***Principles of Managerial Finance, Brief 6e*** **(Gitman)**
**Chapter 2 The Financial Market Environment**

2.1 Understand the role that financial institutions play in managerial finance

1) A financial institution is an intermediary that channels the savings of individuals, businesses, and governments into loans or investments.
Answer: TRUE
Topic: Financial Institutions
Question Status: Revised

2) Loan transactions between commercial banks in which the federal government becomes involved are referred to as federal funds.
Answer: FALSE
Topic: Financial Institutions
Question Status: Revised

3) The key participants in financial transactions are individuals, businesses, and governments. Individuals are net ________ of funds, and businesses are net ________ of funds.
A) demanders; suppliers
B) users; providers
C) suppliers; demanders
D) purchasers; sellers
Answer: C
Topic: Financial Institutions
Question Status: Revised

4) Government usually
A) is a net supplier of funds.
B) is a net demander of funds.
C) borrows funds directly from financial institutions.
D) maintains permanent deposits with financial institutions.
Answer: B
Topic: Financial Institutions
Question Status: Revised

5) Firms that require funds from external sources can obtain them in one of the following ways EXCEPT
A) financial institution.
B) financial markets.
C) government.
D) private placement.
Answer: C
Topic: Financial Institutions and Markets
Question Status: Revised
AACSB Guidelines: Analytic skills

6) Firms that require funds from external sources can obtain them from
A) private placement.
B) financial institutions.
C) financial markets.
D) all of the above.
Answer:  D
Topic:  Financial Institutions and Markets
Question Status:  Revised
AACSB Guidelines:  Analytic skills

7) Which of the following is NOT a financial institution?
A) A commercial bank
B) An insurance company
C) A pension fund
D) A newspaper publisher
Answer:  D
Topic:  Financial Institutions
Question Status:  Revised
AACSB Guidelines:  Analytic skills

8) Which of the following serve as intermediaries channeling the savings of individuals, businesses and governments into loans and investments?
A) Financial Institutions
B) Financial Markets
C) Securities Exchanges
D) OTC market
Answer:  A
Topic:  Financial Institutions
Question Status:  New

2.2   Contrast the functions of financial institutions and financial markets

1) Primary and secondary markets are markets for short-term and long-term securities, respectively.
Answer:  FALSE
Topic:  Financial Markets
Question Status:  Revised

2) Financial markets are intermediaries that channel the savings of individuals, businesses and government into loans or investments.
Answer:  FALSE
Topic:  Financial Markets
Question Status:  Revised

3) A public offering is the sale of a new security issue□typically debt or preferred stock□directly to an investor or group of investors.
Answer:  FALSE
Topic:  Financial Markets
Question Status:  Revised

4) A primary market is a financial market in which pre-owned securities are traded.
Answer: FALSE
Topic: Financial Markets
Question Status: Revised

5) The Glass-Steagall Act was imposed to allow commercial and investment banks to combine and work together.
Answer: FALSE
Topic: Corporate Governance
Question Status: New

6) The shadow banking system describes a group of institutions that engage in lending activities, much like traditional banks, but these institutions do not accept deposits and are therefore not subject to the same regulations as traditional banks.
Answer: TRUE
Topic: Financial Markets
Question Status: New

7) Most businesses raise money by selling their securities in a
A) public offering.
B) private placement.
C) direct placement.
D) stock exchange.
Answer: A
Topic: Financial Markets
Question Status: Revised
AACSB Guidelines: Analytic skills

8) The nonexclusive sale of either bonds or stocks to the general public is called
A) private placement.
B) public offering.
C) organized selling.
D) none of the above.
Answer: B
Topic: Financial Markets
Question Status: Revised
AACSB Guidelines: Analytic skills

9) Which of the following provide savers with a secure place to invest funds and offer both individuals and companies loans to finance investments?
A) Investment Banks
B) Securities Exchanges
C) Mutual Funds
D) Commercial Banks
Answer: D
Topic: Financial Institutions and Markets
Question Status: New
AACSB Guidelines: Analytic skills

10) Which of the following assist companies in raising capital, advise firms on major transactions such as mergers or financial restructuring, and engage in trading and market making activities?
A) Investment Banks
B) Securities Exchanges
C) Mutual Funds
D) Commercial Banks
Answer: A
Topic: Financial Institutions and Markets
Question Status: New
AACSB Guidelines: Analytic skills

11) The Glass-Steagall Act
A) allowed commercial and investment banks to engage in the same activities.
B) created the Securities Exchange Commission.
C) created the Federal Deposit Insurance program and separated the activities of commercial and investment banks.
D) was intended to regulate the activities in the primary market.
Answer: C
Topic: Corporate Governance
Question Status: New
AACSB Guidelines: Analytic skills

12) Which of the following are forums in which suppliers and demanders of funds can transact business directly?
A) Shadow banking system
B) Financial Markets
C) Commercial Banks
D) Financial Institutions
Answer: B
Topic: Financial Markets
Question Status: New
AACSB Guidelines: Analytic skills

13) The sale of a new security directly to an investor or a group of investors is called
A) the secondary market.
B) the primary mark.et
C) the capital market.
D) the private placement market.
Answer: D
Topic: Financial Markets
Question Status: New
AACSB Guidelines: Analytic skills

14) The ________ market is where securities are initially issued and the ________ market is where pre-owned securities (not new issues) are traded.
A) primary; secondary
B) money; capital
C) secondary; primary
D) primary; money
Answer: A
Topic: Financial Markets
Question Status: New

2.3 Describe the differences between the capital markets and the money markets.

1) The Over-the-Counter (OTC) exchange is not an organization but an intangible market for trading securities which are not listed by the organized exchanges.
Answer: TRUE
Topic: Financial Markets
Question Status: Revised

2) Unlike the organized exchanges, the OTC makes a market in both outstanding securities and new public issues, making it both a secondary and a primary market.
Answer: TRUE
Topic: Financial Markets
Question Status: Revised

3) In the OTC market, the ask price is the highest price offered by a dealer to purchase a given security.
Answer: FALSE
Topic: Financial Markets
Question Status: Revised

4) In the OTC market, the prices at which securities are traded result from both competitive bids and negotiation.
Answer: TRUE
Topic: Financial Markets
Question Status: Revised

5) Capital markets are for investors who want a safe temporary place to deposit funds where they can earn interest and for borrowers who have a short term need for funds.
Answer: FALSE
Topic: Financial Markets
Question Status: New

6) Money markets are markets for long term funds such as bonds and equity.
Answer: FALSE
Topic: Financial Markets
Question Status: New

7) An efficient market is a market that allocates funds to their most productive use as a result of competition among wealth-maximizing investors.
Answer: TRUE
Topic: Financial Markets
Question Status: Revised

8) Money markets involve the trading of securities with maturities of one year or less while capital market involve the buying and selling of securities with maturities of more than one year.
Answer: TRUE
Topic: Financial Markets
Question Status: Revised

9) Eurocurrency deposits arise when a corporation or individual makes a deposit in a bank in a currency other than the local currency of the country where the bank is located.
Answer: TRUE
Topic: Financial Markets
Question Status: Revised

10) The eurocurrency market is a market for short-term bank deposits denominated in U.S. dollars or other easily convertible currencies.
Answer: TRUE
Topic: Financial Markets
Question Status: Revised

11) The money market is a financial relationship created by a number of institutions and arrangements that allows suppliers and demanders of long-term funds to make transactions.
Answer: FALSE
Topic: Financial Markets
Question Status: Revised

12) The over-the-counter (OTC) market is
A) the New York Stock Exchange.
B) an organized stock exchange.
C) a place where securities are bought and sold.
D) an intangible market for unlisted securities.
Answer: D
Topic: Financial Markets
Question Status: Revised

13) Trading is carried out on the floor of the New York Stock Exchange by
A) the negotiation process.
B) the auction process.
C) a telecommunications network.
D) investment bankers.
Answer: B
Topic: Financial Markets
Question Status: Revised

14) All of the following are functions of security exchanges EXCEPT
A) allocating scarce capital.
B) aiding in new financing.
C) creating continuous markets.
D) holding demand deposits.
Answer: D
Topic: Financial Markets
Question Status: Revised
AACSB Guidelines: Analytic skills

15) All of the following are examples of organized stock exchanges EXCEPT
A) the New York Stock Exchange.
B) the American Stock Exchange.
C) the Pacific Stock Exchange.
D) the over-the-counter exchange.
Answer: D
Topic: Financial Markets
Question Status: Revised

16) The major securities traded in the capital markets are
A) commercial paper and Treasury bills.
B) Treasury bills and certificates of deposit.
C) stocks and bonds.
D) bonds and commercial paper.
Answer: C
Topic: Financial Markets
Question Status: Revised
AACSB Guidelines: Analytic skills

17) The ________ stock exchange is a primary market where new public issues are sold.
A) regional
B) American
C) New York
D) over-the-counter
Answer: D
Topic: Financial Markets
Question Status: Revised

18) Trading is carried out in the Over-the-Counter (OTC) Exchange by
A) the competitive bid process.
B) the competitive bid process and the negotiation process.
C) the auction process.
D) an investment banker.
Answer: B
Topic: Financial Markets
Question Status: Revised

19) Securities exchanges create efficient markets that do all of the following EXCEPT
A) ensure a market in which the price reflects the true value of the security.
B) allocate funds to the most productive uses.
C) control the supply and demand for securities through price.
D) allow the price to be determined by supply and demand of securities.
Answer: C
Topic: Financial Markets
Question Status: Revised
AACSB Guidelines: Analytic skills

20) A competitive market that allocates funds to their most productive use is called a(n)
A) liquid market.
B) middleman's market.
C) efficient market.
D) investor's market.
Answer: C
Topic: Financial Markets
Question Status: Revised

21) The ________ is created by a financial relationship between suppliers and demanders of short-term funds.
A) stock market
B) capital market
C) financial market
D) money market
Answer: D
Topic: Financial Markets
Question Status: Revised

22) By definition, the money market involves the buying and selling of
A) stocks and bonds.
B) short-term funds.
C) funds that mature in more than one year.
D) flows of funds.
Answer: B
Topic: Financial Markets
Question Status: Revised

23) Most money market transactions are made in
A) common stock.
B) marketable securities.
C) stocks and bonds.
D) preferred stock.
Answer: B
Topic: Financial Markets
Question Status: Revised
AACSB Guidelines: Analytic skills

24) The ________ is created by a number of institutions and arrangements that allow the suppliers and demanders of long-term funds to make transactions.
A) financial market
B) capital market
C) money market
D) credit market
Answer: B
Topic: Financial Markets
Question Status: Revised

25) Long-term debt instruments used by both government and business are known as
A) stocks.
B) bills.
C) bonds.
D) equities.
Answer: C
Topic: Financial Markets
Question Status: Revised
AACSB Guidelines: Analytic skills

26) The two key financial markets are
A) primary market and secondary market.
B) primary market and money market.
C) money market and capital market.
D) capital market and secondary market.
Answer: C
Topic: Financial Markets
Question Status: Revised

27) In a ________ market, the buyer and seller are brought together to trade securities in an organization called ________.
A) dealer; securities market
B) broker; over-the -counter market
C) broker; securities market
D) dealer; over-the-counter market
Answer: C
Topic: Financial Markets
Question Status: New

28) In a ________ market, the buyer and seller are not brought together to trade securities directly but instead have their orders executed on the ________.
A) dealer; securities market
B) broker; over-the -counter market
C) broker; securities market
D) dealer; over-the-counter market
Answer: D
Topic: Financial Markets
Question Status: New

29) In efficient market is one where
A) prices of stocks move up and down widely without apparent reason.
B) prices of stocks remain steady for long periods of time.
C) prices of stocks are unaffected by market news.
D) prices of stocks incorporate new information quickly and adjust appropriately to their true value.
Answer: D
Topic: Efficient Market Theory
Question Status: New
AACSB Guidelines: Analytic skills

30) An implication of the Efficient Market Hypothesis is that it is very hard for an actively managed mutual fund to earn above average returns. This is true for all of the following reasons EXCEPT
A) new information is predictable and therefore already incorporated into the stock prices.
B) new information is by definition unpredictable, thus hard to incorporate into stock prices.
C) actively managed mutual funds typically charge fees of about 1.5%.
D) index funds make no attempt to analyze stocks.
Answer: A
Topic: Efficient Market Theory
Question Status: New
AACSB Guidelines: Reflective thinking skills

31) In an efficient market if a company announced sales of a new product are lower than expected, what would you expect to happen to the stock price?
A) It would not change.
B) It would increase.
C) It would decrease.
D) It would move it the same direction as the market in general.
Answer: C
Topic: Efficient Market Theory
Question Status: New
AACSB Guidelines: Reflective thinking skills

2.4 Explain the root causes of the 2008 financial crisis and recession.

1) Securitization is the process of pooling mortgages or other types of loans and selling the claims or securities against that pool in the secondary market.
Answer: TRUE
Topic: Securitization
Question Status: New

2) Securitization made it harder for banks to lend money because they could not pass the risk on to other investors.
Answer: FALSE
Topic: Securitization
Question Status: New
AACSB Guidelines: Reflective thinking skills

3) Mortgage-backed securities are securities that represent claims on the cash flows generated by a pool of mortgages.
Answer: TRUE
Topic: Securitization
Question Status: New

4) Mortgage default rates were low from the mid 1990s through 2006 because home prices were rising and lenders allowed borrowers who were having difficulty making payments to refinance on the built up home equity.
Answer: TRUE
Topic: Financial Crisis
Question Status: New
AACSB Guidelines: Reflective thinking skills

5) Sub-prime mortgages are mortgage loans made to borrowers the high incomes and better than average credit histories.
Answer: FALSE
Topic: Financial Crisis
Question Status: New

6) In the year 2000, real estate loans accounted for less than 40% of the total loan portfolios of large banks, but by 2007 real estate loans grew to more than half of all loans made by large banks.
Answer: TRUE
Topic: Financial Crisis
Question Status: New

7) The process of pooling mortgages or other types of loans and selling the claims or securities against that pool in the secondary market is called
A) refinancing.
B) securitization.
C) private placement.
D) pooling.
Answer: B
Topic: Securitization
Question Status: New

8) The primary risk of mortgage-backed securities is that
A) the prices of housing will go down.
B) the prices of housing will increase.
C) the government will not be able to meet the guarantees on the cash flows.
D) homeowners may not be able to, or choose not to, repay their loans.
Answer: D
Topic: Securitization
Question Status: New
AACSB Guidelines: Reflective thinking skills

9) All of the following are true about mortgage-backed securities EXCEPT:
A) They represent claims on the cash flows generated by a pool of mortgages.
B) All of the cash flows from these securities are guaranteed by the U.S. government.
C) They can be purchased by individual investors, pension funds, and mutual funds.
D) The primary risk associated with them is that homeowners may not be able or may not choose to repay the loan.
Answer: B
Topic: Securitization
Question Status: New
AACSB Guidelines: Reflective thinking skills

10) When home prices are falling we would expect
A) high mortgage default rates.
B) low mortgage default rates.
C) unchanged mortgage default rates.
D) a higher percentage of owner home equity.
Answer: A
Topic: Financial Crisis
Question Status: New
AACSB Guidelines: Reflective thinking skills

11) A crisis in the financial sector often spills over into other industries because when financial institutions ________ borrowing, activity in most other industries also ________.
A) increase; slows down
B) contract; slows down
C) increase; increases
D) contract; increases
Answer: A
Topic: Financial Crisis
Question Status: New
AACSB Guidelines: Analytic skills

2.5 Understand the major regulations and regulatory bodies that affect financial institutions and markets

1) The Securities Act of 1933 focuses on regulating the sale of securities in the primary market, whereas the 1934 Act deal with the regulations governing the transactions in the secondary market.
Answer: TRUE
Topic: Regulations
Question Status: New

2) The Federal Deposit Insurance Corporation (FDIC):
A) guarantees individuals will not lose any money held at a bank that fails.
B) guarantees individuals will not lose any money, up to a specified amount, held at a bank that fails.
C) guarantees individuals will not lose any money held at any type of financial institution that fails.
D) guarantees individuals will not lose any money, up to a specified amount, held at any type of financial institution that fails.
Answer: B
Topic: Regulations
Question Status: New

3) The Gramm-Leach-Biley Act
A) does not allows business combinations between commercial banks, investment banks and insurance companies.
B) allows business combinations between commercial banks and investment banks, but not insurance companies.
C) allows business combinations between commercial banks, investment banks and insurance companies.
D) was signed during the Great Depression because of the financial crisis.
Answer: C
Topic: Regulations
Question Status: New

4) Which of the follow regulates the secondary market and created the Securities Exchange Commission (SEC)?
A) The Securities Act of 1933
B) The Gramm-Leach-Biley Act
C) The Securities Exchange Act of 1934
D) The Glass--Steagall Act
Answer: C
Topic: Regulations
Question Status: New

5) Which of the follow regulates the primary market in which securities are originally issued to the public?
A) The Securities Act of 1933
B) The Gramm-Leach-Biley Act
C) The Securities Exchange Act of 1934
D) The Glass-Steagall Act
Answer: A
Topic: Regulations
Question Status: New

2.6 Discuss business taxes and their importance in financial decisions

1) The ordinary income of a corporation is income earned through the sale of a firm's goods and services and is currently taxed subject to the individual income tax rates.
Answer: FALSE
Topic: Business Taxes
Question Status: Revised

2) The marginal tax rate represents the rate at which additional income is taxed.
Answer: TRUE
Topic: Business Taxes
Question Status: Revised

3) All dividend income received by one corporation from an investment in the common and preferred stock of another corporation is excluded from taxation.
Answer: FALSE
Topic: Business Taxes
Question Status: Revised

4) Because of the dividend exclusion only 70 percent of intercorporate dividend dividend income is included as ordinary income.
Answer: FALSE
Topic: Business Taxes
Question Status: Revised

5) Tax laws often are used to accomplish economic goals such as providing incentives for corporate investment in certain types of assets.
Answer: TRUE
Topic: Business Taxes
Question Status: Revised

6) Dividends received by a corporation on an investment in the common and preferred stock of another corporation (where ownership in the dividend paying corporation is less than 20%) is subject to 70 percent exclusion for tax purposes.
Answer: TRUE
Topic: Business Taxes
Question Status: Revised

7) The tax deductibility of various expenses such as general and administrative expenses ________ their after-tax cost.
A) increases
B) reduces
C) has no effect on
D) has an undetermined effect on
Answer: B
Topic: Business Taxes
Question Status: Revised

8) The tax liability of a corporation with ordinary income of $105,000 is ________.
A) $42,000
B) $35,700
C) $23,950
D) $24,200
Answer: D
Topic: Business Taxes
Question Status: Revised
AACSB Guidelines: Analytic skills

9) The tax liability of a corporation with ordinary income of $1,500,000 is ________.
A) $498,250
B) $510,000
C) $585,000
D) $690,000
Answer: B
Topic: Business Taxes
Question Status: Revised
AACSB Guidelines: Analytic skills

10) The tax liability of a corporation with ordinary income of $1,100,000 is ________.
A) $362,250
B) $340,000
C) $374,000
D) $390,000
Answer: C
Topic: Business Taxes
Question Status: Revised
AACSB Guidelines: Analytic skills

11) Jennings, Inc. has a tax liability of $170,000 on pretax income of $500,000. What is the average tax rate for Jennings, Inc.?
A) 34 percent
B) 46 percent
C) 25 percent
D) 40 percent
Answer: A
Topic: Business Taxes
Question Status: Revised
AACSB Guidelines: Analytic skills

12) The average tax rate of a corporation with ordinary income of $105,000 and a tax liability of $24,200 is
A) 46 percent.
B) 23 percent.
C) 34 percent.
D) 15 percent.
Answer: B
Topic: Business Taxes
Question Status: Revised
AACSB Guidelines: Analytic skills

13) If a corporation sells certain capital equipment for more than their initial purchase price, the difference between the sale price and the purchase price is called a(n)
A) ordinary gain.
B) capital loss.
C) capital gain.
D) ordinary loss.
Answer: C
Topic: Business Taxes
Question Status: Revised

14) In general, most corporate capital gains are taxed at ________ tax rate.
A) a 46 percent
B) the ordinary
C) a 28 percent
D) a 30 percent
Answer: B
Topic: Business Taxes
Question Status: Revised

15) Congress allows corporations to exclude from taxes 70 to 100 percent of dividends received from other corporations. Congress did this to
A) encourage corporations to invest in each other.
B) avoid double taxation on dividends.
C) eliminates most of the potential tax liability from the dividends received by the second and any subsequent corporations.
D) lower the cost of equity financing for corporations.
Answer: C
Topic: Business Taxes
Question Status: Revised

16) Corporation X needs $1,000,000 and can raise this through debt at an annual rate of 10 percent, or preferred stock at an annual cost of 7 percent. If the corporation has a 40 percent tax rate, the after-tax cost of each is
A) debt: $100,000; preferred stock: $70,000.
B) debt: $60,000; preferred stock: $42,000.
C) debt: $60,000; preferred stock: $70,000.
D) debt: $100,000; preferred stock: $42,000.
Answer: C
Topic: Business Taxes
Question Status: Revised
AACSB Guidelines: Analytic skills

17) Corporation A owns 15 percent of the stock of corporation B. Corporation B pays corporation A $100,000 in dividends in 2002. Corporation A must pay tax on
A) $100,000 of ordinary income.
B) $ 30,000 of ordinary income.
C) $ 70,000 of ordinary income.
D) $ 70,000 of capital gain.
Answer:  B
Topic:  Business Taxes
Question Status:  Revised
AACSB Guidelines:  Analytic skills

18) The dividend exclusion for corporations receiving dividends from another corporation has resulted in
A) a lower cost of equity for the corporation paying the dividend.
B) a higher relative cost of bond-financing for the corporation paying the dividend.
C) stock investments being relatively less attractive, relative to bond investments made by one corporation in another corporation.
D) stock investments being relatively more attractive relative to bond investments made by one corporation in another corporation.
Answer:  D
Topic:  Business Taxes
Question Status:  Revised
AACSB Guidelines:  Reflective thinking skills

19) All of the following are true EXCEPT
A) Interest income received by a corporation is taxed as ordinary income.
B) Corporations pay taxes on all dividends received from other corporations, no matter their share of ownership.
C) Corporations may pay taxes on only 30 percent of the dividends received from other corporations, depending on their percentage of ownership.
D) Capital gains is taxed as ordinary income.
Answer:  B
Topic:  Business Taxes
Question Status:  Revised

20) Meese Paper Distributors, Inc. has before-tax earnings of $1,900,000. Calculate the amount of the total tax liability.
Answer:

**Meese Paper Distributors**

| | | Tax Liability |
|---|---|---|
| 0.15 × $50,000 | = | $ 7,500 |
| 0.25 × $25,000 | = | 6,250 |
| 0.34 × $25,000 | = | 8,500 |
| 0.39 × ($335,000 - $100,000) | = | 91,650 |
| 0.34 × (1,900,000 - $335,000) | = | $532,100 |
| Total tax liability | = | $646,000 |

Topic: Business Taxes
Question Status: Revised
AACSB Guidelines: Analytic skills

21) During 2002, a firm has sold 5 assets described below. Calculate the tax liability on the assets. The firm pays a 40 percent tax rate on ordinary income.

| Asset | Purchase Price | Sale Price |
|---|---|---|
| 1 | $10,000 | $12,000 |
| 2 | $50,000 | $40,000 |
| 3 | $37,500 | $50,000 |
| 4 | $ 3,000 | $ 3,500 |
| 5 | $15,000 | $12,000 |

Answer:

| Asset | Tax Liability | | |
|---|---|---|---|
| 1 | $ 2,000(0.40) | = | $ 800 |
| 2 | — | | |
| 3 | $12,500(0.40) | = | $5,000 |
| 4 | $ 500(0.40) | = | $ 200 |
| 5 | — | | |

Topic: Business Taxes
Question Status: Revised
AACSB Guidelines: Analytic skills

22) Consider two firms, Go Debt corporation and No Debt corporation. Both firms are expected to have earnings before interest and taxes of $100,000 during the coming year. In addition, Go Debt is expected to incur $40,000 in interest expenses as a result of its borrowings whereas No Debt will incur no interest expense because it does not use debt financing. However, No Debt will have to pay stockholders $40,000 in dividend income. Both firms are in the 40 percent tax bracket. Calculate the Earnings after tax for both firms. Which firm has the higher after-tax earnings? Which firm appears to have the higher cash flow? How do you account for the difference?
Answer:

| | Go Debt | No Debt |
|---|---|---|
| Earnings before interest and taxes | $100,000 | $100,000 |
| Less: Interest expense | 40,000 | 0 |
| Earnings before taxes | $ 60,000 | $100,000 |
| Less: Taxes (40%) | 24,000 | 40,000 |
| Earnings after taxes | $ 36,000 | $ 60,000 |
| Less: Dividends paid | 0 | 40,000 |

Go Debt has lower earnings after taxes compared to No Debt. However, from a cash outflow perspective, Go Debt paid out a total of only $64,000 ($40,000 in interest expenses plus $24,000 in taxes) while No debt paid out a total of $80,000 ($40,000 in taxes and $40,000 in dividends). The difference between the two is $16,000 which is exactly the difference in taxes paid between the two firms ($24,000 compared to $40,000). This difference results from the fact that interest expense is a tax deductible expense.
Topic: Business Taxes
Question Status: Revised
AACSB Guidelines: Analytic skills