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Course Name: Financial Management

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Mid Term Exam

Q#1

McDougal Printing, Inc., had sales totaling $40,000,000 in fiscal year 2003. Some ratios for the company are listed below. Use this information to determine the dollar values of various income statement and balance sheet accounts as requested.

McDougal Printing, Inc.
Year Ended December 31, 2003

Sales	$40,000,000
Gross profit margin	80%
Operating profit margin	35%
Net profit margin	8%
Return on total assets	16%
Return on common equity	20%
Total asset turnover	2
Average collection period	62.2 days

Requirements:
Calculate values for the following:
a. Gross profits
b. Cost of goods sold
c. Operating profits
d. Operating expenses
e. Earnings available for common stockholders
f. Total assets
g. Total common stock equity
h. Accounts receivable

Solutions.

Requirements

1. **Gross profits (Gross profits formula)**

Answer. Gross profit = sales × gross profit margin

Gross profit = $40,000,000 × 80% = $32,000,000

Gross profit = $32,000,000

2. **Cost of goods sold**

Answer. Cost of goods sold = sales - gross profit

Cost of goods sold = $40,000,000 - $32,000,000 = $8,000,000

Cost of goods sold = $8,000,000

3. **Operating profits**

Answer. Operating profit = sales × operating profit margin

Operating profit = $40,000,000 × 35% = $14,000,000

Operating profit = $14,000,000

4. **Operating Expenses.**

Answer. Operating Expenses = gross profit – operating profit

Operating Expenses = $32,000,000 - $14,000,000 = $18,000,000

Operating Expenses = $18,000,000

5. **Earnings available for common stockholders.**

Answer.

Net profit = sales × net profit margin

Net profit = $40,000,000 × 8% = $32,00,000

Net profit = $32,00,000

6. **Total Assets.**

Answer.

$$\text{Total Assets} = \frac{\text{sales}}{\text{total assets turnover}}$$

$$\text{Total Assets} = \frac{\$40{,}000{,}000}{2}$$

Total assets = $20,000,000

7. **Total common stock equity.**

Answer.

$$\text{Total common stock equity} = \frac{\text{Net Income}}{\text{ROE}}$$

$$\text{Total common stock equity} = \frac{\$32{,}00{,}000}{20\%}$$

Total common stock equity = $16,000,000

8. Accounts receivable.

$$\text{Accounts receivable} = \text{average collection period} \times \frac{\text{sales}}{360}$$

$$\text{Accounts receivable} = 62.2 \text{ days} \times \frac{\$40{,}000{,}000}{360}$$

Accounts receivable = 62.2 days × $111,111 = $6.911,111

Accounts receivable = $6.911,111,111

Q#2

Identify the primary activities of the financial manager within the firm. Explain why wealth maximization, rather than profit maximization, is the firm's goal and how the agency issue is related to it.

Solution:

Requirement.1

the primary activities of the financial manager within the firm:

Financial Manager activities of a firm is one of the most important and complex activities of a firm. Therefore, in order to take care of these activities a financial manager performs all the requisite financial activities.

A financial manager is a person who takes care of all the important financial functions of an organization. The person in charge should maintain a far sightedness in order to ensure that the funds are utilized in the most efficient manner. His actions directly affect the Profitability, growth and goodwill of the firm.

The tasks undertaken by a financial manager are at the heart of major business decisions.

The duties of a finance manager include:

- Daily reporting.
- Analyzing targets.
- Meeting with department heads.
- Managing and coordinating monthly reporting, budgeting and reforecast processes.
- Providing back office services such as accounts payable, collection and payroll.
- Monitoring cash flow.
- Liaising with accountant teams.

Any company, whether it's a small-town bakery or General Motors, needs money to operate. To make money, it must first spend money—on inventory and supplies, equipment and facilities, and employee wages and salaries. Therefore, finance is critical to the success of all companies. It may not be as visible as marketing or production, but management of a firm's finances is just as much a key to the firm's success.

Requirement.2

Explain why wealth maximization, rather than profit maximization, is the firm's goal:

The process through which the company is capable of increasing earning capacity is known as profit maximization, on the other hand the ability of the company in increasing the value of stock is known as wealth maximization.

Wealth maximization is a better operative criterion then profit maximization on following ground:

- Profit maximization avoids time value of money but wealth maximization recognizes it
- Profit maximization is a short term objective where wealth maximization is long term objective
- Profit maximization ignore risk and invest but wealth maximization take care of it

The terms Profit Maximization and Wealth Maximization are related to Financial Management.

When we talk about **Profit Maximization**, it means that the business's primary focus is on generating profits. It is a short term objective of the organization whereas **Wealth Maximization** is an objective where the focus is on Maximization of wealth or the worth of the business. In other words, we can say it means increasing the shareholdersers wealth (I.e. increase in share value). It is a long term objective of the firm.

Profit Maximization v/s Wealth Maximization.

- Profit Maximization is the short term goal whereas Wealth Maximization is long term goal.
- Profit Maximization is a traditional approach. Financial management has shifted its focus to modern approach I.e. Wealth Maximization.

- Profit Maximization is a more relative term as compared to wealth maximization
- Profit Maximization doesn't consider risks and uncertainties whereas Wealth Maximization takes risks and uncertainties into consideration.
- Profit Maximization avoids time value of money but, wealth maximization recognizes it.
- Profit Maximization is important for the growth and survival. Wealth Maximization on the other hand accelerates the growth rate and aims at market share Maximization.

Requirement.3

The agency issue:

We have seen that the goal of the financial manager should be to maximize the wealth of firm's owners. Thus managers can be viewed as agents of the owners who have hired them and given them decision making authority to manage the firm. Technically, any manager who owns less than 100 percent of the firm is to some degree an agent of the other owners.

"In some situations, an agent is utilizing resources of a principal. Therefore, although the agent is the decision-maker, they are incurring little to no risk, because all losses will be the burden of the principal. This is most commonly seen when shareholders contribute financial support to an entity that corporate executives use at their discretion. The agent may have a different risk tolerance than the principal because of the uneven distribution of risk."