

Chapter 2

Financial Statements, Cash Flow, and Taxes

ANSWERS TO END-OF-CHAPTER QUESTIONS

- 2-1 a. The annual report is a report issued annually by a corporation to its shareholders. It contains basic financial statements, as well as management's opinion of the past year's operations and the firm's future prospects. A firm's balance sheet is a statement of the firm's financial position at a specific point in time. It specifically lists the firm's assets on the left-hand side of the balance sheet, while the right-hand side shows its liabilities and equity, or the claims against these assets. An income statement is a statement summarizing the firm's revenues and expenses over an accounting period. Net sales are shown at the top of each statement, after which various costs, including income taxes, are subtracted to obtain the net income available to common shareholders. The bottom of the statement reports earnings and dividends per share.
- b. Common Shareholders' Equity (Net Worth) is the capital supplied by common shareholders--capital stock, paid-in capital, retained earnings, and, occasionally, certain reserves. Paid-in capital is the difference between the stock's par value and what shareholders paid when they bought newly issued shares. Retained earnings is the portion of the firm's earnings that have been saved rather than paid out as dividends.
- c. The statement of retained earnings shows how much of the firm's earnings were retained in the business rather than paid out in dividends. Note that retained earnings represents a claim against assets, not assets per se. Firms retain earnings primarily to expand the business, not to accumulate cash in a bank account. The statement of cash flows reports the impact of a firm's operating, investing, and financing activities on cash flows over an accounting period.
- d. Depreciation is a non-cash charge against tangible assets, such as buildings or machines. It is taken for the purpose of showing an asset's estimated dollar cost of the capital equipment used up in the production process. Amortization is a non-cash charge against intangible assets, such as goodwill. EBITDA is earnings before interest, taxes, depreciation, and amortization.

- e. Operating current assets are the current assets used to support operations, such as cash, accounts receivable, and inventory. It does not include short-term investments. Operating current liabilities are the current liabilities that are a natural consequence of the firm's operations, such as accounts payable and accruals. It does not include notes payable or any other short-term debt that charges interest. Net operating working capital is operating current assets minus operating current liabilities. Total net operating capital is sum of net operating working capital and operating long-term assets, such as net plant and equipment. Operating capital also is equal to the net amount of capital raised from investors. This is the amount of interest-bearing debt plus preferred stock plus common equity minus short-term investments.
- f. Accounting profit is a firm's net income as reported on its income statement. Net cash flow, as opposed to accounting net income, is the sum of net income plus non-cash adjustments. NOPAT, net operating profit after taxes, is the amount of profit a company would generate if it had no debt and no financial assets. Free cash flow is the cash flow actually available for distribution to investors after the company has made all investments in fixed assets and working capital necessary to sustain ongoing operations.
- g. Market value added is the difference between the market value of the firm (i.e., the sum of the market value of common equity, the market value of debt, and the market value of preferred stock) and the book value of the firm's common equity, debt, and preferred stock. If the book values of debt and preferred stock are equal to their market values, then MVA is also equal to the difference between the market value of equity and the amount of equity capital that investors supplied. Economic value added represents the residual income that remains after the cost of all capital, including equity capital, has been deducted.
- h. A progressive tax means the higher one's income, the larger the percentage paid in taxes. Taxable income is defined as gross income less a set of exemptions and deductions which are spelled out in the instructions to the tax forms individuals must file. Marginal tax rate is defined as the tax rate on the last unit of income. Average tax rate is calculated by taking the total amount of tax paid divided by taxable income.
- i. Capital gain (loss) is the profit (loss) from the sale of a capital asset for more (less) than its purchase price. Ordinary corporate operating losses can be carried backward for 3 years or forward for 10 years to offset taxable income in a given year.

- 2-2 The four financial statements contained in most annual reports are the balance sheet, income statement, statement of retained earnings, and statement of cash flows.
- 2-3 No because the \$20 million of retained earnings would probably not be held as cash. The retained earnings figure represents the reinvestment of earnings by the firm. Consequently, the \$20 million would be an investment in all of the firm's assets.
- 2-4 Operating capital is the amount of interest bearing debt, preferred stock, and common equity used to acquire the company's net operating assets. Without this capital a firm cannot exist, as there is no source of funds with which to finance operations.
- 2-5 NOPAT is the amount of net income a company would generate if it had no debt and held no financial assets. NOPAT is a better measure of the performance of a company's operations because debt lowers income. In order to get a true reflection of a company's operating performance, one would want to take out debt to get a clearer picture of the situation.
- 2-6 Free cash flow is the cash flow actually available for distribution to investors after the company has made all the investments in fixed assets and working capital necessary to sustain ongoing operations. It is the most important measure of cash flows because it shows the exact amount available to all investors.
- 2-7 If the business were organized as a partnership or a proprietorship, its income could be taken out by the owners without being subject to double taxation. Also, if you expected to have losses for a few years while the company was getting started, if you were *not* incorporated, and if you had outside income, the business losses could be used to offset your other income and reduce your total tax bill. These factors would lead you to *not* incorporate the business.

SOLUTIONS TO END-OF-CHAPTER PROBLEMS

- 2-1 Corporate yield = 9%; T = 35%
 AT yield = $9\%(1 - T)$
 $= 9\%(0.65) = 5.85\%$.

- 2-2 NI = \$3,000,000; EBIT = \$6,000,000; T = 40%; Interest = ?
 Need to set up an income statement and work from the bottom up.

EBIT	\$6,000,000	
Interest	<u>1,000,000</u>	
EBT	\$5,000,000	$EBT = \frac{\$3,000,000}{(1 - T)} = \frac{\$3,000,000}{0.6}$
Taxes (40%)	<u>2,000,000</u>	
NI	<u>\$3,000,000</u>	

$$\text{Interest} = \text{EBIT} - \text{EBT} = \$6,000,000 - \$5,000,000 = \$1,000,000.$$

- 2-3 EBITDA = \$7,500,000; NI = \$1,800,000; Int = \$2,000,000; T = 40%; DA = ?

EBITDA	\$7,500,000	
DA	<u>2,500,000</u>	$EBITDA - DA = \text{EBIT}; DA = \text{EBITDA} - \text{EBIT}$
EBIT	\$5,000,000	$\text{EBIT} = \text{EBT} + \text{Int} = \$3,000,000 + \$2,000,000$
Int	<u>2,000,000</u>	(Given)
EBT	\$3,000,000	$\xrightarrow{\quad} \frac{\$1,800,000}{(1 - T)} = \frac{\$1,800,000}{0.6}$
Taxes (40%)	<u>1,200,000</u>	
NI	<u>\$1,800,000</u>	(Given)

- 2-4 NI = \$3,100,000; DEP = \$500,000; AMORT = 0; NCF = ?
 $\text{NCF} = \text{NI} + \text{DEP} \text{ and } \text{AMORT} = \$3,100,000 + \$500,000 = \$3,600,000.$

- 2-5 NI = \$50,000,000; $R/E_{Y/E} = \$810,000,000$; $R/E_{B/Y} = \$780,000,000$; Dividends = ?

$$\begin{aligned} R/E_{B/Y} + \text{NI} - \text{Div} &= R/E_{Y/E} \\ \$780,000,000 + \$50,000,000 - \text{Div} &= \$810,000,000 \\ \$830,000,000 - \text{Div} &= \$810,000,000 \\ \$20,000,000 &= \text{Div}. \end{aligned}$$

2-6

Cash Provided or Used

Operating Activities

Net Income	\$30,000
Adjustments:	
Noncash adjustments:	
Amortization	6,000
Due to changes in working capital	
Increase in accounts receivable	(5,000)
Decrease in inventories	8,000
Increase in accounts payable	<u>4,000</u>
Net cash provided by operating activities	<u>\$43,000</u>

2-7 Interest Income = \$500

Capital Gain = $\$10,000 / \$50 = 200 \text{ shares} \times \$2.50 / \text{share} = \$500$

Interest Income

$\$500 \times 16.67\% =$	\$83.35
$\$500 \times 22\% =$	<u>\$110.00</u>
Total tax =	\$193.35

$$\$500 - \$193.35 = \underline{\underline{\$306.65}}$$

Capital Gain

$\$500 \times 16.67\% \times 0.5 =$	\$41.68
$\$500 \times 22\% \times 0.5 =$	<u>\$55.00</u>
Total tax =	\$96.68

$$\$500 - \$96.68 = \underline{\underline{\$403.32}}$$

2-8

	Alpha	Beta
Sales	\$2,000,000	\$2,000,000
COGS (55%)	<u>1,100,000</u>	<u>1,100,000</u>
Gross Profit	\$900,000	\$900,000
Operating Expense	300,000	300,000
Depreciation	<u>40,000</u>	<u>80,000</u>
EBT	560,000	520,000
Taxes (40%)	<u>224,000</u>	<u>208,000</u>
Earnings After Tax	\$336,000	\$312,000
+ Amortization	<u>40,000</u>	<u>80,000</u>
Cash Flow	\$376,000	\$392,000

The difference between the cash flows is \$16,000 (\$392,000 - \$376,000). Beta has larger cash flows because it claimed higher depreciation expense. Since depreciation is a tax deductible item, it creates a tax shield. The depreciation tax shield for Beta is \$32,000 (\$80,000 \times 0.40), while the depreciation tax shield for Alpha is \$16,000 (\$40,000 \times 0.40). The difference in tax shields of \$16,000 accounts for the difference in cash flows.

2-9 EBIT = \$750,000; DEP = \$200,000; 100% Equity; T = 40%
NI = ?; NCF = ?

First, determine net income by setting up an income statement:

EBIT	\$750,000
Interest	<u>0</u>
EBT	\$750,000
Taxes (40%)	<u>300,000</u>
NI	<u>\$450,000</u>

$$\text{NCF} = \text{NI} + \text{DEP} = \$450,000 + \$200,000 = \$650,000.$$

2-10 a. Income Statement

Sales revenues	\$12,000,000
Costs except depreciation	9,000,000
Depreciation	<u>1,500,000</u>
EBT	\$ 1,500,000
Taxes (40%)	<u>600,000</u>
Net income	\$ 900,000
Add back depreciation	<u>1,500,000</u>
Net cash flow	<u>\$ 2,400,000</u>

- b. If depreciation doubled, taxable income would fall to zero and taxes would be zero. Thus, net income would decrease to zero, but net cash flow would rise to \$3,000,000. Berndt would save \$600,000 in taxes, thus increasing its cash flow:

$$\Delta CF = T(\Delta \text{Depreciation}) = 0.4(\$1,500,000) = \$600,000.$$

- c. If depreciation were halved, taxable income would rise to \$2,250,000 and taxes to \$900,000. Therefore, net income would rise to \$1,350,000, but net cash flow would fall to \$2,100,000.
- d. You should prefer to have higher depreciation charges and higher cash flows. Net cash flows are the funds that are available to the owners to withdraw from the firm and, therefore, cash flows should be more important to them than net income.

2-11 NOPAT = EBIT(1 – Tax rate)

$$= \$60 \text{ million}(1 - 0.30) = \$42 \text{ million}$$

FCF = NOPAT - Net investment in operating capital

$$\text{FCF} = \$42 \text{ million} - \$30 \text{ million}$$

$$\text{FCF} = \$12 \text{ million}$$

$$\text{Mkt Value of 10\% of shares} = 0.10(\$18 \times 100 \text{ million}) = \$18 \text{ million}$$

Since the \$12 million of free cash flow is less than the market value of 10% of the company's shares, \$18 million, Aeroparts will not be able to carry out its repurchase plan.

2-12 a. $\text{NOPAT} = \text{EBIT}(1 - \text{Tax rate})$
 $= \$150,000,000(0.6)$
 $= \$90,000,000.$

b. $\text{NOWC}_{07} = \text{Operating CA} - \text{operating CL}$
 $= \$360,000,000 - (\$90,000,000 + \$60,000,000)$
 $= \$210,000,000.$

$\text{NOWC}_{08} = \$372,000,000 - \$180,000,000 = \$192,000,000.$

c. $\text{Operating capital}_{07} = \begin{matrix} \text{Net plant} \\ \text{and equipment} \end{matrix} + \begin{matrix} \text{Net operating} \\ \text{working capital} \end{matrix}$
 $= \$250,000,000 + \$210,000,000$
 $= \$460,000,000.$

$\text{Operating capital}_{08} = \$300,000,000 + \$192,000,000$
 $= \$492,000,000.$

d. $\text{FCF} = \text{NOPAT} - \text{Net investment in operating capital}$
 $= \$90,000,000 - (\$492,000,000 - \$460,000,000)$
 $= \$58,000,000.$

e. The large increase in dividends for 2008 can most likely be attributed to a large increase in free cash flow from 2007 to 2008, since FCF represents the amount of cash available to be paid out to shareholders after the company has made all investments in fixed assets and working capital necessary to sustain the business.

2-13

a. $\text{MVA} = \text{Market Value of Stock} - \text{Equity Capital supplied by shareholders}$
 $= (\$15/\text{share}) \times (50,000,000 \text{ shares}) - \$275,000,000 = \underline{\$475,000,000}.$

b. $\text{ROIC} = \text{NOPAT}/\text{Operating Capital}.$ NOPAT was previously calculated to = \$90,000,000.
 Operating capital was also previously calculated to = \$492,000,000.
 $\text{ROIC} = \$90,000,000/\$492,000,000 = 0.183 = \underline{18.3\%}$

c. $\text{EVA} = (\text{Operating capital})(\text{ROIC} - \text{WACC}) = (\$492,000,000)(0.183 - 0.12) = \underline{\$30,996,000}.$

2-14 Bridgewater Equine Corporation: Statement of Cash Flows for 2008 (Millions of Dollars)

	Cash Provided or (Used)
<i>Operating Activities</i>	
Net income	\$77.0
Adjustments:	
Noncash adjustments:	
Depreciation	30.0
Due to changes in working capital	
Increase in accounts receivable	(30.0)
Decrease in inventories	20.0
Increase in accounts payable	18.0
Increase in accruals	<u>12.0</u>
Net cash provided by operating activities	\$127.0
<i>Investing Activities</i>	
Cash used to acquire fixed assets	(\$80.0)
Change in short-term investments	<u>0.0</u>
Net cash provided by investing activities	(\$80.0)
<i>Financing Activities</i>	
Increase in notes payable	\$15.5
Increase in bonds outstanding	0.0
Payment of pref. and common dividends	<u>(60.5)</u>
Net cash provided by financing activities	(\$45.0)
<i>Summary</i>	
Net change in cash	\$2.0
Cash at beginning of year	\$10.0
Cash at end of year	\$12.0

2-15	<u>Prior Years</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>
	Profit earned	\$150,000	\$150,000	\$150,000
	Carry-back credit	<u>150,000</u>	<u>150,000</u>	<u>150,000</u>
	Adjusted profit	\$ 0	\$ 0	\$ 0
	Tax previously paid (40%)	<u>60,000</u>	<u>60,000</u>	<u>60,000</u>
	Tax refund: Taxes previously paid	<u>\$ 60,000</u>	<u>\$ 60,000</u>	<u>\$ 60,000</u>

Total check from Canada Revenue Agency = \$60,000 + \$60,000 + \$60,000 = \$180,000.

	<u>Future Years</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>
	Estimated profit	\$(650,000)	\$150,000	\$150,000	\$150,000	\$150,000
	Carry-forward credit	<u>0</u>	<u>150,000</u>	<u>50,000</u>	<u>0</u>	<u>0</u>
	Adjusted profit	\$ 0	\$ 0	\$100,000	\$150,000	\$150,000
	Tax (at 40%)	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 40,000</u>	<u>\$ 60,000</u>	<u>\$ 60,000</u>

SOLUTION TO SPREADSHEET PROBLEM

- 2-16 The detailed solution for the spreadsheet problem, *Solution for FM1 Ch 02 Build a Model.xls* is available on the textbook's Web site.

MINI CASE

Donna Jamison, a recent graduate of the University of Waterloo with four years of banking experience, was recently brought in as assistant to the chairman of the board of Computron Industries, a manufacturer of electronic calculators.

The company doubled its plant capacity, opened new sales offices outside its home territory, and launched an expensive advertising campaign. Computron's results were not satisfactory, to put it mildly. Its board of directors, which consisted of its president and vice-president plus its major shareholders (who were all local business people), was most upset when directors learned how the expansion was going. Suppliers were being paid late and were unhappy, and the bank was complaining about the deteriorating situation and threatening to cut off credit. As a result, Al Watkins, Computron's president, was informed that changes would have to be made, and quickly, or he would be fired. Also, at the board's insistence Donna Jamison was brought in and given the job of assistant to Fred Campo, a retired banker who was Computron's chairman and largest shareholder. Campo agreed to give up a few of his golfing days and to help nurse the company back to health, with Jamison's help.

Jamison began by gathering financial statements and other data. Assume that you are Jamison's assistant, and you must help her answer the following questions for Campo.

Balance Sheets

<u>Assets</u>	<u>2007</u>	<u>2008</u>
Cash	\$ 9,000	\$ 7,282
Short-term investments.	48,600	20,000
Accounts receivable	351,200	632,160
Inventories	715,200	1,287,360
Total current assets	<u>\$ 1,124,000</u>	<u>\$ 1,946,802</u>
Gross fixed assets	491,000	1,202,950
Less: accumulated depreciation	146,200	263,160
Net fixed assets	<u>\$ 344,800</u>	<u>\$ 939,790</u>
Total assets	<u><u>\$ 1,468,800</u></u>	<u><u>\$ 2,886,592</u></u>
<u>Liabilities and equity</u>	<u>2007</u>	<u>2008</u>
Accounts payable	\$ 145,600	\$ 324,000
Notes payable	200,000	720,000
Accruals	136,000	284,960
Total current liabilities	<u>\$ 481,600</u>	<u>\$ 1,328,960</u>
Long-term debt	323,432	1,000,000
Common stock (100,000 shares)	460,000	460,000
Retained earnings	203,768	97,632
Total equity	<u>\$ 663,768</u>	<u>\$ 557,632</u>
Total liabilities and equity	<u><u>\$ 1,468,800</u></u>	<u><u>\$ 2,886,592</u></u>

Income Statements

	2007	2008
Sales	\$ 3,432,000	\$ 5,834,400
Cost of goods sold	2,864,000	4,980,000
Other expenses	340,000	720,000
Depreciation	18,900	116,960
Total operating costs	\$ 3,222,900	\$ 5,816,960
EBIT	\$ 209,100	\$ 17,440
Interest expense	62,500	176,000
EBT	\$ 146,600	\$ (158,560)
Taxes (40%)	58,640	(63,424)
Net income	\$ 87,960	\$ (95,136)

Other data	2007	2008
Stock price	\$ 8.50	\$ 6.00
Shares outstanding	100,000	100,000
EPS	\$ 0.880	\$ (0.951)
DPS	\$ 0.220	\$ 0.110

Statement of retained earnings, 2008

Balance of retained earnings, 12/31/2007	\$ 203,768
add: Net income, 2008	\$ (95,136)
less: Dividend paid, 2008	\$ (11,000)
Balance of retained earnings, 12/31/2008	\$ 97,632

Statement of Cash Flows, 2008

Operating activities

Net income	\$ (95,136)
Adjustments:	
noncash adjustments:	
depreciation	116,960
changes in working capital:	
change in accounts receivable	(280,960)
change in inventories	(572,160)
change in accounts payable	178,400
change in accruals	<u>148,960</u>
Net cash provided by operating activities	\$ (503,936)

Investing activities

Cash used to acquire fixed assets	\$ (711,950)
change in short term investments	<u>\$ 28,600</u>
Net cash provided by operating activities	\$ (683,350)

Financing activities

change in notes payable	\$ 520,000
change in long-term debt	\$ 676,568
change in common stock	\$ -
payment of cash dividends	\$ (11,000)
Net cash provided by financing activities	<u>\$ 1,185,568</u>

Summary

Net change in cash	\$ (1,718)
Cash at beginning of year	9,000
Cash at end of year	<u><u>\$ 7,282</u></u>

a. What effect did the expansion have on sales and net income? What effect did the expansion have on the asset side of the balance sheet? What effect did it have on liabilities and equity?

Answer: Sales increased by over by over \$2.4 million, but net income fell by over \$190,000. Assets almost doubled. Debt and funds provided by suppliers increased, but retained earnings fell due to the year's loss.

b. What do you conclude from the statement of cash flows?

Answer: Net CF from operations = -\$503,936, because of negative net income and increases in working capital. The firm spent \$711,950 on FA. The firm borrowed heavily and sold some short-term investments to meet its cash requirements. Even after borrowing, the cash account fell by \$1,718.

c. What is free cash flow? Why is it important? What are the five uses of FCF?

Answer: FCF is the amount of cash available from operations for distribution to all investors (including shareholders and debtholders) after making the necessary investments to support operations. A company's value depends upon the amount of FCF it can generate.

1. Pay interest on debt.
2. Pay back principal on debt.
3. Pay dividends.
4. Buy back stock.
5. Buy nonoperating assets (e.g., marketable securities, investments in other companies, etc.)

d. What are operating current assets? What are operating current liabilities? How much net operating working capital and total net operating capital does Computron have?

Answer: Operating current assets are the CA needed to support operations. OP CA include: cash, inventory, receivables. OP CA exclude: short-term investments, because these are not a part of operations. Operating current liabilities are the CL resulting as a normal part of operations. OP CL include: accounts payable and accruals. OP CA exclude: notes payable, because this is a source of financing, not a part of operations.

NOWC = operating CA – operating CL

$$\begin{aligned}\text{NOWC}_{08} &= (\$7,282 + \$632,160 + \$1,287,360) - (\$324,000 + \$284,960) \\ &= \$1,317,842.\end{aligned}$$

$$\text{NOWC}_{07} = \$793,800.$$

Total operating working capital = NOWC + net fixed assets.

$$\begin{aligned}\text{Operating capital in 2008} &= \$1,317,842 + \$939,790 \\ &= \$2,257,632.\end{aligned}$$

$$\text{Operating capital in 2007} = \$1,138,600.$$

e. What are Computron's net operating profit after taxes (NOPAT) and free cash flow (FCF)?

ANSWER: NOPAT = EBIT(1 - TAX RATE)

$$\begin{aligned}\text{NOPAT}_{08} &= \$17,440(1 - 0.4) \\ &= \$10,464.\end{aligned}$$

$$\text{NOPAT}_{07} = \$125,460.$$

$$\begin{aligned}\text{FCF} &= \text{NOPAT} - \text{NET INVESTMENT IN CAPITAL} \\ &= \$10,464 - (\$2,257,632 - \$1,138,600) \\ &= \$10,464 - \$1,119,032 \\ &= -\$1,108,568.\end{aligned}$$

f. Calculate Computron's return on invested capital. Computron has a 10% cost of capital (WACC). Do you think Computron's growth added value?

ANSWER: ROIC = NOPAT / TOTAL NET OPERATING CAPITAL.

$$\begin{aligned}\text{ROIC}_{08} &= \$10,464 / \$2,257,632 \\ &= 0.5\%.\end{aligned}$$

$$\text{ROIC}_{07} = 11.0\%.$$

The ROIC of 0.5% is less than the WACC of 10%. Investors did not get the return they require. Note: high growth usually causes negative FCF (due to investment in capital), but that's OK if ROIC > WACC. For example, Home Depot has high growth, negative FCF, but a high ROIC.

g. Jamison also has asked you to estimate Computron's EVA. She estimates that the after-tax cost of capital was 10 percent in both years.

ANSWER: $EVA = NOPAT - (WACC)(CAPITAL)$.

$$\begin{aligned} EVA_{08} &= \$10,464 - (0.1)(\$2,257,632) \\ &= \$10,464 - \$225,763 \\ &= -\$215,299. \end{aligned}$$

$$\begin{aligned} EVA_{07} &= \$125,460 - (0.10)(\$1,138,600) \\ &= \$125,460 - \$113,860 \\ &= \$11,600. \end{aligned}$$

h. What happened to Computron's market value added (MVA)?

Answer: $MVA = \text{market value of the firm} - \text{book value of the firm}$.

$\text{Market value} = (\# \text{ shares of stock})(\text{price per share}) + \text{value of debt}$.

$\text{Book value} = \text{total common equity} + \text{value of debt}$.

If the market value of debt is close to the book value of debt, then MVA is market value of equity minus book value of equity. Assume market value of debt equals book value of debt.

$\text{Market value of equity 2008} = (100,000)(\$6.00) = \$600,000$.

$\text{Book value of equity 2008} = \$557,632$.

$MVA_{08} = \$600,000 - \$557,632 = \$42,368$.

$MVA_{07} = \$850,000 - \$663,768 = \$186,232$.

i. Given that Computron could have issued preferred shares yielding 6% net of costs, why did the company decide to borrow more from the bank at a rate of 7.5%?

Answer: Although the pre-tax cost of debt is more expensive than the preferred shares, interest costs are tax deductible whereas dividends are not. Therefore, on an after-tax basis the debt would cost Computron $7.5\% \times (1 - 0.4) = 4.5\%$, which is cheaper than the 6% preferred share cost.