Chapter 13 Practice Problems

1. Dick's Hotel has no debt outstanding and a total market value of $550,000. Earnings Before Interest and Taxes, EBIT, are projected to be $35,000. There are currently 20,000 shares outstanding. Dick's tax rate is 35 percent. Calculate the earnings per share, EPS, for Dick's. Remember that Net Income = (EBIT – Interest – Taxes).

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   \begin{align*}
   \text{EBIT} & = 35,000 \\
   \text{Interest} & = 0 \quad \text{There is no debt} \\
   \text{Tangible Inc} & = 35,000 \\
   \text{Taxes} & = (18,250) + (35\%) (35,000) \\
   \text{Net Inc.} & = 22,750
   \end{align*}
   \]

   \[
   \text{EPS} = \frac{22,750}{20,000 \text{ shares}} = 1.1375
   \]

2. What is the difference between direct and indirect bankruptcy costs?

   Direct bankruptcy costs are directly associated with bankruptcy whereas indirect costs are the costs of avoiding a bankruptcy filing incurred by a financially distressed firm.

3. What is a homemade capital structure?

   Also known as homemade leverage, it is the use of personal borrowing to change the overall amount of financial leverage to which the individual is exposed.

4. What is the optimal D/E ratio in Case I (with no taxes and no bankruptcy risk)?

   There is no optimal D/E ratio because capital structure does not matter when there are no taxes and no bankruptcy costs.
5. What is the optimal D/E ratio in Case II (with taxes)?

the optimal D/E ratio mix would be all
debt and no equity.

6. List and explain the types of bankruptcies described in the chapter:

Chapter 7 bankruptcy is when a firm is completely liquidated, which involves selling off all the assets,

Chapter 11 bankruptcy is when a firm undergoes a restructuring process with some provision for repayment of creditors.

7. List the order of payout for bondholders and stockholders in the case of bankruptcy.

Bondholders are always paid before stockholders. Common stockholders are the last to receive payment in the case of bankruptcy.

8. Explain the procedure for Chapter 11 bankruptcy.

1. A voluntary petition can be filed by the firm, or an involuntary petition can be filed by creditors.

2. Judge approves or denies the petition.

3. Usually the firm keeps operating.

4. The corporation and sometimes creditors submit an reorganization plan.

5. Creditors vote on the plan.

6. The plan is confirmed by the court.

7. The plan is executed.

8. For a fixed period, the firm operates according to the provisions of the plan.
Chapter 14 Practice Problem

1. Define the following terms:
   a. Stock payments
      A dividend paid in the form of stock which dilutes the value of each share outstanding
   b. Share repurchase
      The purchase, by a corporation, of its own shares of stock
   c. Cash dividends
      A dividend paid in the form of cash
   d. Stock splits
      An increase or decrease in a firm’s shares outstanding without any change in owner’s equity
   e. Homemade dividend policy
      The ability of shareholders to undo a firm’s dividend policy by reinvesting dividends or selling shares of stock
   f. Special dividend
      A one time dividend issued by a corporation
   g. Rights offer
      The issuance of common stock to existing shareholders
   h. Dividend declaration date
      Board declares the dividend and it becomes a liability of the firm
   i. Date of record
      Holders of record are determined and they will receive the dividend payment
   j. Ex-dividend date
      Occurs 2 days before the date of record, the holders who own the stock at the beginning of the day get the dividend
   k. Date of dividend payment
      Checks are mailed to stockholders entitled to the dividend
   l. Residual dividend policy
      The practice of paying out any remaining earnings as a dividend after maintaining a determined target capital structure
   m. Constant growth dividend policy
      The practice of maintaining a dividend and its historical pattern of growth
   n. Constant payout dividend policy
      The practice of paying out a pre-specified portion of earnings, for example 50%. 50% of earnings would be paid out no matter the amount.