. earnings per share.
c. net profit margin.
d. current ratio.

23. A company had $450,000 in assets, $250,000 in liabilities, and $200,000 in common equity at the beginning of the fiscal year. The company's management is projecting that net income for the current fiscal year will be $55,000 and common equity at the end of the fiscal year will be $210,000. How much will the company's return on equity be at the end of the fiscal year?
a. 12.2%.
b. 22.0%.

c. 26.8%.
d. 27.5%.

24. A company has a net profit margin of 5%, an operating profit margin of 10%, and a gross profit margin of 25%. Sales revenue is $5,000,000. Selling, general, and administrative expenses are $750,000. What is the cost of goods sold?
a. $4,750,000.
b. $4,250,000.
c. $3,750,000.
d. $3,250,000.

25. A corporation had 250,000 shares of common stock outstanding on January 1. The financial manager of the corporation on September 30 is projecting net income of $750,000 for the current year. If the management of the corporation is planning on declaring a $55,000 preferred stock dividend and a 2-for-1 common stock split on December 31, earnings per common share on December 31 is expected to equal
a. $1.39.
b. $1.50.
c. $2.78.
d. $3.00.

26. At the end of its fiscal year on December 31, 2000, Merit Watches had total shareholders' equity of $24,209,306. Of this total, $3,554,405 was preferred equity. During the 2001 fiscal year, Merit's net income after tax was $2,861,003. During 2001, Merit paid preferred share dividends of $223,551 and common share dividends of $412,917. At December 31, 2001, Merit had 12,195,799 common shares outstanding and the company did not sell any common shares during the year. What was Merit Watch's book value per share on December 31, 2001?
a. $1.88.
b. $2.17.
c. $1.91.
d. $2.20.

27. Donovan Corporation recently declared and issued a 50% stock dividend. This transaction will reduce the company's
a. current ratio.
b. book value per common share.
c. debt-to-equity ratio.
d. return on operating assets.

28. Devlin Inc. has 250,000 shares of $10 par value common stock outstanding. For the current year, Devlin paid a cash dividend of $3.50 per share and had earnings per share of $4.80. The market price of Devlin's stock is $34 per share. Devlin's price/earnings ratio is
a. 2.08.
b. 2.85.
c. 7.08.
d. 9.71.

29. Archer Inc. has 500,000 shares of $10 par value common stock outstanding. For the current year, Archer paid a cash dividend of $4.00 per share and had earnings per share of $3.20. The market price of Archer's stock is $36 per share. The average price/earnings ratio for Archer's industry is 14.00. When compared to the industry average, Archer's stock appears to be

a. overvalued by approximately 25%.
b. overvalued by approximately 10%.
c. undervalued by approximately 10%.
d. undervalued by approximately 25%.

30. A steady drop in a firm's price/earnings ratio could indicate that
a. earnings per share has been increasing while the market price of the stock has held steady.
b. earnings per share has been steadily decreasing.
c. the market price of the stock has been steadily rising.
d. both earnings per share and the market price of the stock are rising.

31. On January 1, Esther Pharmaceuticals had a balance of 10,000 shares of common stock outstanding. On June 1, the company issued an additional 2,000 shares of common stock for cash. A total of 5,000 shares of 6%, $100 par, nonconvertible preferred stock was outstanding all year. Esther's net income was $120,000 for the year. The earnings per share for the year were
a. $7.50.
b. $8.06.
c. $10.00.
d. $10.75.

32. Roy company had 120,000 common shares and 100,000 preferred shares outstanding at the close of the prior year. During the current year Roy repurchased 12,000 common shares on March 1, sold 30,000 common shares on June 1, and sold an additional 60,000 common shares on November 1. No change in preferred shares outstanding occurred during the year. The number of shares of stock outstanding to be used in the calculation of basic earnings per share at the end of the current year is
a. 100,000.
b. 137,500.
c. 198,000.
d. 298,000.

33. For the most recent fiscal period, Oakland Inc. paid a regular quarterly dividend of $0.20 per share and had earnings of $3.20 per share. The market price of Oakland stock at the end of the period was $40.00 per share. Oakland's dividend yield was
a. 0.50%.
b. 1.00%.
c. 2.00%.
d. 6.25%.

34. The dividend yield ratio is calculated by which one of the following methods?
a. Market price per share divided by dividends per share.
b. Earnings per share divided by dividends per share.
c. Dividends per share divided by market price per share.
d. Dividends per share divided by earnings per share.

35. Mayson Company reported net income of $350,000 for last year. The company had 100,000 shares of $10 par value common stock outstanding and 5,000 shares of common stock in treasury during the year. Mayson declared and paid $1 per share dividends on common stock. The market price per common share at the end of last year was $30. The company's dividend yield for the year was
a. 30.03%.
b. 28.57%.
c. 11.11%.
d. 3.33%.

36. A company is currently reviewing the most recent fiscal year's results of operations and noted an increase in the return on assets ratio when compared to the prior year. Which one of the following could have caused the increase?

a. Sales decreased by the same dollar amount that expenses increased.
b. Sales increased by the same dollar amount as expenses and total assets.
c. Sales remained the same and expenses and total assets decreased.
d. Sales remained the same and ending inventory decreased.

37. According to its public financial statements, a company's gross profit margin decreased by 5% while its operating profit margin increased by 3%. Which one of the following factors could cause both of these changes?

a. An increase in the cost per unit of the goods purchased from a supplier.
b. A change to the variable costing income statement format.
c. A lowered selling price to increase quantities sold.
d. Sale of fully-depreciated production machinery at a gain and replacement of the machines with newer models.

38. A company's Year 4 gross profit margin remained unchanged from Year 3. However, the company's Year 4 net profit margin increased from Year 3. Which one of the following could explain the change from Year 3 to Year 4?

a. Sales decreased at a faster rate than operating expenses.

b. Corporate income tax rates decreased.

c. Preferred dividends increased.

d. Cost of goods sold decreased relative to sales.

39. A U.S. based publicly traded company has a Swedish subsidiary. For the Swedish subsidiary, the Euro impacts the cost of goods sold and revenue. The primary source of long-term debt financing for the U.S. company is Canadian investors. The functional currency of the Swedish subsidiary is the

a. U.S. dollar.

b. Canadian dollar.

c. Euro.

d. Swedish krona.

40. The functional currency of an entity is defined as the currency
a. of the entity's parent company.
b. of the primary country in which the entity is physically located.
c. in which the books of record are maintained for all entity operations.
d. of the primary economic environment in which the entity operates.

41. During inflationary periods, last-in, first-out inventory accounting will generally have a

a. lower cost of goods sold and lower inventory value.

b. lower cost of goods sold and higher inventory value.

c. higher cost of goods sold and higher inventory value.

d. higher cost of goods sold and lower inventory value.

42. The concept of economic profit is **best** defined as total
a. revenue minus all accounting costs.
b. income minus the sum of total fixed and variable costs.
c. revenue minus the sum of total fixed and variable costs.
d. revenue minus all explicit and implicit costs.

43. "Economic costs" often differ from costs shown in a firm's financial statements. For a corporation, a major difference would arise due to
a. interest costs.
b. salary and wage costs.
c. opportunity costs.
d. state and local tax costs.

44. A company could negatively affect its earnings quality if it frequently
a. constructed plants in countries with unstable currency.
b. invested long-term in an erratic stock or bond market.
c. materially changed accounting estimates.
d. offered significant sales discounts.

45. A manufacturing company operates in an environment of significant inflationary pressures. Which one of the following inventory methods should the company choose to produce financial statements considered to be of the highest earnings quality?

a. Specific identification.

b. First-in, first-out.

c. Last-in, first-out.

d. Average cost.

46. An investor is evaluating the common stock of a technology company which has a beta of 1.8. The expected return for the securities market as a whole is 8%. The investor could receive a risk-free return of 2% on a U.S. Treasury bill. Based on the capital asset pricing model (CAPM), what is the expected risk adjusted return of the technology company's common stock?
a. 10.8%.

b. 12.8%.
c. 16.4%.
d. 20.0%.

47. Frasier Products has been growing at a rate of 10% per year and expects this growth to continue and produce earnings per share of $4.00 next year. The firm has a dividend payout ratio of 35% and a beta value of 1.25. If the risk-free rate is 7% and the return on the market is 15%, what is the expected current market value of Frasier's common stock?
a. $14.00.
b. $16.00.
c. $20.00.
d. $28.00.

48. Which one of the following would have the **least** impact on a firm's beta value?
a. Debt-to-equity ratio.
b. Industry characteristics.
c. Operating leverage.
d. Payout ratio.

49. If Dexter Industries has a beta value of 1.0, then its
a. return should equal the risk-free rate.
b. price is relatively stable.
c. expected return should approximate the overall market.
d. volatility is low.

50. The systematic risk of an individual security is measured by the
a. standard deviation of the security's rate of return.
b. covariance between the security's returns and the general market.
c. security's contribution to the portfolio risk.
d. standard deviation of the security's returns and other similar securities.

51. Which one of the following provides the **best** measure of interest rate risk for a corporate bond?
a. Duration.
b. Yield to maturity.
c. Bond rating.
d. Maturity.

52. The term "beta" can **best** be described as the
a. variability or standard deviation of the investment returns.
b. investment return's sensitivity to changes in the market's returns.
c. investment return's sensitivity to changes in interest rates.
d. weighted-average return of an investment portfolio.

53. The call provision in some bond indentures allows
a. the issuer to exercise an option to redeem the bonds.
b. the bondholder to exchange the bond, at no additional cost, for common shares.
c. the bondholder to redeem the bond early by paying a call premium.
d. the issuer to pay a premium in order to prevent bondholders from redeeming bonds.

54. Protective clauses set forth in an indenture are known as
a. provisions.
b. requirements.
c. addenda.
d. covenants.

55. A requirement specified in an indenture agreement which states that a company cannot acquire or sell major assets without prior creditor approval is known as a
a. protective covenant.
b. call provision.
c. warrant.
d. put option.

56. Which one of the following situations would prompt a firm to issue debt, as opposed to equity, the next time it raises external capital?
a. High breakeven point.
b. Significant percentage of assets under capital lease.
c. Low fixed-charge coverage.
d. High effective tax rate.

57. Which one of the following is a debt instrument that generally has a maturity of ten years or more?
a. A bond.
b. A note.
c. A chattel mortgage.
d. A financial lease.

58. James Hemming, the chief financial officer of a mid-western machine parts manufacturer, is considering splitting the company's stock, which is currently selling at $80.00 per share. The stock currently pays a $1.00 per share dividend. If the split is two-for-one, Mr. Hemming may expect the post-split price to be
a. exactly $40.00, regardless of dividend policy.
b. greater than $40.00, if the dividend is changed to $0.45 per new share.
c. greater than $40.00, if the dividend is changed to $0.55 per new share.
d. less than $40.00, regardless of dividend policy.

59. Which one of the following **best** describes the record date as it pertains to common stock?
a. Four business days prior to the payment of a dividend.
b. The 52-week high for a stock published in the Wall Street Journal.
c. The date that is chosen to determine the ownership of shares.
d. The date on which a prospectus is declared effective by the Securities and Exchange Commission.

60. All of the following are characteristics of preferred stock **except** that
a. it may be callable at the option of the corporation.
b. it may be converted into common stock.
c. its dividends are tax deductible to the issuer.
d. it usually has no voting rights.

61. Cox Company has sold 1,000 shares of $100 par, 8% preferred stock at an issue price of $92 per share. Stock issue costs were $5 per share. Cox pays taxes at the rate of 40%. What is Cox's cost of preferred stock capital?
a. 8.00%.
b. 8.25%.
c. 8.70%.
d. 9.20%.

62. In calculating the component costs of long-term funds, the appropriate cost of retained earnings, ignoring flotation costs, is equal to
a. the cost of common stock.
b. the same as the cost of preferred stock.
c. the weighted average cost of capital for the firm.
d. zero, or no cost.

63. The capital structure of an airline company is comprised of 50% common stock, 30% preferred stock, and 20% debt. The company's cost of common stock is 12%, and the cost of preferred stock is 10%. The company's pretax cost of debt is 5%. The company has an effective income tax rate of 30%. What is the company's weighted average cost of capital?
a. 8.8%.
b. 9.7%.
c. 10.0%.
d. 18.9%.

64. Which one of the following entities is **most** likely to assist investors in assessing the default risk of a specific corporate bond?

a. Bond dealers.
b. Investment banks.
c. Credit rating agencies.
d. Brokerage firms.

65. When determining the amount of dividends to be declared, the **most** important factor to consider is the
a. expectations of the shareholders.
b. future planned uses of retained earnings.
c. impact of inflation on replacement costs.
d. future planned uses of cash.

66. As a company becomes more conservative about its working capital management policy, it would **most** likely tend to have a(n)
a. decrease in the quick ratio.
b. decrease in the operating cycle.
c. increase in the ratio of current assets to noncurrent assets.
d. increase in the ratio of current liabilities to noncurrent liabilities.

67. All of the following are reasons for holding cash **except** for the
a. precautionary motive.
b. transactions motive.
c. motive to make a profit.
d. motive to meet future needs.

68. All of the following can be utilized by a firm in managing its cash outflows **except**
a. zero-balance accounts.
b. centralization of payables.
c. controlled disbursement accounts.
d. lock-box system.

69. A credit manager considering whether to grant trade credit to a new customer is **most** likely to place primary emphasis on
a. profitability ratios.
b. valuation ratios.
c. growth ratios.
d. liquidity ratios.

70. All of the following are carrying costs of inventory **except**
a. storage costs.
b. insurance.
c. shipping costs.
d. opportunity costs.

Section – B

Answer all the Questions **(2x 15= 30 Marks)**

71. Danny Chen was recently hired as the manager of capital planning for Suzhou Tool Company, a precision tool company located in Fuzhou, China. Chen's first assignment in this new position is to draft a company-wide policy for the development, approval, acquisition, installation, and retirement of capital assets. In preparation for drafting the new policy, Chen has collected the following information.

- The company uses Weighted Average Cost of Capital (WACC) as its hurdle rate for approving capital acquisition.
- The company's targeted capital funding structure is 60% equity and 40% debt.
- The before-tax, average cost of debt financing is 10%.
- The risk-free rate is 7%.
- The historical beta for Suzhou Tool Company is 1.0.

- The expected return on all common stocks is 13%.
- The company's effective income tax rate is 40%.

Required.

1. Define hurdle rate and explain why the WACC is often appropriate to use as a hurdle rate.

2. Calculate the WACC.

3. Explain the importance of beta in the capital assets pricing model (CAPM) and explain the importance of beta in Suzhou's WACC.

72. . OneCo Inc. produces a single product. Cost per unit, based on the manufacture and sale of 10,000 units per month at full capacity, is shown below.

Direct materials	$4.00
Direct labor	1.30
Variable overhead	2.50
Fixed overhead	3.40
Sales commission	.90
	$12.10

The $0.90 sales commission is paid for every unit sold through regular channels. Market demand is such that OneCo is operating at full capacity, and the firm has found it can sell all it can produce at the market price of $16.50.

Currently, OneCo is considering two separate proposals:

• Gatsby, Inc. has offered to buy 1,000 units at $14.35 each. Sales commission would be $0.35 on this special order.

• Zelda Productions, Inc. has offered to produce 1,000 units at a delivered cost to OneCo of $14.50 each.

Questions:

1. What would be the effect on OneCo's operating income if it accepts of the proposal from Gatsby, but rejects the proposal from Zelda?
2. What would be the effect on OneCo's operating income if it accepts of the proposal from Zelda, but rejects the proposal from Gatsby?
3. What would be the effect on OneCo's operating income if it accepts both proposals?
4. Assume Gatsby has offered a second proposal to purchase 2,000 units at the market price of $16.50, but has requested product modifications that would increase direct materials cost by $.30 per unit and increase direct labor and variable overhead by 15%. The sales commission would be $.35 per unit. Should OneCo accept this order? Explain your recommendation.

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