

Review Questions: Theory

1. Which one of the following is the best description of the goal of the financial manager in a publicly traded corporation?

- a. Maximize sales.
- b. Increase the total assets of the firm.
- c. Maximize the current net income of the firm.
- d. Reduce the level of long-term debt used by the firm.
- e. Maximize the current value per share of the existing stock.
- f. All of the above.

2. Which of the following is/are **TRUE** about callable bonds?

- a. They are more valuable than otherwise identical non-callable bonds if and only if the call price is strictly **HIGHER** than the face value.
- b. They are more valuable than otherwise identical non-callable bonds if and only if the call price is strictly **LOWER** than the face value.
- c. They are **ALWAYS** more valuable than otherwise identical non-callable bonds.
- d. They are **NEVER** more valuable than otherwise identical non-callable bonds.
- e. Both a. and c.
- f. None of the above.

3. Given a fixed APR, which of the following statements about effective annual interest rates (EAR) is/are **NOT** correct?

- a. Higher-frequency compounding **INCREASES** the EAR.
- b. If the number of times you compound the interest rate converges to infinity, then the EAR will converge to infinity as well.
- c. The APR is **NEVER** higher than EAR so long as the compounding frequency is at least once per year.
- d. Both b. and c.
- e. All of the above.
- f. None of the above.

4. Financial managers are responsible for determining:

- I. How suppliers will be paid.
- II. The appropriate level of debt for a firm.
- III. Which projects a firm should undertake.
- IV. How to invest the firm's cash.

- a. I and II only.
- b. II and III only.
- c. I, II and III only.
- d. II, III and IV only.
- e. I, II, III and IV.
- f. III and IV only.

*Effective
must not pay interest*

5. A bond sold five weeks ago for \$1,100. The bond is worth \$1,050 in today's market. Assuming no changes in risk, which one of the following is **TRUE** ?

- a. The face value of the bond must be \$1,100.
- b. The bond must be within one year of maturity.
- c. Interest rates must be **LOWER** now than they were five weeks ago.
- d. The bond's current yield has **INCREASED** from five weeks ago.
- e. The coupon payment of the bond must have **INCREASED**.
- f. None of the above.

6. Which of the following **BEST** describes the preemptive rights of the shareholders? a. The right to preempt shareholders from starting bankruptcy procedures during the 180 days following a default on coupon payments. b. The right **NOT** to pay dividends to the preferred shareholders when the firm's net income is negative. c. The right to buy new shares of common stock before it is offered to the public. d. The right to sell their shares to back to the firm in the case the new debt or equity is issued. e. The right to sell their shares to back to the firm in the case the debt/equity ratio in the firm's financing is substantially increased. f. All of the above.

7. For a normal project with positive NPV which of the following is/are **TRUE**? a. The IRR must be **HIGHER** than the cost of capital. b. The PI must be **HIGHER** than 1. c. The project **MAY** be rejected according to the payback criteria. d. The project **MAY** be rejected according to the discounted payback criteria. e. All of the above. f. None of the above.

8. Which of the following is/are **TRUE**, all else equal? 1. The **LOWER** the discount rate, the **MORE** valuable the coupon payments are at t = 0. 2. Bonds with **HIGH** coupon payments are generally **MORE** sensitive to changes in interest rates than bonds with **LOWER** coupon payments. 3. When market interest rates **RISE**, bond prices will **FALL**. 4. Bonds with **LONG** maturities are generally **MORE** sensitive to changes in interest rates than bonds with **SHORTER** maturities.

- a. I and II only.
- b. I and IV only.
- c. II and III only.
- d. II, III, and IV only.
- e. I, III, and IV only.
- f. I, II, III, and IV.

10. You are considering an investment project. You know that the cost of capital of firm is *of similar risk of firm or other projects.* relevant to the project depends on the:
- a. Total risk of the firm's equity.
 - b. Type of security to be issued to finance the project.
 - c. Type of assets needed for the project, that is, whether they are long-term or short-term assets.
 - ~~d. Risk associated with the project.~~
 - e. Coupon rate on the firm's existing long-term bonds
 - f. All of the above
11. A firm needs to raise cash and at the same time reduce the level of its accounts receivable.
- The firm would likely benefit most by:
- a. Obtaining an unsecured short-term loan.
 - b. Applying for a committed line of credit.
 - c. Assigning its receivables as collateral on a short-term loan.
 - d. Securing short-term credit with a blanket inventory lien.
 - ~~e. Factoring its receivables. *→ go to company and sell RR at discount*~~
 - f. None of the above.
12. Which one of the following statements related to the operating cycle is/are **TRUE?**
- a. The inventory conversion period ends when the receivable is actually paid by the customer.
 - ~~b. The length of the operating cycle is ALWAYS GREATER THAN OR EQUAL to the length of the cash conversion cycle.~~
 - c. The receivables conversion period is ALWAYS GREATER THAN OR EQUAL to the length of the cash conversion cycle.
 - d. The inventory conversion period PLUS the receivables conversion period is EQUAL in length to the operating cycle PLUS the cash conversion cycle.
 - e. The payables deferral period ends when the inventory is sold.
 - f. Both b. and c.
13. Which of the following would fall under the heading of short-term financial planning?
- I. Increasing inventory to better meet the demands of customers.
 - II. Making it easier for customers to purchase on credit.
 - III. Paying an accounts payable within 10 days to get a discount.
 - IV. Purchasing new equipment for the production assembly line.
 - a. I and III only.
 - b. II and III only.
 - c. II, III, and IV only.
 - d. I, II, and IV only.
 - ~~e. I, II, and III only.~~
 - f. I, II, III, and IV.

14. Which one of the following is/are **TRUE** regarding cash management?
- a. The basic objective in cash management is to keep the investment in cash as low as possible while still operating efficiently and effectively.
 - b. A cost of holding cash is the liquidity it gives the firm.
 - c. A cost of holding cash is the interest income earned on the outstanding cash balance.
 - d. A firm should **DECREASE** its cash holdings as long as the net present value (NPV) of doing so is **NEGATIVE**.
 - e. Effective cash management results in **MINIMIZATION** of the total interest earnings involved in holding cash.
 - f. Both b. and e.

15. Jeffries, Inc., keeps excess cash on hand in case of an industrial accident in the manufacturing of its wheat herbicide, Ground Up. This is an example of a _____ need for holding cash.
- a. Speculative.
 - b. Transactions
 - c. Future requirements.
 - d. Compensating balance.
 - e. Precautionary.
 - f. Both c. and d.

16. Which one of the following is/are **TRUE** regarding float?
- a. Cheques **WRITTEN** by a firm generate **COLLECTION** float for that firm.
 - b. Cheques **RECEIVED** by a firm create **DISBURSEMENT** float for that firm.
 - c. A firm's **DISBURSEMENT** activities generate float while its **COLLECTION** activities do **NOT**.
 - d. A firm's float is **NEGATIVE** when its available cash balance **EQUALS** its book cash balance.
 - e. A firm can exploit float by using the cash needed to cover a cheque while the cheque is clearing.
 - f. Both a. and b.

17. Net present value (NPV):
- a. Is **EQUAL** to the initial investment in a project.
 - b. Compares a project's cost to the present value of the project's benefits.
 - c. Is equal to **ZERO** when the discount rate used is **LESS** than the internal rate of return (IRR).
 - d. Is simplified by the fact that future cash flows are easy to estimate.
 - e. Requires the firm set an arbitrary cutoff point for determining whether an investment is acceptable or not.
 - f. All of the above.

18. Your firm needs to buy a metal stamping press. The CFO presents you with two analyses: One for a press that is automated, requiring little labour to operate, and

another that is manual, requiring a significant amount of labor to operate. This is an example of a decision involving:

- a. Independent projects.
- b. Working capital projects.
- c. Positive NPV projects.
- d. Unconventional cash flow projects.
- e. Mutually exclusive projects.
- f. Contingent projects.

19. Which of the following statements is/are accurate concerning the security market line (SML) approach?

- I. The SML applies only to firms with stable dividend growth rates.
- II. The SML generally relies on using the past to predict the future. ✓
- III. The SML estimate is explicitly adjusted for risk. ✓
- IV. The quality of the estimate from the SML approach is sensitive to the quality of the estimates of the variables in the model. ✓

- a. I and III only.
- b. II and IV only.
- c. II and III only.
- d. II, III, and IV only.
- e. I, II, III, and IV.
- f. I only.

20. According to the CAPM, only systematic risk affects the required return on a given stock because:

- a. It is almost impossible to measure the unsystematic risk.
- b. The standard deviation of a given stock return depends **ONLY** on the systematic risk.
- c. The standard deviation of a given stock return does **NOT** depend on the systematic risk.
- d. Systematic risk CANNOT be substantially reduced by holding a well-diversified portfolio.
- e. Systematic risk is used to measure the risk of common equity, while unsystematic risk is used to measure the risk of bonds and preferred shares.
- f. None of the above.

21. To the nearest dollar, what is the total present value of \$75 received in ONE year, \$300 received in TWO years, and \$600 received in SIX years if the discount rate is 7 percent?

$$\frac{75}{1.07} + \frac{300}{1.07^2} + \frac{600}{1.07^6}$$

- a. \$672
- b. \$683
- c. \$687
- d. \$732
- e. \$822
- f. \$975
- g. None of the above.

23. Which of the following is **NOT** one of the things that causes a corporation to have a significant advantage over a partnership or a proprietorship?
- a. Limited liability.
 - b. Ease of transfer of ownership interest.
 - c. Unlimited life.
 - ~~d. Elimination of double taxation.~~
 - e. Ability to retain earnings and thus convert income from personal income to capital gains.
 - f. Both a. and b.
24. The primary goal of a publicly-owned firm serving its shareholders should be to
- a. Social responsibility.
 - b. Maximize EPS.
 - c. Minimize the chances of losses.
 - d. Long-run survival.
 - ~~e. Maximize shareholder wealth.~~
 - f. All of the above.
25. Your uncle would like to minimize his **interest rate risk** and **default risk** but would still like to invest in corporate bonds. Which of the possible bonds below best satisfies your uncle's stipulation?
- a. AAA bond with 10 years to maturity.
 - b. BBB perpetual bond.
 - c. BBB bond with 10 years to maturity.
 - ~~d. AAA bond with 5 years to maturity.~~
 - e. BBB bond with 5 years to maturity.
 - f. AAA perpetual bond.
26. You have just purchased shares in the Health Tech long-term bond fund, which is a mutual fund that invests in long-term corporate bonds. This constitutes a(n)
- a. Direct transfer of funds.
 - b. Indirect transfer through an investment dealer.
 - ~~c. Indirect transfer through a financial intermediary.~~
 - d. Indirect transfer through an over-the-counter market transaction.
 - e. Both b. and d.
 - f. None of the above
27. If the discount rate **INCREASES** from 10% to 20%, the present value of a lump-sum to be received 4 years from now
- a. Gets larger without limit.
 - b. Stays unchanged.
 - c. Gets larger.
 - d. Gets smaller without limit.
 - ~~e. Gets smaller.~~
27. Which of the following is **NOT** one of the things that causes a corporation to have a significant advantage over a partnership or a proprietorship?
- a. Limited liability.
 - b. Ease of transfer of ownership interest.
 - c. Unlimited life.
 - ~~d. Elimination of double taxation.~~
 - e. Ability to retain earnings and thus convert income from personal income to capital gains.
 - f. Both a. and b.

the lower the maturity, the lower impact by interest rate risk

→ lowest rated bond possible: AAA bonds

← least subject to interest rate risk

f. Cannot tell from the information provided.

28. One of the basic relationships in interest rate theory is for a given change in yield to maturity, the _____ the time to maturity, the _____ the change in price.

- a. longer; smaller
- b. shorter; greater
- c. shorter; smaller
- d. longer; greater

a. please

- ~~e. Both c. and d.~~
- f. Both a. and b.

29. Which of the following is (are) workable assumption(s) for the valuation model, $P_0 = D_1 / (k_e - g)$ if it is to give the total present value?

- a. Growth is **NEGATIVE**.
- b. There will be **NO** growth.
- c. The growth rate will **EXCEED** the required return.
- d. The required return is **HIGH** (30%).
- e. All of the above are workable assumptions.

~~f. Answers a., b., and d. are workable assumptions.~~

30. Which of the following **MAY** be true concerning debt and equity?

cost of equity will always be greater than cost of debt

- a. The cost of debt for Firm A is **GREATER** than the cost of equity for Firm A.
- b. The cost of debt for Firm A is **GREATER** than the cost of equity for Firm B.
- c. The cost of internally generated equity for Firm A is **GREATER** than the cost of externally generated equity funds for Firm A.
- d. The cost of internally generated equity for Firm A is **LESS** than the cost of debt for Firm A.

- e. **ALL** of the above **MAY** be **TRUE**.
- f. **NONE** of the above **MAY** be **TRUE**.

31. Typically, the marginal cost of capital (MCC) schedule is either horizontal or rising, which implies that the cost of capital to a firm rises as it raises larger and larger amounts of capital. The rising section of the MCC schedule is caused by economies of scale in financing.

internally generated equity always less expensive than externally

- a. Would be eliminated (i.e. the MCC schedule would be horizontal) if the firm retained all of its earnings.
- b. Results from a change in the debt ratio as the firm expands.
- c. Results from a change in the debt ratio as the firm expands.
- d. Results because the firm's beta increases as the firm expands.
- e. Results from flotation costs associated with the sale of new common and preferred shares.
- f. All of the above.

32. The internal rate of return of a **NORMAL** capital investment project

- a. Changes when the project's cost of capital changes.
- b. Is equal to the annual net cash flows divided by the project's cost when the cash flows are an annuity.

c. Is computed in a manner similar to the computation of the yield to maturity on a bond.
d. Must exceed the project's cost of capital in order for the firm to accept the investment.

Both c. and d.
f. None of the above.

33. Which of the following accounts is (are) **NOT** part of firm's working capital?

a. Plant and equipment.
b. Marketable securities.
c. Cash.
d. Accounts payable.
e. Inventory.

Both a. and d.

34. Which of the following statements concerning commercial paper is (are) **TRUE**?

a. Commercial paper is typically written for terms of one to three months.
b. Commercial paper is **NOT** listed on a stock exchange.
c. Commercial paper is sold to money market mutual funds, as well as to other financial institutions and nonfinancial corporations.
d. Commercial paper is a major source of short-term financing for small firms.
e. All of the above.

a, b, and c

35. An unusually high turnover of accounts receivable, which implies a very short average collection period, **COULD** indicate that

a. The firm is **VERY** conservative (tough) in its credit policy.
b. The firm has a **VERY** efficient credit and collection department.
c. Without **ANY** doubt, the credit department is helping to maximize the value of the firm.
d. All of the above.
e. Both a. and b.
f. None of the above.

36. Which of the following is (are) commonly regarded as being a credit policy variable(s)?

a. Credit period
b. Collection policy
c. Credit standards
d. Cash discounts
e. All of the above.
f. a, b, and c.

38. A firm's marketable securities portfolio, assumed to be held for liquidity purposes, should be

- a. Weighted toward **LONG-TERM** securities because they usually pay higher rates.
 b. Weighted toward **SHORT-TERM** securities because they usually pay higher rates.
 c. Weighted toward Government of Canada securities to avoid interest rate risk.
~~d. Weighted toward **SHORT-TERM** securities to avoid interest rate risk.~~
 e. Balanced between long-and short-term securities so as to minimize the effects of either an upward or a downward trend in interest rates.
 f. Both c. and d.

39. For a **NORMAL** project, which of the following statements is/are **TRUE**?
 a. The NPV will be **POSITIVE** if the IRR is **LESS** than the project's cost of capital.
 b. Any project acceptable by the NPV method will also be acceptable by the IRR method.
 c. When the IRR equals a project's cost of capital, NPV equals 0.
 d. Both a. and b.
~~e. Both b. and c.~~
 f. All of the above.

40. The **DISADVANTAGES** of the payback approach include:
 a. cash flows after the payback period are ignored in the calculation.
 b. Payback ignores the time value of money.
 c. Payback fails to provide an objective decision-making criterion.
~~d. Payback is hard to calculate.~~
 e. All of the above.
 f. a., b., and c.

41. If the **EXPECTED** rate of return on a share **EXCEEDS** the **REQUIRED** rate,
 a. The share is experiencing supernormal growth.
 b. You should **SELL** the share.
~~c. You should **BUY** the share.~~
 d. Dividends are **NOT** being declared.
 e. Both a. and c.
 f. Both b. and d.

42. A beta value of 0.5 for a security indicates
 a. The security has **AVERAGE** systematic risk.
 b. The security has **ABOVE-AVERAGE** systematic risk.
 c. The security has **NO** systematic risk.
~~d. The security has **BELOW-AVERAGE** systematic risk.~~
 e. The security's systematic risk is **TWICE** as high as its **UNSYSTEMATIC** risk.
 f. The security's **UNSYSTEMATIC** risk is **TWICE** as high as its systematic risk.

43. _____ markets deal in long-term securities having maturities greater than one year.
 a. Credit
 b. Money

That's how you solve for IRR

46. Which of the following statements is (are) TRUE about zero coupon bonds?
- a. Are structured similar to long-term T-bills.
 - b. Are popular with pension funds for hedging purposes.
 - c. Are MORE sensitive to interest rates changes than coupon bonds with the same term to maturity.
 - d. All of the above.
 - e. None of the above.
 - f. Both a. and c. above.

47. Which of the following statements is (are) TRUE concerning the arithmetic mean (AM) and geometric mean (GM)?

- a. The AM is ALWAYS greater than the GM.
- b. The GM is NEVER greater than the AM. ✓
- c. The GM usually provides a better estimate of long-run investment performance ✓
- d. All of the above.
- e. None of the above.
- f. Both b. and c. above.

NB. $AM = GM$ if the return is the same in every period. Thus, a. is incorrect.

48. The following are difficulties concerning beta and its estimation, EXCEPT
- a. A security or project may **NOT** have a past history as a basis for calculating beta.
 - b. During a period of transition of beta, the calculated beta **MAY** be drastically different than the true beta.
 - c. The beta of an "average stock," or "the market," changes over time.
 - d. Sometimes the past data used to calculate beta do **NOT** reflect the likely risk of the firm for the future because conditions have changed.
 - e. All of the above are pertinent problems.
 - f. None of the above are pertinent problems.

49. Sam Malone is Vice President and Chief Technology Officer of Boston Software. Sam has just told his best buddy Clark Kent, Chief Investment Officer of Performance Hedge Fund, about a forthcoming 3-D Action Game called Startfighter that will likely set record sales. Clark has his Performance hedge fund buy shares of Boston Software, and Performance makes a \$100 million immediately after Boston announces Startfighter.

- a. This outcome **CONTRADICTS** the Semi-Strong Form of the Efficient Markets Hypothesis.
- b. This outcome **CONTRADICTS** the Strong Form of the Efficient Markets Hypothesis.
- c. This outcome does **NOT** **CONTRADICT** the Semi-Strong Form of the Efficient Markets Hypothesis.

d. This outcome does NOT CONTRADICT the Strong Form of the Efficient Markets Hypothesis.

~~e. Both a. and d. are TRUE.~~
f. Both b. and c. are TRUE.

MARKT behaviour Chapter wpt

50. Multiple internal rates of return may occur when there is (are):

- a. Large abandonment costs at the end of a project's life.
- b. A major shutdown and rebuilding of a facility sometime during its life.
- c. More than one sign change in the pattern of cash flows over a project's life.
- ~~d. All of the above are correct.~~
- e. Both a. and b. above.
- f. Both a. and c. above.

51. Which of the following activities is NOT an example of creating or exercising a real option?

- a. RIM delays introducing the BlackBerry PlayBook to enhance its set of features.
- b. Honda Motors invests in a flexible production line to permit rapid change of model production.
- c. Goldcorp temporarily shuts down a mine because the unit variable cost exceeds the price of gold.
- d. Dofasco permanently closes a plant because its abandonment value exceeds its operating value.
- e. Ontario Power Generation installs a turbine generator that can use either natural gas or fuel oil
- ~~f. In the NPV calculation of its Fusion project, Gillette includes the impact on its Mach 3 product.~~

52. Which of the following is NOT an example of an agency cost or problem.

- ~~a. The base salary of the chief executive officer.~~
- b. During periods of financial distress, there can be a growing divergence between the interests of equity holders and debt holders.
- c. AIG sells credit default swaps on GM bonds, declares the entire premiums received as profit, and pays bonuses to executives based on this profit.
- d. Stock options for the chief executive officer.
- e. All of the above are examples of an agency cost or problem.
- f. None of the above is an example of an agency cost or problem.

53. Which of the following statements about the firm's cost of capital is (are) TRUE.

- a. It is the appropriate discount rate to use to calculate the NPV of project of average risk for the firm.
- b. It is the appropriate hurdle rate to use for the IRR method for a project of average risk for the firm.
- c. It is a market weighted average of the required rates of return for the sources of capital for the firm.
- d. It is used in calculating the profitability index for a project of average risk for the firm.

e. It is essential to allocating capital efficiently for projects of average risk. ~~f. All of the above are TRUE.~~

54. ABC Inc. wants to substitute its current "net 30" credit policy and offer its customers "net 45" credit terms. ABC is more willing to do so when:
- a. This change will result in a significant INCREASE in bad debt loss.
 - ~~b. ABC's WACC is LOW.~~
 - c. This change will result in a significant REDUCTION in ABC's Average Days Sales in Payables (ADSP).
 - d. Both b. and c.
 - e. All of the above.
 - f. None of the above.