1. Which of the following statements is most correct?

a. A risk averse investor will seek to invest only in risk-free securities such as Treasury bills or bonds.
b. In comparing two firms that differ from each other only with respect to risk, the expected returns on the firm with the lower risk will have the higher expected return.
c. Risk aversion implies a general dislike for risk, thus, in equilibrium, the lower the risk premium the lower the expected return.
d. When investors require higher rates of return for investments that demonstrate higher variability of returns, this is evidence of risk aversion.
e. Answers c and d above are correct.

2. Which of the following statements is most correct?

a. The tighter the probability distribution of expected returns, the more likely the outcome will be close to the expected value, and the less likely that the actual return will fall far short of the expected return.
b. The standard deviation, denoted by s, is a statistical operation that allows investors to gauge the degree of risk borne per unit of expected return.
c. Stand-alone risk is the risk an investor faces from holding only one asset, and it can not be reduced through diversification.
d. If investors are risk averse, they would not be willing to pursue an investment with excessive risk, regardless of the expected return.
e. None of the above are correct.

3. Which of the following statements is most correct?

a. Historically speaking, large-company stocks have traditionally provided investors with the highest average returns.
b. The risk premium represents the additional compensation investors require in order to assume additional risk.
c. In an efficient market, a security’s realized return will be equivalent to its expected return.
d. Diversification has a stronger effect when a portfolio consists of perfectly positively correlated stocks.
e. The relevant risk of a security refers to the amount of risk that can be diversified away.

4. Stock A has an expected return of 14.5% and a beta of 1.5. Stock B has a beta of 2. If the risk-free rate is 4%, what is the expected return of Stock B?

a. 15.0% b. 16.0% c. 18.0% d. 18.5% e. 19.0%

5. Suppose a stock is not currently paying dividends, and its management has announced that it will not pay a dividend for several years, but that it does expect to start paying dividends sometime in the future. Under these conditions, which of the following statements is most correct?

a. The value of the stock can be found using DCF procedures by finding the present value of expected future dividends accounting for their timing and amount.
b. According to the text, such a stock should have a value of zero until it actually begins paying dividends.
c. Since it is expected to someday pay dividends, the value of the stock today can be found with this equation: \( P_0 = \frac{D_t}{r - g} \).
d. Under these conditions, we can estimate a value for the stock, but we cannot use any form of the constant growth DCF model to do so.
e. The value of the stock can be found by summing up all of the expected future dividend payments, making sure to insert zeros for \(D_t\) until such time as we expect the company to begin paying dividends.

6. Which of the following statements concerning common stock is most correct?

a. Companies are required by law to issue only one class of common stock, although the rights and privileges associated with shares within that class may vary.
b. A company whose stock is all owned by a few people (typically its managers) is said to be "privately owned" or "closely held."
c. The preemptive right fails to protect shareholders against dilution of value when a company decides to issue additional common stock.
d. Institutional investors hold more than seventy-five percent of the common stock outstanding, but their trading and large block trades mean that they have a minimal influence on stock prices.
e. The decision to go public is automatic and comes after a company has been selected to be listed by a stock exchange such as by NASDAQ.

7. A firm expects to pay dividends at the end of each of the next four years of $1.00, $1.40, $2.00, and $3.00. If growth is then expected to level off at 9 percent, and if you require a 13 percent rate of return, how much should you be willing to pay for this stock?

- a. $55.35
- b. $62.86
- c. $81.75
- d. $24.83
- e. $50.22

8. Suppose you are willing to pay $20.00 today for a share of stock which you expect to sell at the end of one year for $22.20. If you require an annual rate of return of 15 percent, what must be the amount of the annual dividend which you expect to receive at the end of Year 1?

- a. $1.00
- b. $0.80
- c. $1.60
- d. $1.17
- e. $2.20

9. GORR Specialty Plastics Company has decided to make a major investment. The investment will require a substantial early cash outflow, and inflows will be delayed several periods. As a result, it is expected that the impact on the firm's earnings for the first 2 years will cause a negative growth of 8 percent annually. Further, it is anticipated that the firm will then experience 2 years of zero growth, after which it will begin a positive annual sustainable growth of 10 percent. If the firm's required return is 13 percent and its last dividend, \(D_0\), was $1.50 per share, what should be the current price per share?

- a. $12.95
- b. $47.83
- c. $55.26
- d. $26.77
- e. $32.43

10. Which of the following statements is NOT correct about the rights granted to common stockholders?

a. Common stockholders have the right to elect a firm's directors.
b. The manner in which stockholder control is exercised can be subject to state and federal law.
c. Stockholders may transfer their right to vote to a second party by means of a proxy.
d. In large, publicly traded firms, managers typically have some stock but their personal holdings are generally insufficient to win voting control.
e. Dividends due to common stockholders are cumulative.
11. A firm expects to pay a dividend of $2.00 one year from now. They expect the dividend to grow at a constant rate of 8%, forever. If the firm's required return is 12%, what is the expected stock price today?

   a. $16.67       b. $18.00       c. $25.00       d. $50.00       e. $54.00

12. Which of the following statements is NOT correct?

   a. Under normal conditions, we cannot say whether the CAPM approach to estimating a firm's cost of retained earnings gives a better estimate than the DCF approach.
   b. The risk premium used in the bond-yield-plus-risk-premium method is not the same as the one used in the CAPM method.
   c. The CAPM approach cannot be used to estimate a firm's cost of internally generated equity only of externally generated equity.
   d. In practice, the DCF method and the CAPM method usually produce different estimates for r_s.
   e. The CAPM method probably should not be used in isolation (i.e. alone) to estimate a firm's cost of retained earnings equity.

13. Which of the following statements is most correct?

   a. As a firm uses less debt and more equity in its capital structure, the MCC schedule declines.
   b. Depreciation-generated funds have a cost less than the firm's lowest WACC, and hence they have no impact on the MCC schedule.
   c. As a firm's debt ratio approaches 100 percent, the after-tax cost of debt, r_d(1 - T), will approach zero.
   d. As a firm uses more debt the cost of debt decreases which lowers the WACC.
   e. A decrease in the corporate tax rate would increase the weighted average cost of capital for a typical firm other things held constant.

14. Which of the following activities is NOT a major use of the cost of capital?

   a. Evaluating capital budgeting projects     b. Calculating rates of return on investments
   c. Calculating a firm's economic value added     d. Deciding whether to lease or purchase assets
   e. Regulating the monopoly services provided by utilities companies

15. Which of the following correctly ranks the after-tax component costs of capital from the least to the greatest in magnitude?

   a. debt, preferred stock, new common stock, retained earnings
   b. debt, preferred stock, retained earnings, new common stock
   c. debt, preferred stock, new common stock     d. preferred stock, debt, new common stock
   e. preferred stock, debt, retained earnings, new common stock

16. Which of the following cost of capital factors can firms NOT control?

   a. capital structure policy     b. investment policy     c. interest rate levels
   d. dividend policy     e. All of the above factors can be controlled by the firm.

17. A firm's CFO wants to estimate the firm's WACC, and has compiled the following information:

   - The firm's capital structure consists of 60% equity and 40% debt.
   - The firm has bonds outstanding yield 8.75%, The real-risk free rate is 5%. 

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• The market risk premium is 6%. The firm's beta is 1.4.
• The firm's tax rate is 40%.

The firm uses the CAPM to estimate the cost of equity, and does not account for any kind of flotation costs in the calculation of the cost of capital. What is the firm’s weighted average cost of capital (WACC)?

a. 9.44%  b. 9.76%  c. 10.14%  d. 11.54%  e. 12.02%

18. A firm's current ratio has steadily decreased over the past 3 years, from 2.9 three years ago to 1.1 today. What would a financial analyst be most justified in concluding?

a. The firm's stock price has probably declined.
b. The firm's debt ratio will not be affected.
c. The firm's fixed assets turnover has probably deteriorated.
d. The firm's liquidity position has probably deteriorated.
e. The analyst would be unable to draw any conclusions from this information.

19. Burke Company has sales of $2,000,000 and an inventory turnover of 8.0. The firm's current ratio is 2.5, while its quick ratio is 2.0. What are Burke's current assets?

a. $1,000,000  b. $400,000  c. $500,000  d. $1,500,000  e. $1,250,000

20. A firm has total assets of $20 million and a debt/equity ratio of 0.60. Its sales are $15 million, and it has total fixed costs of $6 million. If the firm's EBIT is $3 million, its tax rate is 40 percent, and the interest rate on all of its debt is 9 percent, what is the firm's ROE?

a. 6.98%  b. 13.75%  c. 5.25%  d. 11.16%  e. 11.25%

21. You are given the following information about a firm: The growth rate equals 9 percent; return on assets (ROA) is 12 percent; the debt ratio is 36 percent; and the stock is selling at $38. What is the return on equity (ROE)?

a. 14.05%  b. 18.75%  c. 12.0%  d. 3.0%  e. 13.5%

22. Yohe Inc. has an ROA of 15% and a 10% profit margin. The company has sales equal to $5 million. What is the company's total assets (in millions)?

a. 3.00  b. 3.33  c. 3.73  d. 4.17  e. 4.80

23. Holding other things constant, the additional funds required for financing a firm's operations would be increased with an increase in a firm's


24. You are the owner of a small business which has the following balance sheet:

Current assets $10,000  Accounts payable $ 2,500
Net fixed assets 20,000  Accruals 2,500
Long-term debt  10,000
Common equity  15,000
Total assets  $30,000  Total liab. and equity  $30,000

Fixed and current assets are fully utilized, and the sales/assets and sales/spontaneous liabilities ratios will remain constant. Next year you expect sales to increase by 50 percent. You also expect to retain $2,250 of next year's earnings within the firm. What is next year's additional external funding requirement, i.e., what is your firm's AFN?

a. No AFN required.  b. $10,250  c. $15,000  d. $17,250

25. Which of the following are ways that managers can use pro forma financial statements?

a. To investigate the impact of proposed changes in strategy and operations.
b. To assess whether the firm's anticipated performance is in line with their own targets and with shareholder's expectations.  c. To estimate future free cash flows.
d. All of the above are correct.  e. None of the above are correct.

26. All else equal, which of the following conditions would lead to an increase in the additional funds needed?

a. An increase of the total assets turnover ratio.  b. A decrease in projected sales.
c. An increase in spontaneous liabilities.  d. An increase in the profit margin.
e. A decrease in the retention ratio.

27. All else equal, which of the following conditions would lead to a decrease in the additional funds needed?

a. An increase of the dividend payout ratio.  b. Accounts payable increase slower than sales.
c. The firm has a lot of excess capacity.  d. All of the above are correct.
e. None of the above are correct.

28. The most commonly held view of capital structure, according to the text, is that the weighted average cost of capital

a. Declines steadily as more debt is used.  b. First declines with moderate amounts of leverage and then increases.
c. Increases proportionately with increases in leverage.  d. Is unaffected by the level of debt used.
e. Is minimized at a balanced capital structure of 50% equity and 50% debt.

29. Which of the following is a key determinant of operating leverage?

a. Sales variability.  b. Physical location of production facilities, for example in a high tax state.
c. Cost of debt  d. Capital structure.  e. Level of fixed costs.

30. Friess Associates, Inc. has $4,000,000 in assets, and currently has no debt. It is financed entirely with 300,000 shares of common stock, each of which trades at $15 per share. The firm's EBIT is
expected to be $1,000,000 at year end (i.e., at t = 1). The corporate tax rate is 40 percent. Friess Associates expects to pay out a dividend at year end which is 55 percent of its net income. The company estimates that its earnings and dividends grow at a constant rate of 5 percent a year. Suppose Friess Associates can issue $1,200,000 in debt at an interest rate 10% and uses the proceeds to repurchase shares of stock at the original price of $15. The cost of stock after the change in capital structure will be 12 percent. If the expected growth rate and payout ratio don't change, what is the expected price after the change in capital structure?

a. $17.25   b. $15.00   c. $20.98   d. $18.86   e. $33.17

31. The additional risk placed on stockholders by a firm's decision to use more debt is called

a. market risk   b. interest rate risk   c. financial risk   d. stand-alone risk   e. business risk

32. Fisher Communications’ common stock currently has a required return of 11.49%. The risk-free rate of interest is 5%, the market risk premium is 5.5%, and Fisher's corporate tax rate is 40%. The firm currently has 10% debt in its capital structure, but is considering recapitalizing to achieve a debt ratio of 50%. If the recapitalization is achieved, all else equal, what would the required return on Fisher Communications' common stock be?

a. 11.08%   b. 12.91%   c. 13.85%   d. 14.35%   e. 14.74%

33. If you were to argue that the firm's cost of equity, rs, does not change as the dividend payout decreases, you would be making an argument ______________ with MM's dividend irrelevance theory, and ______________ with Gordon and Lintner's "bird-in-the-hand" theory.

a. consistent; inconsistent   b. inconsistent; consistent   c. consistent; consistent   d. inconsistent; inconsistent   e. The argument above does not make sense.

34. Marsland Industries follows a strict residual dividend policy. The company has a capital budget of $4,000,000. It has a target capital structure which consists of 40 percent debt and 60 percent equity. Marsland forecasts that its net income will be $3,000,000. What will be the company's expected dividend payout ratio this year?

a. 20%   b. 30%   c. 35%   d. 40%   e. 45%

35. Which of the following statements is most correct?

a. Investors are indifferent to stock repurchases or cash dividends, because they are taxed the same way.
   b. Modigliani and Miller suggested that investors prefer capital gains rather than dividends from their stock investments.
   c. The clientele effect suggests that firms attract a certain type of investor based upon their dividend policy.
   d. Both A and C are correct.   e. None of the above are correct.

36. Mitts Inc. stock currently sells for $120 a share. They have just announced a 3:1 stock split to occur today. The market saw this as a positive announcement, and the firm's market capitalization rose 10%. What is Mitts' new stock price?

a. $36   b. $40   c. $44   d. $46   e. $48
37. An unusually high turnover of accounts receivable, which implies a very short days sales outstanding (DSO), could indicate that the firm

a. Has a relaxed (lenient) credit policy.   b. Offers small discounts.
c. Uses a lockbox system, synchronizes cash flows, and has short credit terms.
d. Has an inefficient credit and collection department.   e. Only answers a and c above.

38. For the McIntyre Distribution Company, the average age of accounts receivable is 48 days, the average age of accounts payable is 32 days, and the average age of inventory is 59 days. Assume a 365-day year. If McIntyre's annual sales are $2,050,200, what is the firm's investment in accounts receivable?

a. $96,000   b. $336,005   c. $182,240   d. $212,000   e. $269,616

39. Which of the following statements is most consistent with a relaxed current asset investment policy?

a. A firm carries small amounts of cash and inventories.   b. Sales are stimulated by a tight credit policy.
c. Accounts receivable are held at a high level.    d. All of the above are correct.   e. None of the above are correct.

40. Tullis Tours has average daily sales of $50,000 and average daily cost of goods sold of $35,000. A look at Tullis' balance sheet indicates that the company has $1.5 million of inventories, $1 million of accounts receivable, and accounts payable of $735,000. What is Tullis' cash conversion period?

a. 20 days   b. 21 days   c. 25 days   d. 29 days   e. 50 days

41. Tullis Tours has a credit policy where full payment is required after 60 days. If the customers pay by the 20th day, they are entitled to a 2 percent discount. Which of the following correctly identifies its credit policy?

a. 2/20, net 60   b. 2/60, net 20   c. 20/2 net 60   d. 20/60, net 2   e. 60/20, net 2

42. Roa Computers, Inc. trade policy is 3/10, net 30. Roa's annual cost of goods sold is $9,785,000. Roa uses a 360 day accounting year. How much trade credit can Roa offer to its customers?

a. $268,082   b. $271,806   c. $543,611   d. $804,247   e. $815,417

What are the advantages and disadvantages of stock split?

What are the reasons for repurchasing the company its stocks?