

Fall 2009

MGT201- Financial Management (Session - 3)

Question No: 1 (Marks: 1) - Please choose one

Which type of responsibilities are primarily assigned to Controller and Treasurer respectively?

▶ **Operational; financial management**

- ▶ Financial management; accounting
- ▶ Accounting; financial management
- ▶ Financial management; operations

Question No: 2 (Marks: 1) - Please choose one

Which of the following statement (in general) is correct?

▶ A low receivables turnover is desirable

▶ **The lower the total debt-to-equity ratio, the lower the financial risk for a firm**

▶ An increase in net profit margin with no change in sales or assets means a weaker ROI

▶ The higher the tax rate for a firm, the lower the interest coverage ratio

Question No: 3 (Marks: 1) - Please choose one

Which group of ratios measures a firm's ability to meet short-term obligations?

▶ **Liquidity ratios**

- ▶ Debt ratios
- ▶ Coverage ratios
- ▶ Profitability ratios

Question No: 4 (Marks: 1) - Please choose one

Which group of ratios measures how effectively the firm is using its assets?

- ▶ Liquidity ratios
- ▶ Debt ratios
- ▶ Coverage ratios
- ▶ **Activity ratios**

Question No: 5 (Marks: 1) - Please choose one

Which group of ratios shows the extent to which the firm is financed with debt?

- ▶ Liquidity ratios
- ▶ **Debt ratios**
- ▶ Coverage ratios
- ▶ Profitability ratios

Question No: 6 (Marks: 1) - Please choose one

Interest payments, principal payments, and cash dividends are _____ the typical budgeting cash-flow analysis because they are _____ cash flows.

- ▶ Included in; financing
- ▶ **Excluded from; financing**
- ▶ Included in; operating
- ▶ Excluded from; operating

Question No: 7 (Marks: 1) - Please choose one

Which of the following make the calculation of NPV difficult?

- ▶ Estimated cash flows
- ▶ Discount rate
- ▶ Anticipated life of the business
- ▶ **All of the given options**

Question No: 8 (Marks: 1) - Please choose one

If a company issues bonus shares, what will be its effect on the debt equity ratio?

- ▶ It will improve
- ▶ It will deteriorate
- ▶ **No effect**
- ▶ None of the given options

Question No: 9 (Marks: 1) - Please choose one

For most firms, P/E ratios and risk_____.

- ▶ Will be directly related
- ▶ **Will have an inverse relationship**
- ▶ Will be unrelated
- ▶ Will both increase as inflation increases

Question No: 10 (Marks: 1) - Please choose one

Which of the following is the variability of return on stocks or portfolios not explained by general market movements. It is avoidable through diversification?

- ▶ Systematic risk
- ▶ Standard deviation
- ▶ **Unsystematic risk**
- ▶ Financial risk

Question No: 11 (Marks: 1) - Please choose one

The wider the range of possible outcomes i.e._____.

▶ **The greater the variability in potential Returns that can occur, the greater the Risk**

- ▶ The greater the variability in potential Returns that can occur, the lesser the Risk
- ▶ The greater the variability in potential Returns that can occur, the level of risk remain constant
- ▶ None of the given options

Question No: 12 (Marks: 1) - Please choose one

Assume that the expected returns of the portfolios are the same but their standard deviations are given in the options given below, which of the option represent the most risky portfolio according to standard deviation?

- ▶ 1.5%
- ▶ 2.0%
- ▶ 3.0%
- ▶ **4.0%**

Question No: 13 (Marks: 1) - Please choose one

Which of the following is a drawback of percentage of sales method?

- ▶ It is a rough approximation
- ▶ There is change in fixed asset during the forecasted period
- ▶ Lumpy assets are not taken into account
- ▶ **All of the given options**

Question No: 14 (Marks: 1) - Please choose one

The objective of financial management is to maximize _____ wealth.

- ▶ Stakeholders
- ▶ **Shareholders**
- ▶ Bondholders
- ▶ Directors

Question No: 15 (Marks: 1) - Please choose one

Which of the following is correct regarding the opportunity cost of capital for a project?

- ▶ The opportunity cost of capital is the return that investors give up by investing in the project rather than in securities of equivalent risk.
- ▶ Financial managers use the capital asset pricing model to estimate the opportunity cost of capital

▶ The company cost of capital is the expected rate of return demanded by investors in a company.

▶ **All of the given options**

Question No: 16 (Marks: 1) - Please choose one

Which of the following is equal to the market risk, beta, of a security?

▶ **The covariance between the security's return and the market return divided by the variance of the market's returns**

▶ The covariance between the security and market returns divided by the standard deviation of the market's returns

▶ The variance of the security's returns divided by the covariance between the security and market returns

▶ The variance of the security's returns divided by the variance of the market's returns

Question No: 17 (Marks: 1) - Please choose one

If risk and return combination of any stock is above the SML, what does it mean?

▶ It is offering lower rate of return as compared to the efficient stock

▶ **It is offering higher rate of return as compared to the efficient stock**

▶ Its rate of return is zero as compared to the efficient stock

▶ It is offering rate of return equal to the efficient stock

Question No: 18 (Marks: 1) - Please choose one

If we invest in many securities which are _____ to each other then it is possible to reduce overall risk for your investment.

▶ Comparable

▶ Parallel

▶ Highly correlated

▶ **Negatively correlated**

Question No: 19 (Marks: 1) - Please choose one

Why common stock of a company must provide a higher expected return than the debt of the same company?

- ▶ There is less demand for stock than for bonds
- ▶ There is greater demand for stock than for bonds
- ▶ **There is more systematic risk involved for the common stock**
- ▶ There is a market premium required for bonds

Question No: 20 (Marks: 1) - Please choose one

The ABC Company relies on preferred stock, bonds, and common stock for its long-term financing. Rank in ascending order (i.e., 1 = lowest, while 3 = highest) the likely after-tax component costs of the ABC's long-term financing.

- ▶ 1 = bonds; 2 = common stock; 3 = preferred stock
- ▶ 1 = bonds; 2 = preferred stock; 3 = common stock
- ▶ **1 = common stock; 2 = preferred stock; 3 = bonds**
- ▶ 1 = preferred stock; 2 = common stock; 3 = bonds

Question No: 21 (Marks: 1) - Please choose one

Which of the following is **NOT** a recognized approach for determining the cost of equity?

- ▶ Dividend discount model approach
- ▶ **Before-tax cost of preferred stock plus risk premium approach**
- ▶ Capital-asset pricing model approach
- ▶ Before-tax cost of debt plus risk premium approach

Question No: 22 (Marks: 1) - Please choose one

Which of the following will be confronted by the management in deciding the optimal level of current assets for the firm?

- ▶ **A trade-off between profitability and risk**
- ▶ A trade-off between liquidity and risk

- ▶ A trade-off between equity and debt
- ▶ A trade-off between short-term versus long-term borrowing

Question No: 23 (Marks: 1) - Please choose one

Your firm has a philosophy that is analogous to the hedging (maturity matching) approach. Which of the following is the most appropriate non-spontaneous form for financing the excess seasonal current asset needs?

- ▶ Trade credit
- ▶ 6-month bank notes
- ▶ Accounts payable
- ▶ **Common stock equity**

Question No: 24 (Marks: 1) - Please choose one

Which of the following is the common currency created by the group of European countries?

- ▶ The EU currency
- ▶ The European Union
- ▶ The EMU
- ▶ **The Euro**

Question No: 25 (Marks: 1) - Please choose one

Which of the following statements is most correct as it relates to the recording of a capital lease?

▶ The capital lease is shown on the lessee's balance sheet as an asset and amortized over the asset's useful life.

▶ **The capital lease is listed as an asset on the lessor's balance sheet and amortized over lease term.**

▶ A capital lease is listed as an asset on the lessee's balance sheet and must be amortized over the lease period.

▶ A capital lease is listed as an asset on the lessee's balance sheet and must be amortized over the asset's useful life.

Question No: 26 (Marks: 1) - Please choose one

Which of the following is the dividend that is normally paid to shareholders?

- ▶ Stock split
- ▶ Stock dividend
- ▶ Extra dividend
- ▶ **Regular dividend**

Question No: 27 (Marks: 1) - Please choose one

Which of the following signals is most likely to elicit a decrease in share price for slow growth utility company that currently pays a small dividend?

- ▶ A repurchase of 5% of the firm's stock
- ▶ An unexpected increase in the regular quarterly dividend
- ▶ **An unexpected decrease in the regular quarterly dividend**
- ▶ Borrowing funds in order to pay a cash dividend

Question No: 28 (Marks: 1) - Please choose one

The presence of which of the following costs is **NOT** used as a major argument against the M&M arbitrage process?

- ▶ Transaction costs
- ▶ **Insurance costs**
- ▶ Bankruptcy costs
- ▶ Agency costs

Question No: 29 (Marks: 1) - Please choose one

Which term would most likely be associated with the phrase "actions speak louder than words?"

- ▶ Incentive signaling
- ▶ Shareholder wealth maximization
- ▶ **Financial signaling**
- ▶ Optimal capital structure

Question No: 30 (Marks: 1) - Please choose one

When taxes are considered, the value of a levered firm equals the value of the_____.

- ▶ Unlevered firm
- ▶ Unlevered firm plus the value of the debt
- ▶ **Unlevered firm plus the present value of the tax shield**
- ▶ Unlevered firm plus the value of the debt plus the value of the tax shield

Question No: 31 (Marks: 1) - Please choose one

When financial disaster is looming, why management may borrow to invest in projects having a negative expected NPV?

- ▶ The firm's beta is now negative
- ▶ Taxes are no longer a concern
- ▶ The interest tax shield will cover the loan costs
- ▶ **The lender bears all the risk**

Question No: 32 (Marks: 1) - Please choose one

What is the present value of Rs.6,500 to be paid at the end of 8 years if the interest rate is 10% compounded annually?

- ▶ **Rs.3,032**
- ▶ Rs.3,890
- ▶ Rs.3,190
- ▶ Rs.4,301

Question No: 33 (Marks: 1) - Please choose one

What is the present value of Rs.717 to be paid at the end of 2 years if the interest rate is 9% compounded annually?

▶ **Rs.604**

▶ Rs.417

▶ Rs.715

▶ Rs.556

Question No: 34 (Marks: 1) - Please choose one

All of the following are the components of CML (capital market line) equation EXCEPT:

▶ Risk free rate of return

▶ Risk of the market

▶ Risk of stock portfolio

▶ **Net present value**

Question No: 35 (Marks: 1) - Please choose one

In NPV (Net Present Value) calculations, which of the following is used?

▶ Excepted rate of return

▶ **Required rate of return**

▶ Both expected rate of return and Required rate of return

▶ None of the given options

Question No: 36 (Marks: 1) - Please choose one

If Share A's Beta = +2.0 then it represents which of the following?

▶ **Share is twice as risky (or volatile) as the KSE market**

▶ Share is exactly as risky (or volatile) as the KSE market

▶ Share is half as risky (or volatile) as the KSE market

▶ Share would be exactly as volatile as the KSE market BUT in the opposite way

Question No: 37 (Marks: 1) - Please choose one

Beta coefficient is actually the slope of the line that shows the relationship between which of the following?

- ▶ Stock required rate of return on x-axis and market rate of return on y-axis
- ▶ Stock required rate of return on y-axis and market rate of return on x-axis
- ▶ **Stock expected rate of return on y-axis and market rate of return on x-axis**
- ▶ Stock required rate of return on y-axis and stock expected rate of return on x-axis

Question No: 38 (Marks: 1) - Please choose one

Which of the following is/are ideal source(s) of capital for profitable firms because of no transaction costs?

- ▶ Sizeable Cash
- ▶ Retained Earnings
- ▶ **Both Sizeable Cash and Retained Earnings**
- ▶ None of the given options

Question No: 39 (Marks: 1) - Please choose one

According to Traditionalist Theory, when an un-leveraged firm takes on more and more debt, which of the following phenomenon is observed?

- ▶ Cost of Capital increases, reaches a minimum point, and then falls
- ▶ **Cost of Capital decreases, reaches a minimum point, and then rises**
- ▶ Cost of Capital increases, reaches a maximum point, and then rises
- ▶ None of the given options

Question No: 40 (Marks: 1) - Please choose one

In the WACC equation ($r_D X_D + r_E X_E + r_P X_P$), X_E represents which of the following?

- ▶ Weight or Fraction of Total Capital value raised from bonds
- ▶ Weight or Fraction of Total Capital value raised from preferred stock
- ▶ **Weight or Fraction of Total Capital value raised from common stock**

- ▶ Weight or Fraction of Total Capital value raised from debentures

Question No: 41 (Marks: 1) - Please choose one

In the WACC equation ($r_D X_D + r_E X_E + r_P X_P$), X_D represents which of the following?

- ▶ **Weight or Fraction of Total Capital value raised from bonds**
- ▶ Weight or Fraction of Total Capital value raised from preferred stock
- ▶ Weight or Fraction of Total Capital value raised from common stock
- ▶ Weight or Fraction of Total Capital value raised from retained earnings

Question No: 42 (Marks: 1) - Please choose one

Which of the following represents the tax shield?

- ▶ **Interest on capital**
- ▶ Dividends to shareholders
- ▶ Retained earnings
- ▶ Establishment expenses

Question No: 43 (Marks: 1) - Please choose one

On declaration date of dividend, if ABC Company announces dividend higher than the previous years, which of the following phenomenon is likely to be observe?

- ▶ Stock price falls
- ▶ **Stock price rises**
- ▶ Stock price remains the same
- ▶ None of the given options

Question No: 44 (Marks: 1) - Please choose one

When $IRR < WACC$ it means that:

- ▶ Investment is acceptable as required rate of return is less then cost of capital
- ▶ **Investment is not acceptable as required rate of return is less then cost of capital**
- ▶ Investment is acceptable as required rate of return is equal to the cost of capital

- ▶ None of the given options is true

Question No: 45 (Marks: 1) - Please choose one

ABC Company moves from a "conservative" working capital policy to an "aggressive" policy. Which of the following results it should expect to achieve?

- ▶ Liquidity to decrease, whereas expected profitability would increase
- ▶ **Expected profitability to increase, whereas risk would decrease**
- ▶ Liquidity would increase, whereas risk would also increase
- ▶ Risk as well as profitability to decrease

Question No: 46 (Marks: 1) - Please choose one

Mr. A, a sole proprietor has purchased the raw material on credit; this transaction has generated which of the following?

- ▶ Permanent Financing
- ▶ **Spontaneous Financing**
- ▶ Short-term Loan
- ▶ All of the given options

Question No: 47 (Marks: 1) - Please choose one

Capital structure that minimizes the WACC is also a structure that maximizes the firm's_____.

- ▶ Earnings before interest & taxes (EBIT)
- ▶ Earning after tax (EAT)
- ▶ **Earning per share (EPS)**
- ▶ Return on equity (ROE)

Question No: 48 (Marks: 1) - Please choose one

In calculations regarding lease, net advantage of leasing is the difference between which of the following?

- ▶ Present value of net cash flows and present value of cost of leasing
- ▶ **Present value of cost of owning the asset and present value of cost of leasing**
- ▶ Present value of cost of owning the asset and present value of net cash flows
- ▶ None of the given options

Question No: 49 (Marks: 1) - Please choose one

A car manufacturing firm buys steel from a steel mill. Both these entities combined together to form a new firm. It is referred to which of the following?

- ▶ Horizontal Merger
- ▶ **Vertical Merger**
- ▶ Congeneric Merger
- ▶ Conglomerate Merger

Question No: 50 (Marks: 1) - Please choose one

Which of the following is a form of divestiture in which a subsidiary or division becomes an independent company?

- ▶ Sell-off
- ▶ **Spin-off**
- ▶ Liquidation
- ▶ Merger

Question No: 51 (Marks: 1) - Please choose one

From which of the following equations, net income can be calculated?

- ▶ **$NI = (EBIT - x_D r_D) (1 - T_c)$**
- ▶ $NI = (EAT - x_D r_D) (1 - T_c)$
- ▶ $NI = (EBIT + x_D r_D) (1 - T_c)$
- ▶ $NI = (EBIT - x_D r_D) / (1 - T_c)$

Question No: 52 (Marks: 1) - Please choose one

Which of the following is the formula to calculate the tax shield?

- ▶ **Corporate tax rate x Market value of debt**
- ▶ Corporate tax rate / Market value of debt
- ▶ Corporate tax rate + Market value of debt
- ▶ Corporate tax rate - Market value of debt

Question No: 53 (Marks: 1) - Please choose one

Which one of the following is correct for the spot exchange rate?

▶ It is the effective exchange rate for a foreign currency for delivery at a specific location on a specific future date

▶ **It is the effective exchange rate for a foreign currency for immediate delivery at a specific location**

▶ It is the effective exchange rate for a foreign currency for delivery at a specific future date

▶ It is the effective exchange rate for a foreign currency for delivery on the current day

Question No: 54 (Marks: 1) - Please choose one

What is the primary principle for money changers?

▶ Ask rate should be less than bid rate

▶ **Ask rate should be greater than bid rate**

▶ Ask rate should be equal to bid rate

▶ Bid rate should be greater than ask rate

Question No: 55 (Marks: 3)

If interest tax shields are valuable, why don't all taxpaying firms borrow as much as possible?

Tax shield give us benefit up to certain level but as leverage increases Firm becomes more Risky so Lenders and Banks Charge Higher Interest Rates and Greater Chance of Bankruptcy.

Question No: 56 (Marks: 5)

There are different methods to raise capital within the organization. Briefly explain the advantages of equity financing into the business.

Equity financing gives the flexibility we don't need to pay fix amount. In case of bond or debt we need to pay fixed interest in case of failure there is threat of Defaulter. Mostly the advantages of equity finance are reaped by the small business enterprises. In some case debt rate is too high that time equity help you to get cheaper capital financing.

Question No: 57 (Marks: 5)

What is long-term financing? Explain the factors that can affect the decision of a manager while deciding about long term financing?

Long term financing is a kind of financing which is provided for a period of more than one year.

Permanent Financing comes in two forms:

- Long-term Loans - Bonds It has Low Risk for Firm but has High Cost normally more than one year.
- Common Equity or Stock its Less Risk for Firm but Highest Cost.

If a company is using long-term financing it has higher cost of financing due high interest cost of long term loans despite high cost we have low risk, due to surety of access to money for a longer period. Current liabilities as a source of financing are not reliable as you have no surety whether you will have same amount of money available next month for financing or not.

Question No: 58 (Marks: 10)

What is a credit policy and what factors an organization should consider while designing its credit policy and how can a firm use 5/10, net 30 basis and carrying charges in its credit policy?

Credit Policy: It is the credit adjusted given to customer based upon payment history.

Factors considered for credit:

Assessment of Credit-worthiness of each credit customer

Minimize duration of credit and Value.

Give incentives to Customers to pay cash and to pay quickly

Suppose if someone pays later then last date of payment he/she will pay extra 1% etc.

“Sell on 5/10.net 30 basis”

30 basis Means customer will pay full cash value within 30 days. 5/10.net means 5% discount for customers who will pay within 10 days. It will be like incentive to customer who will pay early.

Impost some extra charge in the form of carry charges in case of later payment

Question No: 59 (Marks: 10)

Firms A and B are identical except their use of debt and the interest rates they pay. Firm A has more debt and thus must pay a higher interest rate.

Requirement:

Based on the data given below, how much higher or lower will be the A's ROE that of B, i.e., what is $ROE_A - ROE_B$?

<u>Applicable to Both Firms</u>	<u>Firm A's Data</u>	<u>Firm LD's Data</u>
Assets Rs. 3,000,000	Debt ratio 70%	Debt ratio 20%
EBIT Rs.500, 000	Int. rate 12%	Int. rate 10%
Tax rate 35%		

For company A 20% leverage so equity will be 30% of 3,000,000 = 900000

EBIT = 500,000

Interest (12% of 500,000) = (6000)

EBT 494,000

Tax (35% of EBT) (148200)

Net income 345,800

Expected ROE (=NI/Equity) $345,800 / (900000) = 38.42\%$

For company B 20% leverage so equity will be 80% of 3,000,000 = 2400000

EBIT = 500,000

Interest (10% of 500,000) = (5000)

EBT 495,000

Tax (35% of EBT) (148500)

Net income 346,500

Expected ROE (=NI/Equity) $346500 / (2400000) = 14.43\%$

$ROE_A - ROE_B = 38.42 - 14.43$

= 23.99

Fall 2009

MGT201- Financial Management (Session - 3)

Question No: 1 (Marks: 1) - Please choose one

Which of the following type of lease is a long-term lease that is not cancelable and its life often matches the useful life of the asset?

- ▶ **A financial**
- ▶ An operating
- ▶ Both financial & operating lease
- ▶ None of the given options

Question No: 2 (Marks: 1) - Please choose one

Which of the following would cause the gross profit margin to remain unchanged, but the net profit margin declined over the same period?

- ▶ Cost of goods sold increased relative to sales
- ▶ Sales increased relative to expenses
- ▶ **Govt. increased the tax rate**
- ▶ Dividends were decreased

Question No: 3 (Marks: 1) - Please choose one

The accounting statement of cash flows reports a firm's cash flows segregated into which of the following categorical order?

- ▶ **Operating, investing, and financing**
- ▶ Investing, operating, and financing
- ▶ Financing, operating and investing
- ▶ Financing, investing, and operating

Question No: 4 (Marks: 1) - Please choose one

Managers prefer IRR over net present value because they evaluate investments:

- ▶ In terms of dollars
- ▶ **In terms of Percentages**
- ▶ Intuitively
- ▶ Logically

Question No: 5 (Marks: 1) - Please choose one

From which of the following category would be the cash flow received from sales revenue and other income during the life of the project?

- ▶ Cash flow from financing activity
- ▶ Cash flow from operating activity
- ▶ Cash flow from investing activity
- ▶ **All of the given options**

Question No: 6 (Marks: 1) - Please choose one

Bond is a type of Direct Claim Security whose value is **NOT** secured by _____.

- ▶ Tangible assets
- ▶ **Intangible assets**
- ▶ Fixed assets
- ▶ Real assets

Question No: 7 (Marks: 1) - Please choose one

Which one of the following is the right of the issuer to call back or retire the bond by paying off the bondholders before the maturity date?

- ▶ Call in
- ▶ Call option

► **Call provision**

- Put option

Question No: 8 (Marks: 1) - Please choose one

Which of the following is designated by the individual investor's optimal portfolio?

- The point of tangency with the opportunity set and the capital allocation line
- The point of highest reward to variability ratio in the opportunity set
- **The point of tangency with the indifference curve and the capital allocation line**
- The point of the highest reward to variability ratio in the indifference curve

Question No: 9 (Marks: 1) - Please choose one

Which of the following is **NOT** the form of cash flow generated by the investments of the shareholders?

- Income
- Capital loss
- Capital gain
- **Operating income**

Question No: 10 (Marks: 1) - Please choose one

You wish to earn a return of 13% on each of two stocks, X and Y. Stock X is expected to pay a dividend of Rs. 3 in the upcoming year while Stock Y is expected to pay a dividend of Rs. 4 in the upcoming year. The expected growth rate of dividends for both stocks is 7%. The intrinsic value of stock X:

- Will be greater than the intrinsic value of stock Y
- Will be the same as the intrinsic value of stock Y
- **Will be less than the intrinsic value of stock Y**
- Cannot be calculated without knowing the market rate of return

Question No: 11 (Marks: 1) - Please choose one

Which of the following is **CORRECT**, if a firm has a required rate of return equal to the ROE?

- ▶ The firm can increase market price and P/E by retaining more earnings
- ▶ The firm can increase market price and P/E by increasing the growth rate
- ▶ **The amount of earnings retained by the firm does not affect market price or the P/E**
- ▶ None of the given options

Question No: 12 (Marks: 1) - Please choose one

Which of the following is **NOT** a major cause of unsystematic risk.

- ▶ New competitors
- ▶ New product management
- ▶ **Worldwide inflation**
- ▶ Strikes

Question No: 13 (Marks: 1) - Please choose one

Assume that the expected returns of the portfolios are the same but their standard deviations are given in the options given below, which of the option represent the most risky portfolio according to standard deviation?

- ▶ 1.5%
- ▶ 2.0%
- ▶ 3.0%
- ▶ **4.0%**

Question No: 14 (Marks: 1) - Please choose one

The logic behind _____ is that instead of looking at net cash flows you look at cash inflows and outflows separately for each point in time.

- ▶ IRR
- ▶ **MIRR**
- ▶ PV

- ▶ NPV

Question No: 15 (Marks: 1) - Please choose one

In which of the following approach you need to bring all the projects to the same length in time?

- ▶ MIRR approach
- ▶ Going concern approach
- ▶ **Common life approach**
- ▶ Equivalent annual approach

Question No: 16 (Marks: 1) - Please choose one

Which of the following is equal to the market risk, beta, of a security?

▶ **The covariance between the security's return and the market return divided by the variance of the market's returns**

- ▶ The covariance between the security and market returns divided by the standard deviation of the market's returns
- ▶ The variance of the security's returns divided by the covariance between the security and market returns
- ▶ The variance of the security's returns divided by the variance of the market's returns

Question No: 17 (Marks: 1) - Please choose one

If you become more aggressive with your investments, which one of the following is likely to occur?

- ▶ Your risk will decrease
- ▶ **Your risk will increase**
- ▶ Your risk will stay the same
- ▶ Your return will be lower

Question No: 18 (Marks: 1) - Please choose one

In efficient market the stock price depends upon the required return which depends upon _____.

▶ **Market risk**

- ▶ Total risk
- ▶ Diversified risk
- ▶ Non- Systematic risk

Question No: 19 (Marks: 1) - Please choose one

How much return would be offered by the stock whose (risk and return) pair lies above the SML?

- ▶ No return
- ▶ Lower return
- ▶ Average return
- ▶ **Excessive return**

Question No: 20 (Marks: 1) - Please choose one

Find the Expected Return on the Market Portfolio given that the Expected Return on Stock is 17%, the Risk-Free Rate is 1.1%, and the Beta for Stock is 1.5.

- ▶ **11.7%**
- ▶ 12.14%
- ▶ 13.23%
- ▶ 13.82%

Question No: 21 (Marks: 1) - Please choose one

Which of the following represent all Risk –Return Combinations for the efficient portfolios in the capital market?

- ▶ Parachute graph
- ▶ **CML straight line equation**
- ▶ Security market line

- ▶ All of the given options

Question No: 22 (Marks: 1) - Please choose one

Assume the nominal interest rates (annual) in the country of Freedonia and the United States are 6% and 12% respectively. What is the implied 90-day forward rate if the current spot rate is 5 Freedonian marks (FM) per U.S. dollar?

- ▶ 4.732
- ▶ **4.927**
- ▶ 5.074
- ▶ 5.283

Question No: 23 (Marks: 1) - Please choose one

Which of the following statements is most correct as it relates to the recording of a capital lease?

- ▶ The capital lease is shown on the lessee's balance sheet as an asset and amortized over the asset's useful life.
- ▶ **The capital lease is listed as an asset on the lessor's balance sheet and amortized over lease term.**
- ▶ A capital lease is listed as an asset on the lessee's balance sheet and must be amortized over the lease period.
- ▶ A capital lease is listed as an asset on the lessee's balance sheet and must be amortized over the asset's useful life.

Question No: 24 (Marks: 1) - Please choose one

The trade terms "1/10, net 45" indicate that _____.

- ▶ **A 45% discount is permitted if payment is made within 10 days**
- ▶ A 1% discount is permitted if payment is made within 10 days
- ▶ A 10% discount is permitted if payment is made within 45 days
- ▶ A 1% discount is permitted if payment is made within 45 days

Question No: 25 (Marks: 1) - Please choose one

When the buyer purchases securities through a brokerage house, it is called as:

- ▶ Dutch-auction operation
- ▶ **Fixed-price operation**
- ▶ Open-market operation
- ▶ Fair-warning operation

Question No: 26 (Marks: 1) - Please choose one

The presence of which of the following costs is **NOT** used as a major argument against the M&M arbitrage process?

- ▶ Transaction costs
- ▶ **Insurance costs**
- ▶ Bankruptcy costs
- ▶ Agency costs

Question No: 27 (Marks: 1) - Please choose one

An implicit cost of adding debt to the capital structure is that it:

- ▶ Adds interest expense to the operating statement
- ▶ **Increases the required return on equity**
- ▶ Reduces the expected return on assets
- ▶ Decreases the firm's beta

Question No: 28 (Marks: 1) - Please choose one

When financial disaster is looming, why management may borrow to invest in projects having a negative expected NPV?

- ▶ The firm's beta is now negative
- ▶ Taxes are no longer a concern
- ▶ The interest tax shield will cover the loan costs
- ▶ **The lender bears all the risk**

Question No: 29 (Marks: 1) - Please choose one

What is difference between shares and bonds?

- ▶ Bonds represent ownership whereas shares do not
- ▶ **Shares represent ownership whereas bonds do not**
- ▶ Shares and bonds both represent equity
- ▶ Bonds represent equity whereas shares do not

Question No: 30 (Marks: 1) - Please choose one

What is the present value of Rs.53,000 to be paid at the end of 15 years if the interest rate is 9% compounded annually?

- ▶ Rs.25,300
- ▶ Rs.34,122
- ▶ **Rs.14,549**
- ▶ Rs.11,989

Question No: 31 (Marks: 1) - Please choose one

Market portion of risk can be represented through which of the following?

- ▶ **Standard deviation**
- ▶ Beta coefficient
- ▶ Correlation coefficient
- ▶ Variance

Question No: 32 (Marks: 1) - Please choose one

The KSE (Karachi Stock Exchange) 100 Index represents what?

- ▶ **The value of Portfolio of Highest volume stocks**
- ▶ The value of Portfolio of all Stocks
- ▶ The value of Portfolio of lowest volume stocks

- ▶ None of the given options

Question No: 33 (Marks: 1) - Please choose one

All of the following are used in calculation of required return on a particular stock using SML equation **EXCEPT**:

- ▶ Risk free rate
- ▶ Market risk premium
- ▶ Stock's beta
- ▶ **Stock's price**

Question No: 34 (Marks: 1) - Please choose one

What will be the Stock Y's risk premium if the average share of stock Y has a required return of 20% and beta for that stock is 1.0? In addition, treasury bonds yield is 10%?

- ▶ 5%
- ▶ **10%**
- ▶ 20%
- ▶ 30%

Question No: 35 (Marks: 1) - Please choose one

Which of the following represents the tax shield?

- ▶ **Interest on capital**
- ▶ Dividends to shareholders
- ▶ Retained earnings
- ▶ Establishment expenses

Question No: 36 (Marks: 1) - Please choose one

Which of the following theory suggests that shareholder wealth is maximized by a low Dividend Payout?

- ▶ MM Irrelevance Theory
- ▶ Bird in the Hand Theory
- ▶ **Tax Preference Theory**
- ▶ Signaling Theory

Question No: 37 (Marks: 1) - Please choose one

In residual dividend model, what does the term 'Conservatism' refer?

- ▶ Overvaluation of free cash flows
- ▶ **Underestimation of free cash flows**
- ▶ Overestimation of free cash flows
- ▶ None of the given option

Question No: 38 (Marks: 1) - Please choose one

Which of the following states that dividends can not exceed retained earnings which are shown in balance sheet?

- ▶ Irrelevance theory
- ▶ **Impairment of Capital Rule**
- ▶ Bird-in-the-hand rule
- ▶ Tax preference theory

Question No: 39 (Marks: 1) - Please choose one

Mr. X is going to purchase the stock of ABC Company. Mr. X should purchase the stock on which date so that he can be entitled to receive the dividend, keeping in mind the ex-dividend date is December 7?

- ▶ **December 6**
- ▶ December 7
- ▶ December 8
- ▶ December 9

Question No: 40 (Marks: 1) - Please choose one

Which of the following statement shows the total stand alone risk of a firm?

- ▶ Unique risk + Market risk
- ▶ Diversified risk + Financial risk
- ▶ **Business risk + Financial risk**
- ▶ Business risk + Market risk

Question No: 41 (Marks: 1) - Please choose one

Which of the following best matches this statement: "A policy under which relatively large amount of cash, marketable securities, and inventories are carried and under which sales are stimulated by a liberal credit policy, resulting in a high level of receivable"?

- ▶ **Fat cat working capital policy**
- ▶ Lean & Mean working capital policy
- ▶ Moderate working capital policy
- ▶ None of the given options

Question No: 42 (Marks: 1) - Please choose one

Calculate the return on equity (ROE) of ABC Company using Du Pont equation and the data given below:

Profit Margin= 30%

Asset Turnover= 50%

Leverage Factor = 60%

- ▶ 3.6%
- ▶ **9%**
- ▶ 14%
- ▶ 33%

Question No: 43 (Marks: 1) - Please choose one

Which of the following is the total cost formula?

- ▶ Fixed cost * Quantity + Variable cost
- ▶ Variable cost * Quantity - Fixed cost
- ▶ **Variable cost * Quantity + Fixed cost**
- ▶ Fixed cost * Quantity - Variable cost

Question No: 44 (Marks: 1) - Please choose one

Capital structure theory is presented by which of the following?

- ▶ Robert Alan Hill
- ▶ **Modigliani & Miller**
- ▶ Brigham & Houston
- ▶ Van Horne & Gittman

Question No: 45 (Marks: 1) - Please choose one

Which of the following statements is correct regarding an aggressive financing policy for a firm relative to a previous conservative policy?

- ▶ The firm will use long-term financing to finance all fixed and current assets
- ▶ **The firm will see an increase in its expected profits than before**
- ▶ The firm will see a decline in its overall risk profile
- ▶ The firm will need to issue additional common stock this period to finance the assets

Question No: 46 (Marks: 1) - Please choose one

Under which of the following conditions, suppliers may refuse to supply the raw material?

- ▶ **When there is rumor of bankruptcy of the firm**
- ▶ When firms are financed through debt
- ▶ When firms are financed through equity
- ▶ Under uncertain market conditions

Question No: 47 (Marks: 1) - Please choose one

Which of the following is also known as service lease?

- ▶ Capital Lease
- ▶ Financial Lease
- ▶ **Operating Lease**
- ▶ Sale & Lease-Back

Question No: 48 (Marks: 1) - Please choose one

Company A has to purchase another company. How do Company A pay for buying the other company?

- ▶ In Cash
- ▶ In Shares
- ▶ Bank Borrowing
- ▶ **All of the given options**

Question No: 49 (Marks: 1) - Please choose one

Two businesses at the same level of production are merging together. It is referred as:

- ▶ **Horizontal Merger**
- ▶ Vertical Merger
- ▶ Congeneric Merger
- ▶ Conglomerate Merger

Question No: 50 (Marks: 1) - Please choose one

Under pure M&M theory, WACC does not change with _____.

- ▶ **Change of debt in capital structure**

- ▶ Change in EPS
- ▶ Change financial expenses
- ▶ Change in business risk

Question No: 51 (Marks: 1) - Please choose one

According to the trade off theory, value of the firm rises as a result of _____.

▶ **Tax saving**

- ▶ Increase in EPS
- ▶ Increase in EBIT
- ▶ Saving in cost of debt

Question No: 52 (Marks: 1) - Please choose one

From which of the following equations, net income can be calculated?

▶ **$NI = (EBIT - x_D r_D) (1 - T_c)$**

- ▶ $NI = (EAT - x_D r_D) (1 - T_c)$
- ▶ $NI = (EBIT + x_D r_D) (1 - T_c)$
- ▶ $NI = (EBIT - x_D r_D) / (1 - T_c)$

Question No: 53 (Marks: 1) - Please choose one

Calculate the Forward Rate for Rupee using Interest Rate Parity if the interest on 1 Year Maturity in Pakistan is 10% and on Euro is 6% and the forward rate is Rs.124/ EUR.

- ▶ Rs. 6 per EUR
- ▶ Rs. 120 per EUR
- ▶ **Rs. 124 per EUR**
- ▶ Rs. 1240 per EUR

Question No: 54 (Marks: 1) - Please choose one

Which of the following is known as selling price for currency?

► **Bid rate**

- Ask rate
- Forward rate
- Spot rate

Question No: 55 (Marks: 3)

Write a short note on real asset markets and also give some examples.

The real asset market where the real physical asset are traded .for example, you have wheat market, cotton market, where real material change hands.

Examples: Gold Market, Property (land, house)

Question No: 56 (Marks: 5)

Company XYZ wants to issue more Common Stock of Face Value Rs 12. Next Year the Dividend is expected to be Rs. 3 per share assuming a Dividend Growth Rate of 10% pa.

The Lawyer's fee and Stock Brokers' Commissions will cost Rs 1 per share. Investors are confident about Company ABC so the Common Share is floated at a Market Price of Rs 18 (i.e. Premium of Rs 6).

If the Capital Structure of Company ABC is entirely Common Equity, then what is the Company's WACC? Use New Stock Issuance Approach to calculate the results.

$$DIV1 = 2$$

$$G = 10\%$$

$$\text{Lawyer fee and comm.} = 1 \text{ Rs}$$

$$P_0 = 16$$

Capital structure is equity base 100%

As company is 100 equity it means unleveraged company so its wacc will be required rate of return on equity.

Required ROR for Common Stock using Gordon's Formula

$$r = (DIV1/P_0) + g$$

$$P_0 = \text{market price} = 18$$

$$Div1 = \text{Next Dividend} = 3$$

G = growth rate = 10%

$r = (3/18) + 10\% = 26.66\%$

Now If company wanted to issue the stock via new float then it has to pay the lawyer fee and broker commission which 1 Rs.

Net proceed = $18 - 1 = 17$

$r = (3/17) + 10\% = 27.64\%$

Question No: 57 (Marks: 5)

Why may payout decisions be used by management to signal the prospects of the firm? Give answer in bulleted form.

- If a company selected the high pay out policy without the cash flow to back it up.
- They will find that it ultimately has to either reduce the investments or turn to capital markets for additional debt or equity financing.
- As it is costly, managers will not increase dividends unless they are confident that the firm will get enough cash to pay them.
- It is main reason that we say that there is an information signal attached to dividends payout policy.
- So any change in the dividend payout policy send signals of a change in the firm's prospects.
- Investors take it positively that a company plans to repurchase its stock.
- If they are worried that the company has more cash than it can profitably employ, they may be pleased to see the cash given back to the shareholders.

Question No: 58 (Marks: 10)

What are the factors affecting signaling theory?

(Give the answer in bulleted form only with brief description)

- This theory consider that all Investors not have equal amount of information.
- All investors are not rational.
- Insider have more information compare to general public
- A Firm's Owners & Managers (Insiders) know more about it than Ordinary outside Investors.
- When manage or owner knows that there are better chances of high cash flow or some project which can bring good profit or earning. They try to finance the capital via debt or bond. They avoid use the equity issuance. Because they don't wanted to share the profit with number share holders. They take capital via debt by paying small amount of interest by this they can earn huge profits.
- When Firm's Outlook looks bad or some risky project, then Managers will choose to raise capital by Issuing Equity by doing this they will be able to share the Likely Losses amongst more Shareholders. If they took Debt and couldn't repay it, they might Default and be forced to go Bankrupt.
- By doing this investor also get signal that if companies is financing its capital via debt then likely it will be some good prospect in the company.
- By looking at these practices by management we can so mangers are in a better position to decide about the firm.

Question No: 59 (Marks: 10)

Explain the following conditions:

- **IRR <WACC**
- **IRR >WACC> SML**
- **IRR <SML**
- **IRR <WACC< SML**

IRR <WACC

you should not invest in this project as rate of return is less than WACC. In other words your returns are less than the cost of capital.

IRR >WACC> SML

we should take this project as its rate of return is higher than the WACC and it offers better return than an efficient market offers. Due to IRR is higher than SML

IRR <SML

It is showing rate of return which is lower than SML we should not invest in such project because it is not giving as much return as efficient market is returns

IRR <WACC< SML

IRR lower than WACC and SML company should not invest as IRR is not enough to cover the WACC (not enough to cover the cost of capital) plus its returns are lower than returns offered by efficient market.

Fall 2009

MGT201- Financial Management (Session - 3)

Question No: 1 (Marks: 1) - Please choose one

The DuPont Approach breaks down the earning power on shareholders' book value (ROE) as follows: ROE = _____.

- ▶ **Net profit margin × Total asset turnover × Equity multiplier**
- ▶ Total asset turnover × Gross profit margin × Debt ratio
- ▶ Total asset turnover × Net profit margin
- ▶ Total asset turnover × Gross profit margin × Equity multiplier

ROE = (Profit margin)*(Asset turnover)*(Equity multiplier) = (Net profit/Sales)*(Sales/Assets)*(Assets/Equity)

Question No: 2 (Marks: 1) - Please choose one

Which group of ratios shows the extent to which the firm is financed with debt?

- ▶ Liquidity ratios
- ▶ **Debt ratios**
- ▶ Coverage ratios
- ▶ Profitability ratios

A ratio that indicates what proportion of debt a company has relative to its assets. The measure gives an idea to the leverage of the company along with the potential risks the company faces in terms of its debt-load.

Question No: 3 (Marks: 1) - Please choose one

Interest paid (earned) on both the original principal borrowed (lent) and previous interest earned is often referred to as _____.

- ▶ Present value
- ▶ Simple interest
- ▶ Future value

► **Compound interest**

When the compound interest calculation is used, interest is calculated on the original principal plus all interest accrued to that point in time. Since interest is paid on interest as well as on the amount borrowed, the effective interest rate is greater than the nominal interest rate. The compound interest rate method is often used by banks and savings institutions in determining interest they pay on savings deposits "loaned" to the institutions by the depositors.

Question No: 4 (Marks: 1) - Please choose one

A capital budgeting technique that is NOT considered as discounted cash flow method is:

► **Payback period**

- Internal rate of return
- Net present value
- Profitability index

Payback cannot be calculated if the positive cash inflows do not eventually outweigh the cash outflows. That is why payback (like IRR) is of little use when used with a pure "costs only" it does not take into account the concept of time value of money. The cash flows are considered regardless of the time in which they are occurring. You must have noticed that we have not used any interest rate while making calculation

Question No: 5 (Marks: 1) - Please choose one

You are selecting a project from a mix of projects, what would be your first selection in descending order to give yourself the best chance to add most to the firm value, when operating under a single-period capital-rationing constraint?

► **Profitability index (PI)**

- Net present value (NPV)
- Internal rate of return (IRR)
- Payback period (PBP)

Question No: 6 (Marks: 1) - Please choose one

Which of the following is a legal agreement between the corporation issuing bonds and the bondholders that establish the terms of the bond issue?

▶ **Indenture**

- ▶ Debenture
- ▶ Bond
- ▶ Bond trustee

Indenture": Long Legal Agreement between the Issuer (or Borrower) and the Bond Trustee (Generally a bank of financial institution that acts as the representative for all Bondholders). Basically protects Bondholders from mis-management by the bond issuer, default, other security holders, etc.

Question No: 7 (Marks: 1) - Please choose one

What is yield to maturity on a bond?

▶ It is below the coupon rate when the bond sells at a discount, and equal to the coupon rate when the bond sells at a premium

▶ **The discount rate that will set the present value of the payments equal to the bond price**

▶ It is based on the assumption that any payments received are reinvested at the coupon rate

▶ None of the given options

Question No: 8 (Marks: 1) - Please choose one

The value of direct claim security is derived from which of the following?

▶ Fundamental analysis

▶ **Underlying real asset**

▶ Supply and demand of securities in the market

▶ All of the given options

Question No: 9 (Marks: 1) - Please choose one

_____ is equal to (common shareholders' equity/common shares outstanding).

▶ **Book value per share**

- ▶ Liquidation value per share
- ▶ Market value per share
- ▶ None of the above

Question No: 10 (Marks: 1) - Please choose one

The present value of growth opportunities (PVGO) is equal to

- I) The difference between a stock's price and its no-growth value per share
- II) The stock's price
- III) Zero if its return on equity equals the discount rate
- IV) The net present value of favorable investment opportunities

- ▶ I and IV
- ▶ II and IV
- ▶ **I, III, and IV**
- ▶ II, III, and IV

Question No: 11 (Marks: 1) - Please choose one

Which of the following statement about portfolio statistics is **CORRECT**?

- **A portfolio's expected return is a simple weighted average of expected returns of the individual securities comprising the portfolio.**
- A portfolio's standard deviation of return is a simple weighted average of individual security return standard deviations.
- The square root of a portfolio's standard deviation of return equals its variance.
- The square root of a portfolio's standard deviation of return equals its coefficient of variation.

Question No: 12 (Marks: 1) - Please choose one

Which of the following is NOT a major cause of unsystematic risk.

- ▶ New competitors
- ▶ New product management
- ▶ **Worldwide inflation**
- ▶ Strikes

Question No: 13 (Marks: 1) - Please choose one

Which of the following is the characteristic of a well diversified portfolio?

- ▶ Its market risk is negligible
- ▶ **Its unsystematic risk is negligible**
- ▶ Its systematic risk is negligible
- ▶ All of the given options

Question No: 14 (Marks: 1) - Please choose one

Which of the following factor(s) do **NOT** affects the movements in the market index?

- ▶ Macroeconomic factors
- ▶ Socio political factors
- ▶ **Social factors**
- ▶ All of the given options

Question No: 15 (Marks: 1) - Please choose one

If stock is a part of totally diversified portfolio then its company risk must be equal to:

- ▶ **0**
- ▶ 0.5
- ▶ 1
- ▶ -1

Question No: 16 (Marks: 1) - Please choose one

How much return would be offered by the stock whose (risk and return) pair lies below the SML?

- ▶ No return
- ▶ **Lower return**
- ▶ Average return
- ▶ Excessive return

Any Stock whose (Risk, Return) Pair lies BELOW THE SML is offering a Return that is lower than the Market.

Question No: 17 (Marks: 1) - Please choose one

Market risk is measured in terms of the _____ of the market portfolio or index.

- ▶ Variance
- ▶ Covariance
- ▶ **Standard deviation**
- ▶ Correlation coefficient

Market Risk is measured in terms of the Standard Deviation (or Volatility) of the Market Portfolio or Index

Question No: 18 (Marks: 1) - Please choose one

What is the meaning of the term “arbitrage”?

- ▶ Buying low and selling high
- ▶ **Earning risk-free economic profits**
- ▶ Negotiating for favorable brokerage fees
- ▶ Hedging your portfolio through the use of options

Arbitrage is exploiting security mispricing by the simultaneous purchase and sale to gain economic profits without taking any risk. A capital market in equilibrium rules out arbitrage opportunities

Question No: 19 (Marks: 1) - Please choose one

Which of the following is the market where tangible or physical asset change hand?

- ▶ Money market
- ▶ Capital market
- ▶ **Real asset market**
- ▶ Equity market

The real asset market where the real or tangible asset or physical asset change hand .for example, you have cotton exchange where raw bales of cotton change hands .computer hardware and many other examples are available. For example, Cotton Exchange, Gold Market, Kapra Market Property (land, house, apartment, warehouse) ,Computer hardware, Used Cars, Wheat, Sugar, Vegetables, etc.

Question No: 20 (Marks: 1) - Please choose one

Which of the following is related to the use Lower financial leverage?

- ▶ Fixed cost
- ▶ Variable cost
- ▶ Debt financing
- ▶ **Common equity financing**

Question No: 21 (Marks: 1) - Please choose one

Which of the following will be confronted by the management in deciding the optimal level of current assets for the firm?

- ▶ **A trade-off between profitability and risk**
- ▶ A trade-off between liquidity and risk
- ▶ A trade-off between equity and debt
- ▶ A trade-off between short-term versus long-term borrowing

Question No: 22 (Marks: 1) - Please choose one

Which of the following is an example of a natural hedge?

▶ **The prices and costs are both determined in the global market place.**

▶ The prices are determined in the global market place and costs are determined in the domestic market place.

▶ The costs are determined in the global market place and prices are determined in the domestic market place.

▶ None of the given options is correct

Natural hedges are generated when both prices and costs are determined in similar market places.

Question No: 23 (Marks: 1) - Please choose one

For which of the following strategy; economies of scale, market share dominance, and technological advances are reasons most likely to be offered to justify?

▶ Financial acquisition

▶ **Strategic acquisition**

▶ Divestiture

▶ Supermajority merger approval provision

Question No: 24 (Marks: 1) - Please choose one

Which of the following is incorrect regarding the costs and benefits of holding inventories and cash?

▶ The benefit of higher inventory levels is the reduction in order costs associated with restocking and the reduced chances of running out of material.

▶ The costs of higher inventory levels are the carrying costs, which include the cost of space, insurance, spoilage, and the opportunity cost of the capital tied up in inventory.

▶ Cash provides liquidity, but it doesn't pay interest. Securities pay interest, but you can't use them to buy things.

▶ **As financial manager you want to hold cash up to the point where the incremental or marginal benefit of liquidity is 25% higher than the cost of holding cash, that is, the interest that you could earn on securities.**

Question No: 25 (Marks: 1) - Please choose one

Which of the following is the dividend that is normally paid to shareholders?

- ▶ Stock split
- ▶ Stock dividend
- ▶ Extra dividend
- ▶ **Regular dividend**

Question No: 26 (Marks: 1) - Please choose one

A technique that tells us the number of years required to recover our initial cash investment based on the project's expected cash flows is:

- ▶ **Pay back period**
- ▶ Internal rate of return
- ▶ Net present value
- ▶ Profitability index

In this technique, we try to figure out how long it would take to recover the invested capital through positive cash flows of the business.

Question No: 27 (Marks: 1) - Please choose one

A proposal is accepted if payback period falls within the time period of 3 years. According to the given criteria which of the following project will be accepted?

	Payback period
Project A	1.66
Project B	2.66
Project C	3.66

- ▶ Project A

- ▶ Project B
- ▶ Project C
- ▶ **Project A & B**

Question No: 28 (Marks: 1) - Please choose one

Assume a company had Rs.1 billion in free cash flow last year, and it is expected to grow that cash flow at 3% into perpetuity. Assuming a 9% cost of equity, what is the present value of the company?

- ▶ **Rs. 12.08 billion**
- ▶ Rs. 18.15 billion
- ▶ Rs. 14.16 billion
- ▶ Rs. 16.67 billion

Question No: 29 (Marks: 1) - Please choose one

What is the present value of Rs.1,000 to be paid at the end of 5 years if the interest rate is 8% compounded annually?

- ▶ **Rs. 680.58**
- ▶ Rs. 1,462.23
- ▶ Rs. 322.69
- ▶ Rs. 401.98

$$FV = PV \times (1 + i)^n$$

$$PV = FV / (1 + i)^n$$

$$= 1000 / (1 + 0.08)^5$$

$$= 680.27$$

Question No: 30 (Marks: 1) - Please choose one

What will be the market risk premium for stock C if the average share of stock C has a required return of 15% and treasury bonds yield is 10%?

- ▶ **5%**

- ▶ 10%
- ▶ 15%
- ▶ 25%

15%-10%= 5%

The difference between the expected return on a market portfolio and the risk-free rate.

Question No: 31 (Marks: 1) - Please choose one

All of the following are used in calculation of required return on a particular stock using SML equation **EXCEPT**:

- ▶ Risk free rate
- ▶ Market risk premium
- ▶ Stock's beta
- ▶ **Stock's price**

SML Equation (assumes Efficient Stock Pricing, Risk, and Return)

$$r_A = r_{RF} + (r_M - r_{RF}) \beta_A$$

Question No: 32 (Marks: 1) - Please choose one

On which of the following ground, the Arbitrage Pricing Model is different from the Capital Asset Pricing Model?

- ▶ It places more emphasis on market risk
- ▶ It minimizes the importance of diversification
- ▶ **It recognizes multiple systematic risk factors**
- ▶ It recognizes multiple unsystematic risk factors

Question No: 33 (Marks: 1) - Please choose one

According to Traditionalist Theory, when a 100% Equity Firm takes on more and more debt, which of the following phenomenon is observed?

- ▶ Share Price first falls, then reaches minimum and finally rises
- ▶ Share Price first rises, then reaches minimum and finally falls
- ▶ **Share Price first rises, then reaches maximum and finally falls**
- ▶ None of the given options

Total Market Value of Firm ($V = D + E = \text{Market Value of Debt} + \text{Market Value of Equity}$) first rises (because of Interest Tax Shield savings), then reaches a maximum point (optimal capital structure), and finally falls (because of excessive fall in Net Income and Equity value because of interest payments).

Question No: 34 (Marks: 1) - Please choose one

Which of the following formula represents the yield to maturity?

- ▶ Interest yield + Market price
- ▶ Capital gain yield + Book value
- ▶ **Interest yield + Capital gain yield**
- ▶ Market price + Capital gain yield

YTM= interest yield +capital gain yield and it is representative of over all cost of debt in the form of bond.

Question No: 35 (Marks: 1) - Please choose one

Bird-in-the-hand dividend theory was proposed by which of the following?

- ▶ Miller Modigliani
- ▶ **Myron Gordon and John Lintner**
- ▶ Henry Fayol
- ▶ William John and Lehman

Bird in the Hand (Gordon & Lintner) Theory

Question No: 36 (Marks: 1) - Please choose one

XYZ Corporation has offered its shareholders the option that their dividends will be used to purchase additional shares of this corporation. This offer of XYZ Corporation is referred as:

- ▶ Stock repurchases
- ▶ **Dividend reinvestment**
- ▶ Stock dividends
- ▶ Stock splits

Dividend Reinvestment Plans (DRIP): Firms give stockholders option to automatically reinvest cash dividends by buying more of the same stock

Question No: 37 (Marks: 1) - Please choose one

When $IRR < WACC$ it means that:

- ▶ Investment is acceptable as required rate of return is less than cost of capital
- ▶ **Investment is not acceptable as required rate of return is less than cost of capital**
- ▶ Investment is acceptable as required rate of return is equal to the cost of capital
- ▶ None of the given options is true

Link for Reference

Question No: 38 (Marks: 1) - Please choose one

Which of the following statement depicts the disadvantage of issuing debt?

- ▶ Debt financing leads toward unlimited liability
- ▶ **If company doesn't pay interest, it can be close down**
- ▶ It can improve the return on equity
- ▶ Not fixed payment of interest is required by investors

Disadvantage of Too Much Debt: Firm becomes more Risky so Lenders and Banks Charge Higher Interest Rates and Greater Chance of Bankruptcy

Question No: 39 (Marks: 1) - Please choose one

The decisions regarding capital structure of a firm are mainly concerned with which of the following?

- ▶ Assets side of balance sheet
- ▶ **Liabilities side of balance sheet**
- ▶ Expense side of profit and loss account
- ▶ Incomes side of profit and loss account

Capital Structure and Corporate Financing - Long Term LIABILITIES Side of Balance Sheet

Question No: 40 (Marks: 1) - Please choose one

If Current assets = Rs. 16,000,

Current liabilities= Rs. 10,000

Inventory= Rs. 2500

Calculate quick ratio for the firm?

- ▶ **1.35**
- ▶ 6.0
- ▶ 1.60
- ▶ 0.25

A desirable quick ratio can range from (0.8:1) to (1.5:1) depending on the nature of the business.

= (Current Assets – Inventory) / Current Liabilities

= (16000-2500)/10000

= 1.35

Question No: 41 (Marks: 1) - Please choose one

If an investor is risk averse, then which of the following options best suits him?

- ▶ Debentures
- ▶ Common stock

▶ **T -Bills**

- ▶ Preferred stock

It is important to remember that we have the option of investing in the T-bill portfolio which offers a risk free rate of return

Question No: 42 (Marks: 1) - Please choose one

Capital structure theory is presented by which of the following?

- ▶ Robert Alan Hill
- ▶ **Modigliani & Miller**
- ▶ Brigham & Houston
- ▶ Van Horne & Gittman

Answer provided by Capital Structure Theory.

Modigliani - Miller:

- **Fathers of Corporate Finance**

Question No: 43 (Marks: 1) - Please choose one

Which of the following is true regarding financial leverage?

- ▶ Whenever a firm's equity increases faster than its debt, financial leverage increases
- ▶ **Investors can undo the effects of the firm's capital structure by using home-made leverage**
- ▶ Increasing financial leverage will always increase the EPS for stockholders
- ▶ The level of financial leverage that produces the minimum firm value is the most beneficial to stockholders

[Click For Reference](#)

Question No: 44 (Marks: 1) - Please choose one

If a firm wants to use short-term bank loan to finance its temporary current assets and even to buy some of its permanent current inventory, then which of the following policy it is going to adopt?

- ▶ **Moderate working capital policy**
- ▶ Conservative working capital policy
- ▶ Aggressive working capital policy
- ▶ Any of the given policy

• **Balance of Long and Short-term Financing.**

• **Long Term Financing for Fixed and Permanent Current Assets. Use Short Term Financing for Permanent Current Assets. Use Spontaneous Current Liability Financing for Temporary Current Assets**

Question No: 45 (Marks: 1) - Please choose one

Which of the following statements depicts the trade-off theory in a better way?

- ▶ It states a tradeoff between the costs and benefits of debt financing
- ▶ **It states the tradeoff between the debt financing and equity financing**
- ▶ There is tradeoff between assets and liabilities of the firm
- ▶ There is tradeoff between revenues and expenses of the firm

Question No: 46 (Marks: 1) - Please choose one

Modigliani and Miller presented capital structure theory in which of the following years?

- ▶ 1950
- ▶ **1958**
- ▶ 1963
- ▶ 1965

Cost of Capital, Corporate Finance and the Theory of Investment” Revolutionary Article Published by Professors Modigliani & Miller in American Economic Review in June 1958. Won Nobel Prize

Question No: 47 (Marks: 1) - Please choose one

In which of the following, synergies are not expected?

- ▶ Operating merger
- ▶ **Financial merger**
- ▶ Vertical Merger
- ▶ Horizontal Merger

- Pure Financial Merger - Operations remain independent
- Operating Merger - Operations are Integrated & Changed & Synergies Expected

Question No: 48 (Marks: 1) - Please choose one

“Company X wants to merge with Company Y but Company X’s management is resisting the merger. Company X asks the shareholders of Company Y to tender their shares in exchange the offered price.” This statement refers to which of the following?

- ▶ Horizontal Merger
- ▶ Vertical Merger
- ▶ **Hostile Merger**
- ▶ Conglomerate Merger

Reference 4 Specific Types of Mergers:

- **Horizontal Merger: merger of 2 competitors - can lead to Monopoly**
- **Vertical Merger: merger of a supplier with a buyer**
- **Co generic Merger: merger of firms in same industry**
- **Conglomerate Merger: merger of firms in unrelated industries**

Question No: 49 (Marks: 1) - Please choose one

What happens to the total risk when leverage increases at a slow rate?

- ▶ Total risk increases with slow rate than the leverage

- ▶ Total risk increases with decreasing rate
- ▶ Total risk remains the same
- ▶ **Total risk increases faster than the leverage**

Question No: 50 (Marks: 1) - Please choose one

According to _____, the firm's cost of equity increases with greater debt financing, while the WACC first decreases and then increases.

- ▶ M&M Proposition I with taxes
- ▶ M&M Proposition I without taxes
- ▶ The traditional theory of capital structure
- ▶ **M&M Proposition II without taxes**

Question No: 51 (Marks: 1) - Please choose one

Which of the following is incorrect regarding Modigliani and Miller's (MM's) famous debt irrelevance proposition?

- ▶ It states that firm value can't be increased by changing capital structure
- ▶ MM show that the extra return and extra risk balance out, leaving shareholders no better or worse off
- ▶ MM's argument rests on simplifying assumptions i.e. efficient capital markets and ignores taxes and costs of financial distress
- ▶ **Firm value increases when more debt is used**

As companies take more debt they are exposed to more financial risk.

Question No: 52 (Marks: 1) - Please choose one

Which of the following refers to a unique type of Japanese corporate organization based on a close partnership between government and businesses?

- ▶ **Keiretsu**
- ▶ Chaebols

- ▶ Lean and mean
- ▶ Options

A grouping of Japanese firms through historic associations and equity interlocks such that each firm maintains its operational independence (definition of keiretsu)

Question No: 53 (Marks: 1) - Please choose one

Calculate the Forward Rate for Rupee if the interest on 1 Year Maturity in Pakistan is 10% and in Australia is 6% and the current spot rate is Rs.76/ AUD.

- ▶ Rs. 6 per AUD
- ▶ Rs. 76 per AUD
- ▶ **Rs. 79 per AUD**
- ▶ Rs. 456 per AUD

$$\begin{aligned}
 F &= S (\text{Rs. /AUD\$}) (1+ i \text{ Rs.}) / (1+ i \text{ AUD\$}) \\
 &= 76(1+0.1)/ (1+0.06) \\
 &= 78.87
 \end{aligned}$$

Question No: 54 (Marks: 1) - Please choose one

Calculate the Forward Rate for Rupee using Interest Rate Parity if the interest on 1 Year Maturity in Pakistan is 10% and on Euro is 6% and the forward rate is Rs.124/ EUR.

- ▶ Rs. 6 per EUR
- ▶ Rs. 120 per EUR
- ▶ **Rs. 124 per EUR**
- ▶ Rs. 1240 per EUR

$$F = S (\text{Rs. /AUD\$}) (1+ i \text{ Rs.}) / (1+ i \text{ AUD\$})$$

There some technical problem with question

It should give spot rate if they wanted to calculate forward rate. If we assume 124 as spot rate then its answer for forward rate should be 128.67

How it can be possible with parity of 10% and 6% after one year euro has the same value of 124Rs.

$$= F = S (\text{Rs.}) (1 + i \text{ Rs.}) / (1 + i \text{ euro})$$
$$= (124) (1 + 0.1) / (1 + 0.06) = 128.6792$$

or if we assume it ask us to calculate the spot Rate and 124 is assumed as forward rate in that case answer could be 120

Question No: 55 (Marks: 3)

Tax shield for the calculation of cost of debt but not for the calculation of the equity stock. Why? Give reason.

Because you can get tax exemption on the interest payment, in case of debt financing. But you are not entitled for any Tax shield in case of equity.

Question No: 56 (Marks: 5)

Ahsan Enterprises, an all-equity firm, is considering a proposal of new capital investment. Analysis has indicated that the proposed investment has a beta of 0.5 and will generate an expected return of 7%. The firm currently has a required return of 10.75% and a beta of 1.25. The investment, if undertaken, will double the firm's total assets.

Requirement:

If r_{RF} is 7% and the market risk premium is 3%, should the firm undertake the investment?

Beta = .5

Expected Rate of return = 7%

Required rate of return = 10.75

Beta = 1.25%

Ahsan Enterprises uses only equity capital, so its cost of equity is also its corporate cost of capital, or WACC.

WACC = 10.75 %

“The investment, if undertaken, will double the firm's total assets” tells us that exactly same amount will be injected

So after the injection of new investment with beta of .5, impact on overall beta will be

$$.5 * (1.25) + .5*(.5) = .875$$

Now we will calculate the Required Rate of return with new beta

RR = WACC = risk free rate of return + (Market rate of return - risk free rate of return)*beta

$$WACC = 7\% + (7\% - 3\%)*.875 = 10.50\%$$

$$= .5*10.50 + .5*7 =$$

Due to new investment cost of capital reduced from 10.75% to 10.50%

Overall expected rate of return must be more than 10.50% but new investment is giving us the expected rate of return of 7%

Now we will see expected return after injection of new investment

$$.5(10.75) + .5(7) = 8.87\%$$

as it is less than 10.50 so we should drop it.

Question No: 57 (Marks: 5)

Mergers can be classified in two broad categories i.e. Financial and Operating merger. Differentiate between these two.

Financial Merger	Operating Merger
------------------	------------------

The operations remains independent	The operations are integrated and changed and synergies expected.

Question No: 58 (Marks: 10)

Using the Capital Asset Pricing Model (CAPM), determine the required return on equity for the following situations:

Situations	Expected return on market portfolio	Risk- free rate	Beta
1	16%	12%	1.00
2	18%	8%	0.80
3	15%	14%	0.70

What generalization can you make?

Required Rate of return = risk free rate of return + (market return- risk free rate)* beta

1. = 12% + (16%-12%)*1 = 16%
2. = 8% + (18%-8%)*.8 = 16%
3. = 14% + (15%-14%)*.7 = 14.7%

Generalization: as beta of 1 in case of our security No.1 It is fully diversified and its return is 16% which exactly equal to market portfolio return. Any value of beta above the 1 can increase the rate of return but same it will increase the Risk as well.

Question No: 59 (Marks: 10)

What are stock dividends and stock splits? Explain with the help of examples and how do these affect stock prices?

(3+3+4 marks)

Stock Dividend: They are used to control the share price if it rises too fast. They bring share price down to within an optimal price range so that more investors can afford to trade in it and trading volume rises.

Example: Company offers 10% stock dividend to all shareholders. It means that if you own 100 shares then company will give you 10 more shares free of cost. Number of shares increases but total value of firm is unchanged.

Stock Split: They are used to share price if it rises too fast. Number of share outstanding increase. They are used to increase Float.

Example: Company with 1000 shares outstanding to outside shareholders declares 2-for-1 stock split. Means that the number of shares outstanding will increase to 2000 shares (i.e. 100% increase). Number of shares rises but firm value unchanged.

Effect of Stock Dividend and Stock Splits on prices:

Prices rises immediately afterwards because investors take them to be positive signals about the company's future. But if company does not declares higher earnings and dividends in near future, price will come back down again.

Fall 2009

MGT201- Financial Management (Session - 3)

Question No: 1 (Marks: 1) - Please choose one

Which of the following would **NOT** improve the current ratio?

- ▶ **Borrow short term to finance additional fixed assets**
- ▶ Issue long-term debt to buy inventory
- ▶ Sell common stock to reduce current liabilities
- ▶ Sell fixed assets to reduce accounts payable

Question No: 2 (Marks: 1) - Please choose one

Which group of ratios measures how effectively the firm is using its assets?

- ▶ Liquidity ratios
- ▶ Debt ratios
- ▶ **Coverage ratios**
- ▶ Activity ratios

Question No: 3 (Marks: 1) - Please choose one

The RBS pays 5.60%, compounded daily (based on 360 days), on a 9-month certificate of deposit, if you deposit Rs. 20, 000 you would expect to earn around _____ in interest.

- ▶ Rs.840
- ▶ **Rs.858**
- ▶ Rs.1,032
- ▶ Rs.1,121

Question No: 4 (Marks: 1) - Please choose one

Assume that the interest rate is greater than zero. Which of the following cash-inflow streams totaling Rs.1, 500 would you prefer? The cash flows are listed in order for Year 1, Year 2, and Year 3 respectively.

- ▶ **Rs.700 Rs.500 Rs.300**
- ▶ Rs.300 Rs.500 Rs.700
- ▶ Rs.500 Rs.500 Rs.500
- ▶ Any of the above, since they each sum to Rs.1,500

Question No: 5 (Marks: 1) - Please choose one

Which of the following would be considered a cash-flow item from an "operating activity"?

- ▶ **Cash outflow to the government for taxes**
- ▶ Cash outflow to shareholders as dividends
- ▶ Cash inflow to the firm from selling new common equity shares
- ▶ Cash outflow to purchase bonds issued by another company

Question No: 6 (Marks: 1) - Please choose one

Which of the following will **NOT** equate the future value of cash inflows to the present value of cash outflows?

- ▶ Discount rate
- ▶ **Profitability index**
- ▶ Internal rate of return
- ▶ Multiple Internal rate of return

Question No: 7 (Marks: 1) - Please choose one

Which of the following is a legal agreement between the corporation issuing bonds and the bondholders that establish the terms of the bond issue?

- ▶ **Indenture**

- ▶ Debenture
- ▶ Bond
- ▶ Bond trustee

Question No: 8 (Marks: 1) - Please choose one

_____ is a high-risk, high-yield bond.

- ▶ Zero coupon bond
- ▶ Mortgage bond
- ▶ **Junk bond**
- ▶ Income bond

Question No: 9 (Marks: 1) - Please choose one

A coupon bond pays annual interest, has a par value of Rs.1,000, matures in 4 years, has a coupon rate of 10%, and has a yield to maturity of 12%. What is the current yield on this bond?

- ▶ **10.65%**
- ▶ 10.45%
- ▶ 10.95%
- ▶ 10.52%

Question No: 10 (Marks: 1) - Please choose one

When a bond will sell at a discount?

- ▶ The coupon rate is greater than the current yield and the current yield is greater than yield to maturity
- ▶ The coupon rate is greater than yield to maturity
- ▶ The coupon rate is less than the current yield and the current yield is greater than the yield to maturity

▶ The coupon rate is less than the current yield and the current yield is less than yield to maturity

Question No: 11 (Marks: 1) - Please choose one

What is the price of a stock?

▶ The future value of all expected future dividends, discounted at the dividend growth rate

▶ The present value of all expected future dividends, discounted at the dividend growth rate

▶ The future value of all expected future dividends, discounted at the investor's required return

▶ The present value of all expected future dividends, discounted at the investor's required return

[Click for Reference](#)

Question No: 12 (Marks: 1) - Please choose one

Which of the following combinations will produce the highest growth rate? Assume that the firm's projects offer a higher expected return than the market capitalization rate.

▶ A high plowback ratio and a high P/E ratio

▶ A high plowback ratio and a low P/E ratio

▶ A low plowback ratio and a low P/E ratio

▶ A low plowback ratio and a high P/E ratio

[Click For Reference](#)

Question No: 13 (Marks: 1) - Please choose one

Diversification can reduce risk by spreading your money across many different _____.

- ▶ Investments
- ▶ Markets
- ▶ Industries
- ▶ **All of the given options**

It states that don't put all your eggs in one basket. Diversification can reduce risk. By spreading your money across many different Investments, Markets, Industries, Countries you can avoid the weakness of each.

Question No: 14 (Marks: 1) - Please choose one

The square of the standard deviation is known as the _____.

- ▶ Beta
- ▶ Expected return
- ▶ Coefficient of variation
- ▶ **Variance**

Question No: 15 (Marks: 1) - Please choose one

Which of the following is **NOT** a major cause of systematic risk.

- ▶ A worldwide recession
- ▶ A world war
- ▶ World energy supply
- ▶ **Company management change**

Question No: 16 (Marks: 1) - Please choose one

_____ means expanding the number of investments which cover different kinds of stocks.

- ▶ **Diversification**
- ▶ Standard deviation
- ▶ Variance

- ▶ Covariance

Question No: 17 (Marks: 1) - Please choose one

Which of the following would **NOT** be the part of the risk if the stock is a single stock investment?

- ▶ Company specific risk
- ▶ Un-diversifiable risk
- ▶ **Diversifiable risk**
- ▶ Random risk

In case of portfolio risk we can further made distinction between Diversifiable Risk and Market risk

Question No: 18 (Marks: 1) - Please choose one

To limit volatility what should be the appropriate action?

- ▶ **To diversify**
- ▶ To check the stocks prices daily
- ▶ To own just a few securities
- ▶ Not to invest in risky securities

Question No: 19 (Marks: 1) - Please choose one

In efficient market the stock price depends upon the required return which depends upon _____.

- ▶ **Market risk**
- ▶ Total risk
- ▶ Diversified risk
- ▶ Non- Systematic risk

In Perfect Markets and Efficient Markets where Rational Investors have Diversified Away ALL Company Specific Risk, Value (and Stock Price) depends on Required Return which depends on Market Risk (and not Total Risk).

Question No: 20 (Marks: 1) - Please choose one

Why markets and market returns fluctuate?

- ▶ Because of political factors
- ▶ Because of social factors
- ▶ Because of socio-political factors
- ▶ **Because of macro systematic factors**

Question No: 21 (Marks: 1) - Please choose one

The overall (weighted average) cost of capital is composed of weighted averages of which of the following?

- ▶ The cost of common equity and the cost of debt
- ▶ The cost of common equity and the cost of preferred stock
- ▶ The cost of preferred stock and the cost of debt
- ▶ **The cost of common equity, the cost of preferred stock, and the cost of debt**

Question No: 22 (Marks: 1) - Please choose one

Which of the following costs would be considered a fixed cost?

- ▶ Raw materials
- ▶ **Depreciation**
- ▶ Bad-debt losses
- ▶ Production labor

Question No: 23 (Marks: 1) - Please choose one

Assume the nominal interest rates (annual) in the country of Fredonia and the United States are 6% and 12% respectively. What is the implied 90-day forward rate if the current spot rate is 5 Fredonia marks (FM) per U.S. dollar?

- ▶ 4.732
- ▶ **4.927**
- ▶ 5.074
- ▶ 5.283

$1 + (.12/4) = 1.03$; $1 + (.06/4) = 1.015$; $FM / 5 = (1.015 / 1.03)$; $FM = 4.927$.

Question No: 24 (Marks: 1) - Please choose one

A firm that acquires another firm as part of its strategy to sell off assets, cut costs, and operates the remaining assets more efficiently is engaging in _____.

- ▶ A strategic acquisition
- ▶ **A financial acquisition**
- ▶ Two-tier tender offer
- ▶ Shark repellent

Question No: 25 (Marks: 1) - Please choose one

When a firm can acquire another firm?

- ▶ Only by purchasing the assets of the target firm
- ▶ Only by purchasing the common stock of the target firm
- ▶ **By either purchasing the assets or the common equity of the target firm**
- ▶ None of the given options

Question No: 26 (Marks: 1) - Please choose one

Which of the following is **NOT** a type of financial lease arrangement?

- ▶ Sale and leaseback
- ▶ **Indirect leasing**

- ▶ Leveraged leasing
- ▶ All of the given options

Question No: 27 (Marks: 1) - Please choose one

The Board of Directors announces the amount and date of the next dividend on the _____ date; while the _____ date is the first date on which the purchaser of a stock is no longer entitled to the recently declared dividend.

- ▶ Declaration; record
- ▶ Ex-dividend; record
- ▶ **Declaration; ex-dividend**
- ▶ Payment; record

Question No: 28 (Marks: 1) - Please choose one

What would you expect to happen to the price of a share of stock on the day it goes ex-dividend?

- ▶ **The price should increase by the amount of the dividend**
- ▶ The price should decrease by the amount of the dividend
- ▶ The price should decrease by one-half the amount of the dividend
- ▶ The price should remain constant

Question No: 29 (Marks: 1) - Please choose one

What is the amount of the annual interest tax shield for a firm with Rs. 3 million in debt that pays 12% interest if the firm is in the 35% tax bracket?

- ▶ **Rs.126, 000**
- ▶ Rs.234, 000
- ▶ Rs.360, 000
- ▶ Rs.1, 050,000

Tax Shield =(income-(debt*interest rate))*tax rate

=(3000000)*12%*35%

Question No: 30 (Marks: 1) - Please choose one

While calculating the Stock Portfolio Risk using 3x3 Matrix Approach, non-diagonal terms shown in Boxes are called:

- ▶ Variance
- ▶ Coefficient
- ▶ **Covariance**
- ▶ Correlation

Terms in all other (or NON-DIAGONAL) Boxes are called "COVARIANCE" terms which account for affect of one stock's movement on another stock's movement

Question No: 31 (Marks: 1) - Please choose one

While calculating the stock beta graphically, the formula to calculate the beta coefficient for stock B is:

- ▶ $(r_M^* - r_{RF}) / (r_B^* - r_{RF})$
- ▶ **$(r_B^* - r_{RF}) / (r_M^* - r_{RF})$**
- ▶ $(r_B^* - r_{RF}) / r_{RF}$
- ▶ $(r_B^* - r_{RF}) / r_M^*$

Slope = Beta = $\Delta Y / \Delta X = \% \Delta r_A^* / \% \Delta r_M^*$

= A = Risk Relative to Market = $(r_A^* - r_{RF}) / (r_M^* - r_{RF})$

Question No: 32 (Marks: 1) - Please choose one

While analyzing any portfolio the value of "r" represents which of the following?

- ▶ Internal rate of return
- ▶ Expected rate of return
- ▶ **Required rate of return**
- ▶ Assumed rate of return

Question No: 33 (Marks: 1) - Please choose one

If a stock is part of totally diversified portfolio then which of the following is TRUE for that stock?

- ▶ Stock's total Risk = Company Risk
- ▶ Stock's total Risk = Market Risk
- ▶ **Stock's total Risk = Market Risk + Company Risk**
- ▶ All of the given options

Question No: 34 (Marks: 1) - Please choose one

High uncertainty is associated with which of the following?

- ▶ Preferred stock
- ▶ **Common stock**
- ▶ Bonds
- ▶ T –Bills

Question No: 35 (Marks: 1) - Please choose one

The date on which the names of stockholders in the Stock Transfer Register of firm are documented is referred as:

- ▶ Declaration Date
- ▶ **Holder-of-record Date**
- ▶ Ex-Dividend Date
- ▶ Payment Date

**Firm records names of shareholders in the Stock Transfer Register i.e. Feb 28th 2003.
About 1 month after Declaration Date**

Question No: 36 (Marks: 1) - Please choose one

Operating revenue can be calculated from which of the following formulas?

- ▶ Operating Revenue = Fixed cost * Quantity + Variable cost
- ▶ Operating Revenue = Price / Quantity + Variable cost
- ▶ Operating Revenue = Sale price * Quantity
- ▶ Operating Revenue = Variable cost * Quantity / Fixed cost

Question No: 37 (Marks: 1) - Please choose one

Which of the following statements is **TRUE** about an aggressive approach to finance working capital?

- ▶ Financing seasonal requirements of current assets with short-term debt and permanent requirement of current assets with long term debt
- ▶ Financing permanent requirements of current assets with short-term debt and seasonal requirement of current assets with long term debt
- ▶ **Financing seasonal as well as permanent requirements of current assets with short-term debt**
- ▶ Financing seasonal as well as permanent requirements of current assets with long term debt

Financing some long-term needs with short-term funds. This is a maturity matching approach and is neither aggressive nor conservative in nature Rather, it is a moderate approach.

Question No: 38 (Marks: 1) - Please choose one

Capital structure theory is presented by which of the following?

- ▶ Robert Alan Hill
- ▶ **Modigliani & Miller**
- ▶ Brigham & Houston
- ▶ Van Horne & Gittman

Question No: 39 (Marks: 1) - Please choose one

All of the following are the examples of permanent financing **EXCEPT:**

- ▶ Common Equity
- ▶ **Current Liabilities**
- ▶ Long-term Loans
- ▶ Bonds

Question No: 40 (Marks: 1) - Please choose one

Which of the followings proposes that the value of the firm is independent of its capital structure?

- ▶ The Capital Asset Pricing Model
- ▶ **M&M capital structure theory**
- ▶ The law of variable proportion
- ▶ The Law of One Price

What Rubinstein generalized, was the most basic of the M&M propositions: The proposition on the irrelevance of capital structure.

Proposition I: "The market value of any firm is independent of its capital structure and is given by capitalizing its expected return at the rate ρ appropriate to its class", Modigliani and Miller [1958, page 268]. In modern terms, capital structure is irrelevant, and firm value is equal to the present value of the free cash flow discounted at the relevant cost of capital.

Question No: 41 (Marks: 1) - Please choose one

Value of the firm can be calculated with the help of which of the following formulas?

- ▶ Price of a share x No. of shares outstanding
- ▶ Price of a share x debt / equity
- ▶ Price of a share / No. of shares outstanding
- ▶ Price of a share x earnings after tax / equity

Question No: 42 (Marks: 1) - Please choose one

If the sales are expected to be poor in future than management wants to raise capital through which of the following:

- ▶ Debt financing
- ▶ Equity financing (common & preferred stock)
- ▶ Term finance certificates
- ▶ National saving certificates

Question No: 43 (Marks: 1) - Please choose one

Company A has to purchase another company. How do Company A pay for buying the other company?

- ▶ In Cash
- ▶ In Shares
- ▶ Bank Borrowing
- ▶ All of the given options

Question No: 44 (Marks: 1) - Please choose one

Which of the following mathematical expressions depicts divestiture?

- ▶ $5-1=4$
- ▶ $5-1=6$
- ▶ $5+1=6$
- ▶ **None of the given options**

**“Divestiture” = Reverse Merger. Benefit of Efficient Reallocation of Resources: $5 - 1 = 5!$
It means by selling an inefficient or unproductive unit of the company you can have more value as it saves costs**

Question No: 45 (Marks: 1) - Please choose one

Under efficient market, the effect of debt on WACC can be represented with the help of which of the following?

▶ **Straight line**

- ▶ U shaped curve
- ▶ Concave
- ▶ Time to time fluctuation

Effect under Pure MM View (Ideal Efficient Markets): Its assumptions are No Taxes and No Bankruptcy Costs so Debt increases Risk BUT is also cheaper than Equity. Change in Debt has no effect on WACC and Value of the firm. WACC curve is flat.

Question No: 46 (Marks: 1) - Please choose one

Under traditional view, the effect of debt on WACC can be represented with the help of which of the following?

- ▶ Straight line
- ▶ **U shaped curve**
- ▶ Concave
- ▶ Time to time fluctuation

Effect under Traditionalist View (Tradeoff Theorists, Real Markets): Combined Effects of Taxes and Financial Distress / Bankruptcy Costs are a Flat U-Shaped WACC Curve with a Minimum Point which represents the Optimal Capital Structure (i.e. Best Debt Ratio for the Firm).

Question No: 47 (Marks: 1) - Please choose one

According to the trade off theory, value of the firm rises as a result of _____.

▶ **Tax saving**

- ▶ Increase in EPS
- ▶ Increase in EBIT
- ▶ Saving in cost of debt

This is the case of pure MM theory where there are no taxes and bankruptcy costs. But in case of trade off theory in reality initially value of the firm rises as there is interest tax saving but with excessive leverage, value of the firm starts declining as interest cost goes very high due to bankruptcy risk.

Question No: 48 (Marks: 1) - Please choose one

Which of the following statements is true about business risk?

- ▶ The financial risk of a firm decreases when it takes on a risky project
- ▶ The financial risk of a firm increases when it takes on more equity
- ▶ **The business risk of a firm increases when it takes on a risky project**
- ▶ The business risk of a firm increases when it takes on more debt

Click For Reference

Question No: 49 (Marks: 1) - Please choose one

Under Net income approach, which of the following is a correct sequence of calculating cost of capital?

- ▶ Net income – Total firm's market value – WACC
- ▶ Net income – WACC – total firm's market value
- ▶ WACC – Net income – market value of equity
- ▶ Market value of firm – WACC – Net income

Question No: 50 (Marks: 1) - Please choose one

From which of the following equations, net income can be calculated?

- ▶ **$NI = (EBIT - x_D r_D) (1 - T_c)$**
- ▶ $NI = (EAT - x_D r_D) (1 - T_c)$
- ▶ $NI = (EBIT + x_D r_D) (1 - T_c)$
- ▶ $NI = (EBIT - x_D r_D) / (1 - T_c)$

$E = \text{Net Income (NI)} / \text{Cost of Equity for levered firm (rE,L)}$

Note that $NI = EBIT - \text{Interest} - \text{Tax} = EBT - \text{Tax}$

$$NI = (EBIT - xD rD) (1 - T_c)$$

Question No: 51 (Marks: 1) - Please choose one

Which of the following refers to a unique type of Japanese corporate organization based on a close partnership between government and businesses?

- ▶ **Keiretsu**
- ▶ Chaebols
- ▶ Lean and mean
- ▶ Options

www.qualitysolutions.ca/key-quality-terms.htm

Question No: 52 (Marks: 1) - Please choose one

Which of the following is a South Korea type business in that is a conglomerate with Monopoly power?

- ▶ Keiretsu
- ▶ **Chaebols**
- ▶ Lean and mean
- ▶ Options

Chaebol (alternatively Jaebol, Jaebeol;) refers to a South Korean form of business conglomerate. (form definition of chaebols)

Question No: 53 (Marks: 1) - Please choose one

What is bid rate for currency?

- ▶ **Buying rate for currency**
- ▶ Selling rate of currency
- ▶ Forward rate of currency
- ▶ Ask rate of currency\

BID Rate = Buying Price for Currency. Example: Bid Rs.60 / US\$1 Means Bank or Money Changer will Buy (or Bid) one US\$ from you for Rs.60. This also means that you (the Customer) are Selling Dollar to the Bank. Bid Rs.60 / US\$1 means Bid Rs60 /Ask US\$1

Question No: 54 (Marks: 1) - Please choose one

What is the primary principle for money changers?

- ▶ Ask rate should be less than bid rate
- ▶ **Ask rate should be greater than bid rate**
- ▶ Ask rate should be equal to bid rate
- ▶ Bid rate should be greater than ask rate

Fundamental Principle for F/x Traders and “Money Changers”: Buy Low and Sell High. So, ASK > BID Rate

Question No: 55 (Marks: 3)

Calculate tax shield from the given information.

Corporate tax rate is 35% and amount of debt is Rs. 20, 000 and rate of return is 8%.

Tax Shield =(income-(debt*interest rate))*tax rate

Tax shield = (20,000 * 8%)* 35%

= 560 Rs

Question No: 56 (Marks: 5)

How can a manager calculate the opportunity cost of capital for a project? Give answer in bulleted form only.

Question No: 57 (Marks: 5)

Suppose you are a financial manager of XYZ Corporation and you have been assigned the task to calculate the numerical value of your firm’s WACC (Weighted Average Cost

of Capital), what procedure would you follow keeping in mind that the firm is using NOI (Net Operating Income) approach?

Question No: 58 (Marks: 10)

Suppose that the risk free rate is 12% and the expected market return is 20%. The FM Corporation has a beta of 0.75 and the Gord Corporation has a beta of 1.25.

- a. Find the expected return on the FM Corporation.
- b. Find the expected return on the Gord Corporation.
- c. Suppose that because of a suddenly unanticipated increase in inflation, the risk free rate raises to 16% and the market risk premium remains at 8%. Find the expected return on of FM and Gord.

Question No: 59 (Marks: 10)

Ammar Watch Company is the renowned ladies watch manufacturers. They are offering watch in the market at a price of Rs. 30. They have estimated that they will manufacture and sale almost 30, 000 watches. Fixed cost for the preparation of these watches is Rs.150, 000. Variable cost associated with the preparation of these watches is Rs. 20 per watch.

From the above information you are required to calculate the followings:

- What is the profit or loss for the units of 8, 000 or 18, 000?
- Calculate the break even point? (in units and sales)

Fall 2009

MGT201- Financial Management (Session - 3)

Question No: 1 (Marks: 1) - Please choose one

ABC's and XYZ's debt-to-total assets ratio is 0.4. What is its debt-to-equity ratio?

- ▶ 0.2
- ▶ 0.77
- ▶ **0.667**
- ▶ 0.333

Question No: 2 (Marks: 1) - Please choose one

As interest rates go up, the present value of a stream of fixed cash flows _____

- ▶ **Goes down**
- ▶ Goes up
- ▶ Stays the same
- ▶ Can not be found

Question No: 3 (Marks: 1) - Please choose one

A 5-year ordinary annuity has a future value of Rs.1,000. If the interest rate is 8 percent, the amount of each annuity payment is closest to which of the following?

- ▶ Rs.231.91
- ▶ Rs.184.08
- ▶ Rs.181.62
- ▶ **Rs.170.44**

Question No: 4 (Marks: 1) - Please choose one

Managers prefer IRR over net present value because they evaluate investments:

- ▶ In terms of dollars
- ▶ **In terms of Percentages**
- ▶ Intuitively
- ▶ Logically

Question No: 5 (Marks: 1) - Please choose one

When there is single period capital rationing, what would be the most sensible way of making investment decisions?

- ▶ Choose all projects with a positive NPV
- ▶ **Group projects together to allocate the funds available and select the group of projects with the highest NPV**
- ▶ Choose the project with the highest NPV
- ▶ Calculate IRR and select the projects with the highest IRRs

Question No: 6 (Marks: 1) - Please choose one

Which of the following is the value of bond that we expect the bond to be?

- ▶ Intrinsic value
- ▶ Fair value
- ▶ **Both intrinsic and fair value**
- ▶ Market price

Question No: 7 (Marks: 1) - Please choose one

An investment opportunity set formed with two securities that are perfectly negatively correlated. What will be standard deviation in the global minimum variance portfolio?

- ▶ **Equal to zero**
- ▶ Greater than zero
- ▶ Equal to the sum of the securities' standard deviations

- ▶ Equal to -1

Question No: 8 (Marks: 1) - Please choose one

Which of the following value of the shares changes with investor's perception about the company's future and supply and demand situation?

- ▶ Par value
- ▶ **Market value**
- ▶ Intrinsic value
- ▶ Face value

Question No: 9 (Marks: 1) - Please choose one

Which of the following statement about portfolio statistics is **CORRECT**?

▶ **A portfolio's expected return is a simple weighted average of expected returns of the individual securities comprising the portfolio.**

▶ A portfolio's standard deviation of return is a simple weighted average of individual security return standard deviations.

▶ The square root of a portfolio's standard deviation of return equals its variance.

▶ The square root of a portfolio's standard deviation of return equals its coefficient of variation.

Question No: 10 (Marks: 1) - Please choose one

Which of the following is simply the weighted average of the possible returns, with the weights being the probabilities of occurrence?

- ▶ A probability distribution
- ▶ **The expected return**
- ▶ The standard deviation
- ▶ Coefficient of variation

Question No: 11 (Marks: 1) - Please choose one

The ratio of the standard deviation of a distribution to the mean of that distribution is referred to as _____.

- ▶ A probability distribution
- ▶ The expected return
- ▶ The standard deviation
- ▶ **Coefficient of variation**

Question No: 12 (Marks: 1) - Please choose one

The Higher the Risk of a Share, the _____ its Rate of Return and the _____ its Market Price.

- ▶ **Higher; Lower**
- ▶ Lower; Higher
- ▶ Higher; Higher
- ▶ Lower; Lower

Question No: 13 (Marks: 1) - Please choose one

If a company intends to start a new project, _____ technique are employed to assess the financial viability of the project.

- ▶ Financial planning
- ▶ Financial forecasting
- ▶ **Capital budgeting**
- ▶ Capital rationing

Question No: 14 (Marks: 1) - Please choose one

The logic behind _____ is that instead of looking at net cash flows you look at cash inflows and outflows separately for each point in time.

- ▶ IRR
- ▶ **MIRR**
- ▶ PV
- ▶ NPV

Question No: 15 (Marks: 1) - Please choose one

Expected Portfolio Return = _____

- ▶ **$r_P^* = x_A r_A + x_B r_B$**
- ▶ $r_P^* = x_A r_A - x_B r_B$
- ▶ $r_P^* = x_A r_A / x_B r_B$
- ▶ $r_P^* = x_A r_A * x_B r_B$

Question No: 16 (Marks: 1) - Please choose one

Market risk is measured in terms of the _____ of the market portfolio or index.

- ▶ Variance
- ▶ Covariance
- ▶ **Standard deviation**
- ▶ Correlation coefficient

Question No: 17 (Marks: 1) - Please choose one

Which of the following represent all Risk –Return Combinations for the efficient portfolios in the capital market?

- ▶ Parachute graph
- ▶ **CML straight line equation**
- ▶ Security market line
- ▶ All of the given options

Question No: 18 (Marks: 1) - Please choose one

Generally companies want to keep the balance in the form of:

- ▶ **Debt**
- ▶ Equity
- ▶ Hybrid security
- ▶ Both debt and equity

Question No: 19 (Marks: 1) - Please choose one

A firm has a DFL of 3.5 at X dollars. What does this tell us about the firm?

- ▶ If sales rise by 3.5% at the firm, then EBIT will rise by 1%
- ▶ If EBIT rises by 3.5% at the firm, then EPS will rise by 1%
- ▶ **If EBIT rises by 1% at the firm, then EPS will rise by 3.5%**
- ▶ If sales rise by 1% at the firm, then EBIT will rise by 3.5%

Question No: 20 (Marks: 1) - Please choose one

Which of the following is the maximum amount of debt (and other fixed-charge financing) that a firm can adequately service?

- ▶ **Debt capacity**
- ▶ Debt-service burden
- ▶ Adequacy capacity
- ▶ Fixed-charge burden

Question No: 21 (Marks: 1) - Please choose one

Which of the following represents financial leverage?

- ▶ **Use of more debt capital to increase profit**
- ▶ Debt is not used in capital to increase profit
- ▶ High degree of solvency
- ▶ Low degree of solvency

Question No: 22 (Marks: 1) - Please choose one

Which of the following statements regarding leverage is true?

- ▶ **The ultimate effect of leverage depends on the firm's EBIT**
- ▶ If things go poorly for the firm, increased leverage provides greater returns to shareholders.
- ▶ As a firm lever up, shareholders are exposed to less risk
- ▶ The benefits of leverage always outweigh the costs of financial distress

Question No: 23 (Marks: 1) - Please choose one

Your firm has a philosophy that is analogous to the hedging (maturity matching) approach. Which of the following is the most appropriate form for financing a new capital investment in plant and equipment?

- ▶ 6-month bank notes
- ▶ Accounts payable
- ▶ **Common stock equity**
- ▶ Trade credit

Question No: 24 (Marks: 1) - Please choose one

Which of the following term is used when the firm can independently control considerable assets with a very limited amount of equity?

- ▶ Joint venture
- ▶ **Leveraged buyout (LBO)**
- ▶ Spin-off
- ▶ Consolidation

Question No: 25 (Marks: 1) - Please choose one

Which of the following is **NOT** a form of short-term, spontaneous credit?

- ▶ Accrued wages
- ▶ Trade credit
- ▶ **Commercial paper**

- ▶ Accrued taxes

Question No: 26 (Marks: 1) - Please choose one

Which of the following would **NOT** be included in inventory carrying cost?

- ▶ Insurance expense for the inventory
- ▶ Opportunity cost of capital for inventory investment
- ▶ **Cost of inventory**
- ▶ Cost of shelf space

Question No: 27 (Marks: 1) - Please choose one

What would be the result when there is an increase in the number of shares outstanding by reducing the par value of stock?

- ▶ **Stock split**
- ▶ Stock dividend
- ▶ Extra dividend
- ▶ Regular dividend

Question No: 28 (Marks: 1) - Please choose one

What would you expect to happen to the price of a share of stock on the day it goes ex-dividend?

- ▶ The price should increase by the amount of the dividend
- ▶ **The price should decrease by the amount of the dividend**
- ▶ The price should decrease by one-half the amount of the dividend
- ▶ The price should remain constant

Question No: 29 (Marks: 1) - Please choose one

Which of the following add up to the costs of financial distress?

- ▶ Direct bankruptcy costs, primarily legal and administrative costs

- ▶ Indirect bankruptcy costs, reflecting the difficulty of managing a company when it is in bankruptcy proceedings
- ▶ Costs of the threat of bankruptcy, such as poor investment decisions resulting from conflicts of interest between debt holders and stockholders
- ▶ **All of the given options are correct**

Question No: 30 (Marks: 1) - Please choose one

A technique that tells us the number of years required to recover our initial cash investment based on the project's expected cash flows is:

- ▶ **Pay back period**
- ▶ Internal rate of return
- ▶ Net present value
- ▶ Profitability index

Question No: 31 (Marks: 1) - Please choose one

Which is the best measure of risk for a single asset held in isolation, and which is the best measure for an asset held in a diversified portfolio?

- ▶ Variance, correlation coefficient
- ▶ Standard deviation, correlation coefficient
- ▶ Beta, variance
- ▶ **Coefficient of variation, beta**

Question No: 32 (Marks: 1) - Please choose one

All of the following are used in calculation of required return on a particular stock using SML equation **EXCEPT**:

- ▶ Risk free rate
- ▶ Market risk premium
- ▶ Stock's beta
- ▶ **Stock's price**

Question No: 33 (Marks: 1) - Please choose one

What will be the Stock Y's risk premium if the average share of stock Y has a required return of 20% and beta for that stock is 1.0? In addition, treasury bonds yield is 10%?

- ▶ 5%
- ▶ **10%**
- ▶ 20%
- ▶ 30%

Question No: 34 (Marks: 1) - Please choose one

What should be used to calculate the proportional amount of equity financing employed by a firm?

- ▶ The book value of the firm
- ▶ The sum of common stock and preferred stock on the balance sheet
- ▶ **The current market price per share of common stock times the number of shares outstanding**
- ▶ The common stock equity account on the firm's balance sheet

Question No: 35 (Marks: 1) - Please choose one

According to Traditionalist Theory, when an un-leveraged firm takes on more and more debt, which of the following phenomenon is observed?

- ▶ Cost of Capital increases, reaches a minimum point, and then falls
- ▶ **Cost of Capital decreases, reaches a minimum point, and then rises**
- ▶ Cost of Capital increases, reaches a maximum point, and then rises
- ▶ None of the given options

Question No: 36 (Marks: 1) - Please choose one

In the WACC equation ($r_D X_D + r_E X_E + r_P X_P$), X_D represents which of the following?

- ▶ **Weight or Fraction of Total Capital value raised from bonds**
- ▶ Weight or Fraction of Total Capital value raised from preferred stock

- ▶ Weight or Fraction of Total Capital value raised from common stock
- ▶ Weight or Fraction of Total Capital value raised from retained earnings

Question No: 37 (Marks: 1) - Please choose one

In residual dividend model, what does the term 'Conservatism' refer?

- ▶ Overvaluation of free cash flows
- ▶ **Underestimation of free cash flows**
- ▶ Overestimation of free cash flows
- ▶ None of the given option

Question No: 38 (Marks: 1) - Please choose one

The date on which the names of stockholders in the Stock Transfer Register of firm are documented is referred as:

- ▶ Declaration Date
- ▶ **Holder-of-record Date**
- ▶ Ex-Dividend Date
- ▶ Payment Date

Question No: 39 (Marks: 1) - Please choose one

XYZ Corporation has offered its shareholders the option that their dividends will be used to purchase additional shares of this corporation. This offer of XYZ Corporation is referred as:

- ▶ Stock repurchases
- ▶ **Dividend reinvestment**
- ▶ Stock dividends
- ▶ Stock splits

Question No: 40 (Marks: 1) - Please choose one

When $IRR < WACC$ it means that:

- ▶ Investment is acceptable as required rate of return is less than cost of capital
- ▶ **Investment is not acceptable as required rate of return is less than cost of capital**
- ▶ Investment is acceptable as required rate of return is equal to the cost of capital
- ▶ None of the given options is true

Question No: 41 (Marks: 1) - Please choose one

Which of the following statement depicts the advantage of raising capital through debt?

- ▶ Debt adds to company specific risk
- ▶ If company does not pay interest it can be close down
- ▶ **It can improve the return on equity**
- ▶ Not required to pay fixed amount of interest

Question No: 42 (Marks: 1) - Please choose one

Which of the following can be defined as “additional risk faced by common stockholders if firms take debt.”?

- ▶ Unsystematic risk
- ▶ Systematic risk
- ▶ Business risk
- ▶ **Financial risk**

Question No: 43 (Marks: 1) - Please choose one

The decisions regarding working capital management of a firm are mainly concerned with which of the following?

- ▶ Current assets & long-term liabilities of balance sheet
- ▶ Current assets & current liabilities of balance sheet
- ▶ **Fixed assets & current liabilities of balance sheet**
- ▶ Fixed assets & long-term liabilities of balance sheet

Question No: 44 (Marks: 1) - Please choose one

If Current assets = Rs. 16,000,

Current liabilities= Rs. 10,000

Inventory= Rs. 2500

Calculate quick ratio for the firm?

- ▶ 1.35
- ▶ 6.0
- ▶ 1.60
- ▶ 0.25

Question No: 45 (Marks: 1) - Please choose one

Which of the following states that “Cash is King and only Cash can pay the bills”?

- ▶ Fat cat working capital policy
- ▶ Lean & Mean perspective
- ▶ **Balance Sheet Perspective**
- ▶ Moderate working capital policy

Question No: 46 (Marks: 1) - Please choose one

Which of the following depicts the break even point in best way?

- ▶ **EBIT = 0**
- ▶ EBIT < 0
- ▶ EBIT > 0
- ▶ None of the given options

Question No: 47 (Marks: 1) - Please choose one

Financial leverage is considered good in which of the following?

- ▶ Earning after interest & tax / Total asset > Interest cost
- ▶ Earning after interest & tax / Total asset < Interest cost

- ▶ Earning before interest & tax / Total asset < Interest cost
- ▶ **Earning before interest & tax / Total asset > Interest cost**

Question No: 48 (Marks: 1) - Please choose one

Suppose that there is no personal or corporate income tax and that the firm's WACC is not affected by its capital structure, then which of the following statements is true?

- ▶ **A firm's cost of equity depends on the firm's business and financial risks**
- ▶ The value of the firm is dependent on its capital structure
- ▶ The cost of equity increases as the firm's leverage decreases
- ▶ The greater the financial leverage, the more valuable is the firm

Question No: 49 (Marks: 1) - Please choose one

Company A has to purchase another company. How do Company A pay for buying the other company?

- ▶ In Cash
- ▶ In Shares
- ▶ Bank Borrowing
- ▶ **All of the given options**

Question No: 50 (Marks: 1) - Please choose one

A car manufacturing firm buys steel from a steel mill. Both these entities combined together to form a new firm. It is referred to which of the following?

- ▶ Horizontal Merger
- ▶ **Vertical Merger**
- ▶ Congeneric Merger
- ▶ Conglomerate Merger

Question No: 51 (Marks: 1) - Please choose one

Under efficient market, the effect of debt on WACC can be represented with the help of which of the following?

- ▶ **Straight line**
- ▶ U shaped curve
- ▶ Concave
- ▶ Time to time fluctuation

Question No: 52 (Marks: 1) - Please choose one

What is the effect on WACC if debt increases under pure M&M theory model?

- ▶ It will increase
- ▶ It will decrease
- ▶ **It remains unchanged**
- ▶ None of the given options

Question No: 53 (Marks: 1) - Please choose one

Most of the firms wish to maintain their capital structure in the form of which of the following?

- ▶ 100% equity
- ▶ **100% debt**
- ▶ Mix of debt and equity
- ▶ 100% from the personal savings

Question No: 54 (Marks: 1) - Please choose one

Under Net income approach, which of the following is a correct sequence of calculating cost of capital?

- ▶ Net income – Total firm's market value – WACC

- ▶ Net income – WACC – total firm's market value
- ▶ WACC – Net income – market value of equity
- ▶ Market value of firm – WACC – Net income

Question No: 55 (Marks: 3)

If capital structure changes from equity to debt then what will be the effect on capital structure.

Question No: 56 (Marks: 5)

How are dividends paid, and how do companies decide on dividend payments?

Question No: 57 (Marks: 5)

Write a note on capital structure of organizations and cost of capital.

Question No: 58 (Marks: 10)

Why is stock price volatility more likely to imply risk than earnings volatility? Explain with the help of some examples.

Question No: 59 (Marks: 10)

Explain the following conditions:

- $IRR < WACC$
- $IRR > WACC > SML$
- $IRR < SML$
- $IRR < WACC < SML$

Spring 2009

MGT201- Financial Management (Session - 2)

Question No: 1 (Marks: 1) - Please choose one

What is the long-run objective of financial management?

- ▶ Maximize earnings per share
- ▶ **Maximize the value of the firm's common stock**
- ▶ Maximize return on investment
- ▶ Maximize market share

Question No: 2 (Marks: 1) - Please choose one

Which of the following statement (in general) is correct?

- ▶ A low receivables turnover is desirable
- ▶ **The lower the total debt-to-equity ratio, the lower the financial risk for a firm**
- ▶ An increase in net profit margin with no change in sales or assets means a weaker ROI
- ▶ The higher the tax rate for a firm, the lower the interest coverage ratio

Question No: 3 (Marks: 1) - Please choose one

What is the present value of a Rs.1,000 ordinary annuity that earns 8% annually for an infinite number of periods?

- ▶ Rs.80
- ▶ Rs.800
- ▶ Rs.1,000
- ▶ **Rs.12,500**

It will be treated as perpetuity, Formula is as under:

$$PV = \frac{PMT}{i}$$

= 1000/.08

= 12,500

Question No: 4 (Marks: 1) - Please choose one

Companies and individuals running different types of businesses have to make the choices of the asset according to which of the following?

- ▶ Life span of the project
- ▶ Validity of the project
- ▶ Cost of the capital
- ▶ **Return on asset**

Question No: 5 (Marks: 1) - Please choose one

What is the advantage of a longer life of the asset?

- ▶ Cash flows from the asset becomes non-predictable
- ▶ **Cash flows from the asset becomes more predictable**
- ▶ Cash inflows from the asset becomes more predictable
- ▶ Cash outflows from the asset becomes more predictable

Page No.58

Question No: 6 (Marks: 1) - Please choose one

Consider two bonds, A and B. Both bonds presently are selling at their par value of Rs. 1,000. Each pays interest of Rs. 120 annually. Bond A will mature in 5 years while bond B will mature in 6 years. If the yields to maturity on the two bonds change from 12% to 10%,

- ▶ Both bonds will increase in value, but bond A will increase more than bond B
- ▶ Both bonds will increase in value, but bond B will increase more than bond A
- ▶ Both bonds will decrease in value, but bond A will decrease more than bond B
- ▶ **Both bonds will decrease in value, but bond B will decrease more than bond A**

Question No: 7 (Marks: 1) - Please choose one

Given no change in required returns, the price of a stock whose dividend is constant will_____.

- ▶ **Remain unchanged**
- ▶ Decrease over time at a rate of $r\%$
- ▶ Increase over time at a rate of $r\%$
- ▶ Decrease over time at a rate equal to the dividend growth rate

Question No: 8 (Marks: 1) - Please choose one

For most firms, P/E ratios and risk_____.

- ▶ Will be directly related
- ▶ **Will have an inverse relationship**
- ▶ Will be unrelated
- ▶ Will both increase as inflation increases

Question No: 9 (Marks: 1) - Please choose one

Which of the following statement about portfolio statistics is CORRECT?

- ▶ **A portfolio's expected return is a simple weighted average of expected returns of the individual securities comprising the portfolio.**
- ▶ A portfolio's standard deviation of return is a simple weighted average of individual security return standard deviations.
- ▶ The square root of a portfolio's standard deviation of return equals its variance.
- ▶ The square root of a portfolio's standard deviation of return equals its coefficient of variation.

Question No: 10 (Marks: 1) - Please choose one

Which of the following is simply the weighted average of the possible returns, with the weights being the probabilities of occurrence?

- ▶ A probability distribution

- ▶ **The expected return**
- ▶ The standard deviation
- ▶ Coefficient of variation

Question No: 11 (Marks: 1) - Please choose one

The square of the standard deviation is known as the _____.

- ▶ Beta
- ▶ Expected return
- ▶ Coefficient of variation
- ▶ **Variance**

Reference

Question No: 12 (Marks: 1) - Please choose one

Why companies invest in projects with negative NPV?

- ▶ **Because there is hidden value in each project**
- ▶ Because they have chance of rapid growth
- ▶ Because they have invested a lot
- ▶ All of the given options

Question No: 13 (Marks: 1) - Please choose one

An investor was expecting a 18% return on his portfolio with beta of 1.25 before the market risk premium increased from 8% to 10%. Based on this change, what return will now be expected on the portfolio?

- ▶ 22.5%
- ▶ 20.0%
- ▶ **20.5%**
- ▶ 26.0%

Working: 2% rise in market risk premium rise in expected return will be $2 \times \text{beta} =$

$(2 \times 1.25 = 2.50)$

$18\% + 2.50 = 20.5$

Question No: 14 (Marks: 1) - Please choose one

Which of the following is the characteristic of a well diversified portfolio?

- ▶ Its market risk is negligible
- ▶ **Its unsystematic risk is negligible**
- ▶ Its systematic risk is negligible
- ▶ All of the given options

Question No: 15 (Marks: 1) - Please choose one

How the beta of a stock can be calculated?

- ▶ By monitoring price of the stock
- ▶ By monitoring rate of return of the stock
- ▶ **By comparing the changes in the stock market price to the changes in the stock market index**
- ▶ All of the given options

Question No: 16 (Marks: 1) - Please choose one

Which of the following formula relates beta of the stock to the standard deviation?

- ▶ Covariance of stock with market * variance of the market
- ▶ **Covariance of stock with market / variance of the market**
- ▶ Variance of the market / Covariance of stock with market
- ▶ Slope of the regression line

Beta = Covariance (stock versus market returns) / Variance of the Stock Market

<http://www.money-zine.com/Investing/Stocks/Stock-Beta-and-Volatility/>

Question No: 17 (Marks: 1) - Please choose one

A beta greater than 1 for a stock shows:

- ▶ Stock is relatively more risky than the market
- ▶ If the market moves up by 10% the stock will move up by 12%
- ▶ As the market moves the stock will move in the same direction
- ▶ **All of the given options**

Question No: 18 (Marks: 1) - Please choose one

If stock is a part of totally diversified portfolio then its company risk must be equal to:

- ▶ 0
- ▶ 0.5
- ▶ 1
- ▶ -1

Question No: 19 (Marks: 1) - Please choose one

If risk and return combination of any stock is above the SML, what does it mean?

- ▶ It is offering lower rate of return as compared to the efficient stock
- ▶ **It is offering higher rate of return as compared to the efficient stock**
- ▶ Its rate of return is zero as compared to the efficient stock
- ▶ It is offering rate of return equal to the efficient stock

Any Stock whose (Risk, Return) Pair lies ABOVE THE SML is offering Excessive Return (above the Market). So, all rational investors will rush to Buy it. The present Price would Rise and the Return (as measured by Capital Gain Yield = $(P_n - P_o) / P_o$) would Fall until it comes back on SML Any Stock whose (Risk, Return) Pair lies BELOW THE SML is offering a Return that is lower than the Market. So, Rational Investors will rush to sell it. The Stock Price would Fall and the Return would Rise until it comes back on the SML.

Question No: 20 (Marks: 1) - Please choose one

An arbitrage opportunity exists if an investor can construct a _____ investment portfolio that will yield a sure profit.

- ▶ Positive
- ▶ Negative
- ▶ **Zero**
- ▶ All of the given options

If the investor can construct a portfolio without the use of the investor's own funds and the portfolio yields a positive profit, arbitrage opportunities exist.

Question No: 21 (Marks: 1) - Please choose one

Which of the following factors might affect stock returns?

- ▶ The business cycle
- ▶ Interest rate fluctuations
- ▶ Inflation rates
- ▶ **All of the given options**

Question No: 22 (Marks: 1) - Please choose one

If arbitrage opportunities are to be ruled out, what would be the expected excess return of each well-diversified portfolio?

- ▶ Inversely proportional to the risk-free rate
- ▶ Inversely proportional to its standard deviation
- ▶ Proportional to its standard deviation
- ▶ **Proportional to its beta coefficient**

Rationale: For each well-diversified portfolio (P and Q, for example), it must be true that $[E(r_p) - r_f] / \beta_p = [E(r_Q) - r_f] / \beta_Q$.

Question No: 23 (Marks: 1) - Please choose one

Which of the following represent all Risk –Return Combinations for the efficient portfolios in the capital market?

- ▶ Parachute graph
- ▶ **CML straight line equation**
- ▶ Security market line
- ▶ All of the given options

The CML gives the risk/return relationship for efficient portfolios.

Question No: 24 (Marks: 1) - Please choose one

What should be used to calculate the proportional amount of equity financing employed by a firm?

- ▶ The common stock equity account on the firm's balance sheet
- ▶ The sum of common stock and preferred stock on the balance sheet
- ▶ The book value of the firm
- ▶ **The current market price per share of common stock times the number of shares**

Outstanding

<http://web.utk.edu/~jwachowi/mcquiz/mc15.html>

Question No: 25 (Marks: 1) - Please choose one

Which of the following is the market for short term debt?

- ▶ **Money market**
- ▶ Capital market
- ▶ Real asset market
- ▶ Equity market

Question No: 26 (Marks: 1) - Please choose one

Bonds are issued in the market at _____.

- ▶ Premium
- ▶ Discount
- ▶ **Both premium and discount**
- ▶ None of the given options

Question No: 27 (Marks: 1) - Please choose one

Why debt is a less costly source of fund?

- ▶ **Because additional interest creates a new form of tax shield**
- ▶ Because additional money creates a new form of tax shield
- ▶ Because banks extend loan at lower interest rates
- ▶ None of the given options

Question No: 28 (Marks: 1) - Please choose one

Which of the following is as EBIT?

- ▶ Funds provided by operations
- ▶ Earnings before taxes
- ▶ Net income
- ▶ **Operating profit**

Question No: 29 (Marks: 1) - Please choose one

Calculate the degree of operating leverage (DOL) at 400,000 units of quantity sold. The firm has Rs.1, 000,000 in fixed costs. The firm anticipates selling each unit for Rs.25 with variable costs of Rs.5 per unit.

- ▶ 3.33
- ▶ 1.25
- ▶ **1.14**
- ▶ There is not sufficient information provided to calculate the degree of operating leverage (DOL).

$$\text{Sales} = 400,000 * 25 = 10M$$

$$\text{VC} = 400,000 * 5 = 2M$$

$$\text{The DOL is } (S - VC)/(S - VC - FC) = (10M - 2M)/(10M - 2M - 1M) = 1.14$$

Question No: 30 (Marks: 1) - Please choose one

A firm has a DOL of 3.5 at Q units. What does this tell us about the firm?

- ▶ If sales rise by 3.5% at the firm, then EBIT will rise by 1%
- ▶ If EBIT rises by 3.5% at the firm, then EPS will rise by 1%
- ▶ If EBIT rises by 1% at the firm, then EPS will rise by 3.5%
- ▶ **If sales rise by 1% at the firm, then EBIT will rise by 3.5%**

Question No: 31 (Marks: 1) - Please choose one

Which of the following represents financial leverage?

- ▶ **Use of more debt capital to increase profit**
- ▶ Debt is not used in capital to increase profit
- ▶ High degree of solvency
- ▶ Low degree of solvency

Question No: 32 (Marks: 1) - Please choose one

Which of the following best describes the statement; “The value of an asset is preserved regardless of the nature of the claims against it”?

- ▶ Law of diminishing marginal returns
- ▶ **Law of conservation of value**
- ▶ Law of return on equity
- ▶ Law of return on assets

Reference

Question No: 33 (Marks: 1) - Please choose one

Firm ABC has Rs.5 million in outstanding debt, currently has 200,000 shares outstanding priced at Rs.60 a share, and has a borrowing rate of 10%. If the firm's return on equity is 15%, what is the firm's WACC?

- ▶ 5.00%
- ▶ **3.23%**
- ▶ 4.25%
- ▶ 2.16%

Note: we are not sure about answer of this Question it seems options are not framed properly. We try to solve it here

In absence of Tax Rate. Values are as follow

$$D = 5M$$

$$E = 200,000 * 60 = 12 M$$

$$D + E = 5 + 12 = 17M$$

$$WCCA = (5/17) * (10\%) + (12/17) * (15\%) = .1350 = 13.50\%$$

Question No: 34 (Marks: 1) - Please choose one

Which of the following statements regarding the M&M Propositions without taxes is true?

- ▶ The total value of the firm depends on how cash flows are divided up between stockholders and bondholders, under M&M Proposition I.
- ▶ The firm's capital structure is relevant under M&M Proposition I.
- ▶ The cost of equity depends on the firm's business risk but not its financial risk, under M&M Proposition II.
- ▶ **The cost of equity rises as the firm increases its use of debt financing under M&M Proposition II.**

Question No: 35 (Marks: 1) - Please choose one

Which one of the following is correct for the spot exchange rate?

▶ **This is the rate today for exchanging one currency for another for immediate delivery**

▶ This is the rate today for exchanging one currency for another at a specific future date

▶ This is the rate today for exchanging one currency for another at a specific location on a specific future date

▶ This is the rate today for exchanging one currency for another at a specific location for immediate delivery

The rate of a foreign-exchange contract for immediate delivery. Also known as "benchmark rates", "straightforward rates" or "outright rates", spot rates represent the price that a buyer expects to pay for a foreign currency in another currency.

Question No: 36 (Marks: 1) - Please choose one

The restructuring of a firm should be undertaken, when:

- ▶ **The restructuring is expected to create value for shareholders**
- ▶ The restructuring is expected to increase earnings per share next year
- ▶ The restructuring is expected to increase the firm's market share power in industry
- ▶ The current employees will receive additional stock options to align employee interest

Question No: 37 (Marks: 1) - Please choose one

Which of the following term is used when the firm can independently control considerable assets with a very limited amount of equity?

- ▶ Joint venture
- ▶ **Leveraged buyout (LBO)**
- ▶ Spin-off
- ▶ Consolidation

The acquisition of another company using a significant amount of borrowed money (bonds or loans) to meet the cost of acquisition. Often, the assets of the company being acquired are used as collateral for the loans in addition to the assets of the acquiring company. The purpose of leveraged buyouts is to allow companies to make large acquisitions without having to commit a lot of capital.

Question No: 38 (Marks: 1) - Please choose one

What is the economic order quantity for an automobile dealer selling 2,000 cars per year, at a cost of Rs.750 per order, and a carrying cost of Rs.300 per automobile?

- ▶ 40 cars
- ▶ 71 cars
- ▶ **100 cars**
- ▶ 126 cars

EOQ=square root of $2*2000*750 / 300 = 100$

EOQ = square root of $(2*annual QTY * Cost of order)/carrying cost per unit for whole year$

Question No: 39 (Marks: 1) - Please choose one

As the amount of _____ increases the present value of net tax-shield benefits of debt increases.

- ▶ **Debt**
- ▶ Common equity
- ▶ Preferred equity
- ▶ Assets

Question No: 40 (Marks: 1) - Please choose one

Why the present value of the costs of financial distress increases with increases in the debt ratio?

- ▶ Expected return on assets increases
- ▶ Present value of the interest tax shield is greater
- ▶ Equity tax shield is depleted
- ▶ **Probability of default and/or bankruptcy is greater**

Question No: 41 (Marks: 5)

What are the real markets effects of leverage on WAAC? (Answer the question in bulleted form only).

Answer: Real Markets Effects of leverage on WACC:

- Increase in leverage causes a large increase in cost of equity
- Increase in leverage causes relatively small increase in cost of debt as compared to cost of equity
- As leverage increases WACC 1st falls because of tax saving shield.
- With further increase in leverage WACC fall to its minimum point which is the optimal point for capital structure
- Further increase in leverage causes increase in WACC because of bankruptcy risk

Question No: 42 (Marks: 5)

Suppose a Firm ABC has Total Assets of Rs.1000 and is 100% Equity based (i.e. Un-levered). There were 10 equal Owners and 5 of them want to leave. So the Firm takes a Bank Loan of Rs.500 (at 10%pa Mark-up) and pays back the Equity Capital to the 5 Owners who are leaving. Now, half of the Equity Capital has been replaced with a Loan from a Bank (i.e. Debt). What impact does this have on ROE?

As the firm replaces equity with debt it is increasing financial leverage which is a cause of financial risk. The impact of debt on ROE is that ROE will increase but with the greater uncertainty hence greater will be the risk.

Question No: 43 (Marks: 10)

Stock X has a beta of 0.5, stock Y has a beta of 1.0, and stock Z has a beta of 1.25. The risk free rate is 10% and the expected market return is 18%.

- a. Find the expected return on stock X
- b. Find the expected return on stock Y

- c. Find the expected return on stock Z
- d. Suppose that you construct a portfolio consisting of 40% X, 20% Y and 40% Z.
What is the beta of the portfolio?

Answer:

a. $r_M = 18\%$

$r_{RF} = 10\%$

$\beta = 0.5$

$$\begin{aligned} r &= r_{RF} + (r_M - r_{RF}) \beta \\ &= 10\% + (18\% - 10\%) 0.5 \\ &= 10\% + 4\% \\ &= 14\% \end{aligned}$$

b. $r_M = 18\%$

$r_{RF} = 10\%$

$\beta = 1.00$

$$\begin{aligned} r &= r_{RF} + (r_M - r_{RF}) \beta \\ &= 10\% + (18\% - 10\%) 1.00 \\ &= 10\% + 8\% \\ &= 18\% \end{aligned}$$

1. $r_M = 18\%$

$r_{RF} = 10\%$

$\beta = 1.25$

$$\begin{aligned} r &= r_{RF} + (r_M - r_{RF}) \beta \\ &= 10\% + (18\% - 10\%) 1.25 \\ &= 10\% + 10\% \\ &= 20\% \end{aligned}$$

d. Beta of portfolio = $\beta_P = X \beta_X + Y \beta_Y + Z \beta_Z$

$$\begin{aligned} &= (40/100)0.5 + (20/100)1.0 + (40/100)1.25 \\ &= 0.4 \times 0.5 + 0.2 \times 1.0 + 0.4 \times 1.25 \end{aligned}$$

$$= 0.2 + 0.2 + 0.5$$

$$= 0.9$$

Question No: 44 (Marks: 10)

The ABC company is in the 35% marginal tax bracket. The current market value of the firm is Rs. 12 million. If there are no costs to bankruptcy:

- a) What will be ABC' annual tax savings from interest deductions be if it issues Rs. 2 million of five years bonds at 12 % interest rate? What will be the value of the firm?

ANSWER: Annual Coupon payment each yr = 12% of 2,000,000

$$= 2000000 \times 12/100$$

$$= 240000$$

Tax saving for 5 yrs = 5(35 % of 240000)

$$= 5(240000 \times 35/100)$$

$$= 5 \times 84000$$

$$= 420000$$

- b) What will ABC' annual tax savings from interest deductions be if it issues Rs. 2 million of seven years bonds at 12 % interest rate? What will be the value of the firm?

Answer: Annual Coupon payment each yr = 12% of 2,000,000

$$= 2000000 \times 12/100$$

$$= 240000$$

Tax saving for 7 yrs = 7(35 % of 240000)

$$= 7(240000 \times 35/100)$$

$$= 7 \times 84000$$

$$= 588000$$

Question No: 45 (Marks: 10)

Using the Capital Asset Pricing Model (CAPM), determine the required return on equity for the following situations:

Situations	Expected return on market portfolio	Risk- free rate	Beta
1	16%	12%	1.00
2	18	8	0.80
3	15	14	0.70
4	17	13	1.20
5	20	15	1.60

What generalization can you make?

ANSWER: Required return = $r = r_{RF} + (r_M - r_{RF}) \beta$

Where r_{RF} = risk free return

r_M = expected return on market

β = beta of stock

1. $r_M = 16\%$

$r_{RF} = 12\%$

$\beta = 1.00$

$r = r_{RF} + (r_M - r_{RF}) \beta$

$= 12\% + (16\% - 12\%)1.00$

$= 12\% + 4\%$

$= 16\%$

2. $r_M = 18\%$

$r_{RF} = 8\%$

$$\beta = 0.80$$

$$\begin{aligned}r &= r_{RF} + (r_M - r_{RF}) \beta \\ &= 8\% + (18\% - 8\%)0.80 \\ &= 8\% + 8\% \\ &= 16\%\end{aligned}$$

3. $r_M = 15\%$

$$r_{RF} = 14\%$$

$$\beta = 0.70$$

$$\begin{aligned}r &= r_{RF} + (r_M - r_{RF}) \beta \\ &= 14\% + (15\% - 14\%)0.70 \\ &= 14\% + 0.70 \\ &= 14.7\%\end{aligned}$$

4. $r_M = 17\%$

$$r_{RF} = 13\%$$

$$\beta = 1.20$$

$$\begin{aligned}r &= r_{RF} + (r_M - r_{RF}) \beta \\ &= 13\% + (17\% - 13\%)1.20 \\ &= 13\% + 4.8\% \\ &= 17.8\%\end{aligned}$$

5. $r_M = 20\%$

$$r_{RF} = 15\%$$

$$\beta = 1.60$$

$$\begin{aligned}r &= r_{RF} + (r_M - r_{RF}) \beta \\ &= 15\% + (20\% - 15\%) 1.60 \\ &= 15\% + 8\% \\ &= 23\%\end{aligned}$$

GENERALIZATION: As beta of stock rises the return on stock also rises.

Spring 2009

MGT201- Financial Management (Session - 3)

Question No: 1 (Marks: 1) - Please choose one

Which of the following type of lease is a long-term lease that is not cancelable and its life often matches the useful life of the asset?

- ▶ **A financial**
- ▶ An operating
- ▶ Both financial & operating lease
- ▶ None of the given options

An operating lease refers to a short-term lease that is often cancelable. For example, a lease for office space represents this type of lease where the lease life is less than the useful life of the asset

Question No: 2 (Marks: 1) - Please choose one

Among the pairs given below select a(n) example of a principal and a(n) example of an agent respectively.

- ▶ **Shareholder; manager**
- ▶ Manager; owner
- ▶ Accour ntant; bondholder
- ▶ Shareholder; bondholder

Question No: 3 (Marks: 1) - Please choose one

What is the present value of Rs.8,000 to be paid at the end of three years if the interest rate is 11%?

- ▶ **Rs.5,850**
- ▶ Rs.4,872
- ▶ Rs.6,725

- ▶ Rs.1,842

$$8000/(1.11)^3$$

Question No: 4 (Marks: 1) - Please choose one

What is the present value of Rs.717 to be paid at the end of 2 years if the interest rate is 9%?

- ▶ **Rs.604**
- ▶ Rs.417
- ▶ Rs.715
- ▶ Rs.556

$$717/(1.09)^2$$

Question No: 5 (Marks: 1) - Please choose one

As interest rates go up, the present value of a stream of fixed cash flows _____.

- ▶ **Goes down**
- ▶ Goes up
- ▶ Stays the same
- ▶ Can not be found

Question No: 6 (Marks: 1) - Please choose one

An 8-year annuity due has a present value of Rs.1,000. If the interest rate is 5 percent, the amount of each annuity payment is closest to which of the following?

- ▶ Rs.154.73
- ▶ **Rs.147.36**
- ▶ Rs.109.39
- ▶ Rs.104.72

<http://web.utk.edu/~jwachowi/annuity3.html>

Question No: 7 (Marks: 1) - Please choose one

A capital budgeting technique that is **NOT** considered as discounted cash flow method is:

- ▶ **Payback period**
- ▶ Internal rate of return
- ▶ Net present value
- ▶ Profitability index

While the payback period is a simple and straightforward method for analyzing a capital budgeting proposal, it has certain limitations. First and the foremost problem is that it does not take into account the concept of time value of money. The cash flows are considered regardless of the time in which they are occurring. You must have noticed that we have not used any interest rate while making calculation.

Question No: 8 (Marks: 1) - Please choose one

In which of the following situations you can expect multiple answers of IRR?

- ▶ More than one sign change taking place in cash flow diagram
- ▶ There are two adjacent arrows one of them is downward pointing & the other one is upward pointing
- ▶ During the life of project if you have any net cash outflow
- ▶ **All of the given options**

Question No: 9 (Marks: 1) - Please choose one

The value of a bond is directly derived from which of the following?

- ▶ Cash flows
- ▶ Coupon receipts
- ▶ Par recovery at maturity
- ▶ **All of the given options**

Question No: 10 (Marks: 1) - Please choose one

Which of the following is a characteristic of a coupon bond?

- ▶ Pays interest on a regular basis (typically every six months) sure
- ▶ Does not pay interest on a regular basis but pays a lump sum at maturity
- ▶ Can always be converted into a specific number of shares of common stock in the issuing company
- ▶ Always sells at par

Question No: 11 (Marks: 1) - Please choose one

A zero-coupon bond has a yield to maturity of 9% and a par value of Rs.1,000. If the bond matures in 8 years, the bond should sell for a price of _____ today.

- ▶ Rs. 422.41
- ▶ **Rs. 501.87**
- ▶ Rs. 513.16
- ▶ Rs. 483.49

$$\begin{aligned} \text{Price of bond} &= \text{pv of coup pyament} + \text{pv of face vlue} \\ &= 1000 / (1.09)^8 \end{aligned}$$

Question No: 12 (Marks: 1) - Please choose one

When a bond will sell at a discount?

- ▶ The coupon rate is greater than the current yield and the current yield is greater than yield to maturity
- ▶ The coupon rate is greater than yield to maturity
- ▶ **The coupon rate is less than the current yield and the current yield is greater than the yield to maturity**
- ▶ The coupon rate is less than the current yield and the current yield is less than yield to maturity

The coupon rate is less than the current yield and the current yield is less than yield to maturity. In order for the investor to earn more than the current yield the bond must be

selling for a discount. Yield to maturity will be greater than current yield as investor will have purchased the bond at discount and will be receiving the coupon payments over the life of the bond

Question No: 13 (Marks: 1) - Please choose one

Which of the following is the variability of return on stocks or portfolios not explained by general market movements. It is avoidable through diversification?

- ▶ Systematic risk
- ▶ Standard deviation
- ▶ **Unsystematic risk**
- ▶ Financial risk

Systematic risk is not avoidable through diversification

Question No: 14 (Marks: 1) - Please choose one

According to the Capital Asset Pricing Model (CAPM), which of the following combination is equal to the expected rate of return on any security?

- ▶ $R_f + \beta[E(R_M)]$
- ▶ **$R_f + \beta[E(R_M - R_f)]$**
- ▶ $R_f + \beta[E(R_M) - R_f]$
- ▶ $E(R_M) + R_f$

Question No: 15 (Marks: 1) - Please choose one

What is the expected return of a zero-beta security?

- ▶ **The risk-free rate**
- ▶ Zero rate of return
- ▶ A negative rate of return
- ▶ The market rate of return

Question No: 16 (Marks: 1) - Please choose one

How the beta of a stock can be calculated?

- ▶ By monitoring price of the stock
- ▶ By monitoring rate of return of the stock
- ▶ **By comparing the changes in the stock market price to the changes in the stock market index**
- ▶ All of the given options

Question No: 17 (Marks: 1) - Please choose one

If stock is a part of totally diversified portfolio then its company risk must be equal to:

- ▶ 0
- ▶ 0.5
- ▶ 1
- ▶ -1

Question No: 18 (Marks: 1) - Please choose one

How can you limit company-specific risks?

- ▶ Invest in that company's bonds
- ▶ **Invest in a variety of stocks**
- ▶ Invest in securities that do well in a recession
- ▶ Invest in securities that do well in a boom

Company-specific risks. Operating risk and price risk are two factors contributing to short-term volatility of individual stocks. Operating risk is the risk to the company as a business and includes anything that might adversely affect the company's profitability. Price risk, meanwhile, has more to do with the company's stock than with its business: How expensive is the stock compared with the company's earnings, cash flow, or sales? To limit company-specific risk, own a collection of stocks rather than just a few.

Question No: 19 (Marks: 1) - Please choose one

Find the Risk-Free Rate given that the Expected Return on Stock is 12.44%, the Expected Return on the Market Portfolio is 13.4%, and the Beta for Stock is 0.9.

- ▶ 3.8%
- ▶ 4.9%
- ▶ 5.34%
- ▶ 6.38%

$$r_j = r_f + b(r_m - r_f)$$

Question No: 20 (Marks: 1) - Please choose one

Which of the following can be used to calculate the risk of the larger portfolio?

- ▶ Standard deviation
- ▶ EPS approach
- ▶ **Matrix approach**
- ▶ Gordon's Approach

We can calculate the risk of larger portfolio using the matrix approach

Question No: 21 (Marks: 1) - Please choose one

Market risk is measured in terms of the _____ of the market portfolio or index.

- ▶ Variance
- ▶ Covariance
- ▶ **Standard deviation**
- ▶ Correlation coefficient

Market Risk is measured in terms of the Standard Deviation (or Volatility) of the Market Portfolio or Index

Question No: 22 (Marks: 1) - Please choose one

If 2 stocks move in the same direction together then what will be the correlation coefficient?

- ▶ 0
- ▶ **1.0**
- ▶ -1.0
- ▶ 1.5

The strength of the correlation between two variables such as two stock prices is measured by the correlation coefficient. If two stock prices have perfect positive correlation, their correlation coefficient will have the value of +1.

Question No: 23 (Marks: 1) - Please choose one

Which of the following is **NOT** the cost of equity?

- ▶ The minimum rate that a firm should earn on the equity-financed part of an investment
- ▶ **Generally lower than the before-tax cost of debt**
- ▶ It is the most difficult cost component to estimate
- ▶ None of the given options

Question No: 24 (Marks: 1) - Please choose one

Assume management is looking at a set of possible projects with regards to their expected NPV, standard deviation, and management's risk attitude. The firm should attempt to take the set of projects _____.

- ▶ That falls on the lowest indifference curve
- ▶ **That falls on the highest indifference curve**
- ▶ That has the lowest standard deviation
- ▶ That has the highest standard deviation

The lowest indifference curve generates the lowest satisfaction by management with that set of projects.

Question No: 25 (Marks: 1) - Please choose one

The overall (weighted average) cost of capital is composed of weighted averages of which of the following?

- ▶ The cost of common equity and the cost of debt
- ▶ The cost of common equity and the cost of preferred stock
- ▶ The cost of preferred stock and the cost of debt
- ▶ **The cost of common equity, the cost of preferred stock, and the cost of debt**

Question No: 26 (Marks: 1) - Please choose one

How economic value added (EVA) is calculated?

- ▶ It is the difference between the market value of the firm and the book value of equity
- ▶ **It is the firm's net operating profit after tax (NOPAT) less a dollar cost of capital charge**
- ▶ It is the net income of the firm less a dollar cost that equals the WAAC only
- ▶ None of the given options

Question No: 27 (Marks: 1) - Please choose one

Upon which of the following a firm's degree of operating leverage (DOL) depends primarily?

- ▶ Sales variability
- ▶ Level of fixed operating costs
- ▶ **Closeness to its operating break-even point**
- ▶ Debt-to-equity ratio

Question No: 28 (Marks: 1) - Please choose one

A firm has a DFL of 3.5 at X dollars. What does this tell us about the firm?

- ▶ If sales rise by 3.5% at the firm, then EBIT will rise by 1%
- ▶ If EBIT rises by 3.5% at the firm, then EPS will rise by 1%
- ▶ **If EBIT rises by 1% at the firm, then EPS will rise by 3.5%**
- ▶ If sales rise by 1% at the firm, then EBIT will rise by 3.5%

Question No: 29 (Marks: 1) - Please choose one

For an all-equity firm, what is the effect of EBIT on the EPS?

- ▶ **As earnings before interest and taxes (EBIT) increases, the earnings per share (EPS) increases by the same percent**
- ▶ As EBIT increases, the EPS increases by a larger percent
- ▶ As EBIT increases, the EPS decreases
- ▶ None of the given options

Question No: 30 (Marks: 1) - Please choose one

The beta of an all-equity firm is 1.2. If the firm changes its capital structure to 50% debt and 50% equity using 8% debt financing, what will be the beta of the levered firm? The beta of debt is 0.2. (Assume no taxes.)

- ▶ 1.2
- ▶ 2.4
- ▶ **2.2**
- ▶ 1.8

Question No: 31 (Marks: 1) - Please choose one

The Serfraz Company is financed by Rs. 2 million (market value) in debt and Rs. 3 million (market value) in equity. The cost of debt is 10% and the cost of equity is 15%. Calculate the weighted average cost of capital. (Assume no taxes.)

- ▶ 10%

- ▶ 15%
- ▶ 13%
- ▶ 8%

$$V = 2M + 3M = 10M$$

$$WCCA = 2/5 * 10\% + 3/5 * 15\% = 13\%$$

Question No: 32 (Marks: 1) - Please choose one

Which of the following expressed the proposition that the value of the firm is independent of its capital structure?

- ▶ The Capital Asset Pricing Model
- ▶ **M&M Proposition I**
- ▶ M&M Proposition II
- ▶ The Law of One Price

According to M&M's Proposition I, the value of a firm is independent of the financing mix of the firm. Thus, managers cannot alter firm value by their choice of the relative amounts of debt and equity financing. According to M&M, the value of the firm is determined by the size and riskiness of the real cash flows generated by the firm's assets, and not by how these cash flows are divided between the debt and equity stakeholders of the firm. These results hold under the assumption of perfect capital markets with no corporate or personal taxes. Under perfect capital markets, investors face no transactions costs and are symmetrically informed. In addition, firms can borrow and lend at the risk-free rate and can issue securities with no issuance costs

Question No: 33 (Marks: 1) - Please choose one

Which of the following could **NOT** be defined as the capital structure of the Company?

- ▶ The firm's mix of Assets and liabilities
- ▶ The firm's debt-equity ratio
- ▶ All of the given option
- ▶ **The firm's common stocks only**

Capital structure refers to the way a corporation finances its assets through some combination of equity, debt, or hybrid securities

Question No: 34 (Marks: 1) - Please choose one

Which of the following would express the negative net worth of a firm?

- ▶ Experiencing a business failure
- ▶ A legal bankruptcy
- ▶ Experiencing technical insolvency
- ▶ **Experiencing accounting insolvency**

Question No: 35 (Marks: 1) - Please choose one

Suppose that the Euro is selling at a forward discount in the forward-exchange market. This implies that most likely _____.

- ▶ The Euro has low exchange-rate risk
- ▶ The Euro is gaining strength in relation to the dollar
- ▶ **Interest rates are higher in Euroland than in the United States**
- ▶ Interest rates are declining in Europe

Question No: 36 (Marks: 1) - Please choose one

Which of the following term is used when the firm can independently control considerable assets with a very limited amount of equity?

- ▶ Joint venture
- ▶ **Leveraged buyout (LBO)**
- ▶ Spin-off
- ▶ Consolidation

The acquisition of another company using a significant amount of borrowed money (bonds or loans) to meet the cost of acquisition. Often, the assets of the company being acquired are used as collateral for the loans in addition to the assets of the acquiring

company. The purpose of leveraged buyouts is to allow companies to make large acquisitions without having to commit a lot of capital.

Question No: 37 (Marks: 1) - Please choose one

Which of the following is **NOT** a reason that DeStore.com would prefer to pay a stock dividend rather than a regular cash dividend?

- ▶ **It decreases the supply of shares and enhances shareholder wealth**
- ▶ It may conserve cash for other firm needs
- ▶ It will reduce the stock price
- ▶ The investors anticipates that it cannot convey credibly otherwise

Question No: 38 (Marks: 1) - Please choose one

After the payment of a 25% stock dividend, an investor has 500 shares of stock and Rs. 400 total value. What did the investor have prior to the stock dividend?

- ▶ 375 shares of stock and Rs. 375 total value
- ▶ **400 shares of stock and Rs. 400 total value**
- ▶ 400 shares of stock and Rs. 500 total value
- ▶ 625 shares of stock and Rs. 400 total value

Because stock dividend did not increase the value. It only increases the number of stocks.

Question No: 39 (Marks: 1) - Please choose one

What is the proportion of assets in debt financing for a firm that expects a 24% return on equity, a 16% return on assets, and a 12% return on debt? Ignore taxes.

- ▶ 54.0%
- ▶ 60.0%
- ▶ **66.7%**
- ▶ 75.0%

Question No: 40 (Marks: 1) - Please choose one

When financial disaster is looming, why management may borrow to invest in projects having a negative expected NPV?

- ▶ The firm's beta is now negative
- ▶ Taxes are no longer a concern
- ▶ The interest tax shield will cover the loan costs
- ▶ **The lender bears all the risk**

Question No: 41 (Marks: 5)

Zee Zee Tops Inc., manufacturer's plaid vinyl and chenille cartops for convertibles. These roofs sell for Rs. 200 each and have an associated variable cost per unit of Rs. 120. Management fully expects next year's sales and NOI to drop sharply, by 20% and 50%, respectively, due to lack of demand (i.e., "consumer resistance"). If Zee Zee's current level of production and sales is 112 car tops, what is the level of fixed costs?

Question No: 42 (Marks: 5)

How working capital affects performance of a business?

Question No: 43 (Marks: 10)

Hoskins Hiking Boot Company is trying to devise an appropriate working capital policy. Their most recent balance sheet is as follows:

ASSETS		LIABILITIES AND OWNER'S EQUITY	
Cash	Rs.30	Accounts payable	Rs.35
Accounts receivable	50	Notes payable	10
Inventories	30	Accruals	5

Current Assets	110	Current liabilities	50
Net fixed assets	150	Mortgage loan (at 13%)	80
		Common equity	130
		Total liabilities &	
Total assets	Rs.260	Owner's equity	Rs.260

You know that net profits in 2004 were Rs.28, 000.

- What is Hoskin's current level of gross and net working capital? **(Marks 2)**
- What percentage of total assets is invested in gross working capital? **(Marks 1)**
- Calculate Hoskins' return on investment. **(Marks 2)**
- Suppose the firm reduces cash, accounts receivable, and inventory by 10% and uses the proceeds to pay off some of its accounts payable. Now, assuming all other items remain the same, answer a, b, and c above using these new figures. **(Marks 5)**

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- What is Hoskin's current level of gross and net working capital? **(Marks 2)**
- What percentage of total assets is invested in gross working capital? **(Marks 1)**
- Calculate Hoskins' return on investment. **(Marks 2)**

$$= [\text{Net Income} / \text{Total Assets}] \times 100$$
- Suppose the firm reduces cash, accounts receivable, and inventory by 10% and uses the proceeds to pay off some of its accounts payable. Now, assuming all other items remain the same, answer a, b, and c above using these new figures.

(Marks 5)

- What percentage of total assets is invested in gross working capital?

Question No: 44 (Marks: 10)

Earnings before interest and taxes (EBIT) of Firm is Rs.1000 and Corporate Tax Rate, T_c is 30%

- a) If the Firm is 100% Equity (or Un-Levered) and $r_E = 30\%$ then what is the WACCU of Un-levered Firm?
- b) If the Firm takes Rs.1000 Debt at 10% Interest or Mark-up then what is the WACCL of Levered Firm? (There is no change in return in equity)
- c) If the Firm is 100% Equity (or Un-Levered) and $r_E = 30\%$ then what is the WACCU of Un-levered Firm?
- d) If the Firm takes Rs.1000 Debt at 10% Interest or Mark-up then what is the WACCL of Levered Firm? (There is no change in return in equity)

Question No: 45 (Marks: 10)

If the capital-asset pricing model approach is appropriate, compute the required rate of return for each of the following stocks: Assume a risk-free rate of **.09** and an expected return for the market portfolio of **.12**

Stock	A	B	C	D	E
Beta	2.0	1.5	1.0	0.7	0.2