FINC 5000 – Introductory Corporate Finance
FINAL EXAM

Name: ______________________________

1. An option that gives the holder the right to sell a stock at a specified price at some future time is

    a. a call option.
    b. a put option.
    c. an out-of-the-money option.
    d. a naked option.
    e. a covered option.

2. Other things held constant, the value of an option depends on the stock's price, the risk-free rate, and the

    a. Strike price.
    b. Variability of the stock price.
    c. Option's time to maturity.
    d. All of the above.
    e. None of the above.

3. An investor who writes standard call options against stock held in his or her portfolio is said to be selling what type of options?

    a. In-the-money
    b. Put
    c. Naked
    d. Covered
    e. Out-of-the-money

4. Which of the following is NOT a capital component when calculating the weighted average cost of capital (WACC) for use in capital budgeting?

    a. Long-term debt.
    b. Accounts payable.
    c. Retained earnings.
    d. Common stock.
    e. Preferred stock.

5. Schalheim Sisters Inc. has always paid out all of its earnings as dividends; hence, the firm has no retained earnings. This same situation is expected to persist in the future. The company uses the CAPM to calculate its cost of equity, and its target capital structure consists of common stock, preferred stock, and debt. Which of the following events would REDUCE its WACC?

    a. The market risk premium declines.
    b. The flotation costs associated with issuing new common stock increase.
    c. The company's beta increases.
    d. Expected inflation increases.
    e. The flotation costs associated with issuing preferred stock increase.

6. Duval Inc. uses only equity capital, and it has two equally-sized divisions. Division A's cost of capital is 10.0%, Division B's cost is 14.0%, and the corporate (composite) WACC is 12.0%. All of Division A's projects are equally risky, as are all of Division B's projects. However, the projects of Division A are less risky than those of Division B. Which of the following projects should the firm accept?

   a. A Division B project with a 13% return.
   b. A Division B project with a 12% return.
   c. A Division A project with an 11% return.
   d. A Division A project with a 9% return.
   e. A Division B project with an 11% return.

7. LaPango Inc. estimates that its average-risk projects have a WACC of 10%, its below-average risk projects have a WACC of 8%, and its above-average risk projects have a WACC of 12%. Which of the following projects (A, B, and C) should the company accept?

   a. Project B, which is of below-average risk and has a return of 8.5%.
   b. Project C, which is of above-average risk and has a return of 11%.
   c. Project A, which is of average risk and has a return of 9%.
   d. None of the projects should be accepted.
   e. All of the projects should be accepted.

8. Norris Enterprises, an all-equity firm, has a beta of 2.0. The chief financial officer is evaluating a project with an expected return of 14%, before any risk adjustment. The risk-free rate is 5%, and the market risk premium is 4%. The project being evaluated is riskier than an average project, in terms of both its beta risk and its total risk. Which of the following statements is CORRECT?

   a. The project should definitely be accepted because its expected return (before any risk adjustments) is greater than its required return.
   b. The project should definitely be rejected because its expected return (before risk adjustment) is less than its required return.
   c. Riskier-than-average projects should have their expected returns increased to reflect their higher risk. Clearly, this would make the project acceptable regardless of the amount of the adjustment.
   d. The accept/reject decision depends on the firm's risk-adjustment policy. If Norris' policy is to increase the required return on a riskier-than-average project to 3% over r_S, then it should reject the project.
   e. Capital budgeting projects should be evaluated solely on the basis of their total risk. Thus, insufficient information has been provided to make the accept/reject decision.

9. Which of the following statements is CORRECT?

   a. The WACC is calculated using before-tax costs for all components.
   b. The after-tax cost of debt usually exceeds the after-tax cost of equity.

c. For a given firm, the after-tax cost of debt is always more expensive than the after-tax cost of non-convertible preferred stock.
d. Retained earnings that were generated in the past and are reported on the firm's balance sheet are available to finance the firm's capital budget during the coming year.
e. The WACC that should be used in capital budgeting is the firm's marginal, after-tax cost of capital.

10. Scanlon Inc.'s CFO hired you as a consultant to help her estimate the cost of capital. You have been provided with the following data: r_{RF} = 4.10%; RP_M = 5.25%; and b = 1.30. Based on the CAPM approach, what is the cost of common from retained earnings?

a. 9.67%
b. 9.97%
c. 10.28%
d. 10.60%
e. 10.93%

11. You were hired as a consultant to Giambono Company, whose target capital structure is 40% debt, 15% preferred, and 45% common equity. The after-tax cost of debt is 6.00%, the cost of preferred is 7.50%, and the cost of common using retained earnings is 12.75%. The firm will not be issuing any new stock. What is its WACC?

a. 8.98%
b. 9.26%
c. 9.54%
d. 9.83%
e. 10.12%

12. Which of the following statements is CORRECT?

a. The regular payback method recognizes all cash flows over a project's life.
b. The discounted payback method recognizes all cash flows over a project's life, and it also adjusts these cash flows to account for the time value of money.
c. The regular payback method was, years ago, widely used, but virtually no companies even calculate the payback today.
d. The regular payback is useful as an indicator of a project's liquidity because it gives managers an idea of how long it will take to recover the funds invested in a project.
e. The regular payback does not consider cash flows beyond the payback year, but the discounted payback overcomes this defect.

13. Which of the following statements is CORRECT? Assume that the project being considered has normal cash flows, with one outflow followed by a series of inflows.

a. The longer a project's payback period, the more desirable the project is normally considered to be by this criterion.

b. One drawback of the regular payback for evaluating projects is that this method does not properly account for the time value of money.
c. If a project's payback is positive, then the project should be rejected because it must have a negative NPV.
d. The regular payback ignores cash flows beyond the payback period, but the discounted payback method overcomes this problem.
e. If a company uses the same payback requirement to evaluate all projects, say it requires a payback of 4 years or less, then the company will tend to reject projects with relatively short lives and accept long-lived projects, and this will cause its risk to increase over time.

14. Assume a project has normal cash flows. All else equal, which of the following statements is CORRECT?

a. A project's IRR increases as the WACC declines.
b. A project's NPV increases as the WACC declines.
c. A project's MIRR is unaffected by changes in the WACC.
d. A project's regular payback increases as the WACC declines.
e. A project's discounted payback increases as the WACC declines.

15. Which of the following statements is CORRECT?

a. The internal rate of return method (IRR) is generally regarded by academics as being the best single method for evaluating capital budgeting projects.
b. The payback method is generally regarded by academics as being the best single method for evaluating capital budgeting projects.
c. The discounted payback method is generally regarded by academics as being the best single method for evaluating capital budgeting projects.
d. The net present value method (NPV) is generally regarded by academics as being the best single method for evaluating capital budgeting projects.
e. The modified internal rate of return method (MIRR) is generally regarded by academics as being the best single method for evaluating capital budgeting projects.

16. Which of the following statements is CORRECT?

a. The MIRR and NPV decision criteria can never conflict.
b. The IRR method can never be subject to the multiple IRR problem, while the MIRR method can be.
c. One reason some people prefer the MIRR to the regular IRR is that the MIRR is based on a generally more reasonable reinvestment rate assumption.
d. The higher the WACC, the shorter the discounted payback period.
e. The MIRR method assumes that cash flows are reinvested at the crossover rate.

17. Resnick Inc. is considering a project that has the following cash flow

data. What is the project's payback?

Year	0	1	2	3
Cash flows	-$350	$200	$200	$200

a. 1.42 years
b. 1.58 years
c. 1.75 years
d. 1.93 years
e. 2.12 years

18. Which of the following is NOT a relevant cash flow and thus should not be reflected in the analysis of a capital budgeting project?

a. Changes in net working capital.
b. Shipping and installation costs.
c. Cannibalization effects.
d. Opportunity costs.
e. Sunk costs that have been expensed for tax purposes.

19. The relative risk of a proposed project is best accounted for by which of the following procedures?

a. Adjusting the discount rate upward if the project is judged to have above-average risk.
b. Adjusting the discount rate downward if the project is judged to have above-average risk.
c. Reducing the NPV by 10% for risky projects.
d. Picking a risk factor equal to the average discount rate.
e. Ignoring risk because project risk cannot be measured accurately.

20. Suppose Tapley Inc. uses a WACC of 8% for below-average risk projects, 10% for average-risk projects, and 12% for above-average risk projects. Which of the following independent projects should Tapley accept, assuming that the company uses the NPV method when choosing projects?

a. Project A, which has average risk and an IRR = 9%.
b. Project B, which has below-average risk and an IRR = 8.5%.
c. Project C, which has above-average risk and an IRR = 11%.
d. Without information about the projects' NPVs we cannot determine which project(s) should be accepted.
e. All of these projects should be accepted.

21. Which of the following statements is CORRECT?

a. A sunk cost is any cost that must be expended in order to complete a project and bring it into operation.
b. A sunk cost is any cost that was expended in the past but can be recovered if the firm decides not to go forward with the project.
c. A sunk cost is a cost that was incurred and expensed in the past and cannot be recovered if the firm decides not to go forward with the project.

d. Sunk costs were formerly hard to deal with but now that the NPV method is widely used, it is possible to simply include sunk costs in the cash flows and then calculate the PV of the project.
e. A good example of a sunk cost is a situation where Home Depot opens a new store, and that leads to a decline in sales of one of the firm's existing stores.

22. Which of the following statements is CORRECT?

a. Since depreciation is a cash expense, the faster an asset is depreciated, the lower the projected NPV from investing in the asset.
b. Under current laws and regulations, corporations must use straight-line depreciation for all assets whose lives are 5 years or longer.
c. Corporations must use the same depreciation method for both stockholder reporting and tax purposes.
d. Using accelerated depreciation rather than straight line normally has the effect of speeding up cash flows and thus increasing a project's forecasted NPV.
e. Using accelerated depreciation rather than straight line normally has no effect on a project's total projected cash flows nor would it affect the timing of those cash flows or the resulting NPV of the project.

23. A company is considering a new project. The CFO plans to calculate the project's NPV by estimating the relevant cash flows for each year of the project's life (i.e., the initial investment cost, the annual operating cash flows, and the terminal cash flow), then discounting those cash flows at the company's overall WACC. Which one of the following factors should the CFO be sure to INCLUDE in the cash flows when estimating the relevant cash flows?

a. All sunk costs that have been incurred relating to the project.
b. All interest expenses on debt used to help finance the project.
c. The investment in working capital required to operate the project, even if that investment will be recovered at the end of the project's life.
d. Sunk costs that have been incurred relating to the project, but only if those costs were incurred prior to the current year.
e. Effects of the project on other divisions of the firm, but only if those effects lower the project's own direct cash flows.

24. Which of the following rules is CORRECT for capital budgeting analysis?

a. The interest paid on funds borrowed to finance a project must be included in estimates of the project's cash flows.
b. Only incremental cash flows, which are the cash flows that would result if a project is accepted, are relevant when making accept/reject decisions.
c. Sunk costs are not included in the annual cash flows, but they must be deducted from the PV of the project's other costs when reaching the accept/reject decision.
d. A proposed project's estimated net income as determined by the firm's accountants, using generally accepted accounting principles

(GAAP), is discounted at the WACC, and if the PV of this income stream exceeds the project's cost, the project should be accepted.

e. If a product is competitive with some of the firm's other products, this fact should be incorporated into the estimate of the relevant cash flows. However, if the new product is complementary to some of the firm's other products, this fact need not be reflected in the analysis.

25. Langston Labs has an overall (composite) WACC of 10%, which reflects the cost of capital for its average asset. Its assets vary widely in risk, and Langston evaluates low-risk projects with a WACC of 8%, average-risk projects at 10%, and high-risk projects at 12%. The company is considering the following projects:

Project	Risk	Expected Return
A	High	15%
B	Average	12%
C	High	11%
D	Low	9%
E	Low	6%

Which set of projects would maximize shareholder wealth?

a. A and B.
b. A, B, and C.
c. A, B, and D.
d. A, B, C, and D.
e. A, B, C, D, and E.

26. Which of the following is NOT a key element in strategic planning as it is described in the text?

a. The mission statement.
b. The statement of the corporation's scope.
c. The statement of cash flows.
d. The statement of corporate objectives.
e. The corporation's strategies.

27. Which of the following assumptions is embodied in the AFN equation?

a. None of the firm's ratios will change.
b. Accounts payable and accruals are tied directly to sales.
c. Common stock and long-term debt are tied directly to sales.
d. Fixed assets, but not current assets, are tied directly to sales.
e. Last year's total assets were not optimal for last year's sales.

28. The term "additional funds needed (AFN)" is generally defined as follows:

a. Funds that are obtained automatically from routine business transactions.
b. Funds that a firm must raise externally from non-spontaneous sources, i.e., by borrowing or by selling new stock to support operations.
c. The amount of assets required per dollar of sales.

d. The amount of internally generated cash in a given year minus the amount of cash needed to acquire the new assets needed to support growth.
e. A forecasting approach in which the forecasted percentage of sales for each balance sheet account is held constant.

29. The capital intensity ratio is generally defined as follows:

a. Sales divided by total assets, i.e., the total assets turnover ratio.
b. The percentage of liabilities that increase spontaneously as a percentage of sales.
c. The ratio of sales to current assets.
d. The ratio of current assets to sales.
e. The amount of assets required per dollar of sales, or $A_0{*}/S_0$.

30. Which of the following is NOT one of the steps taken in the financial planning process?

a. Forecast the funds that will be generated internally. If internal funds are insufficient to cover the required new investment, then identify sources from which the required external capital can be raised.
b. Monitor operations after implementing the plan to spot any deviations and then take corrective actions.
c. Determine the amount of capital that will be needed to support the plan.
d. Develop a set of forecasted financial statements under alternative versions of the operating plan in order to analyze the effects of different operating procedures on projected profits and financial ratios.
e. Consult with key competitors about the optimal set of prices to charge, i.e., the prices that will maximize profits for our firm and its competitors.

31. Which of the following is NOT normally regarded as being a good reason to establish an ESOP?

a. To increase worker productivity.
b. To enable the firm to borrow at a below-market interest rate.
c. To make it easier to grant stock options to employees.
d. To help prevent a hostile takeover.
e. To help retain valued employees.

32. Which of the following is NOT normally regarded as being a barrier to hostile takeovers?

a. Abnormally high executive compensation.
b. Targeted share repurchases.
c. Shareholder rights provisions.
d. Restricted voting rights.
e. Poison pills.

33. Which of the following does NOT always increase a company's market

value?

a. Increasing the expected growth rate of sales.
b. Increasing the expected operating profitability (NOPAT/Sales).
c. Decreasing the capital requirements (Capital/Sales).
d. Decreasing the weighted average cost of capital.
e. Increasing the expected rate of return on invested capital.

34. Which of the following statements is NOT CORRECT?

a. The corporate valuation model can be used both for companies that pay dividends and those that do not pay dividends.
b. The corporate valuation model discounts free cash flows by the required return on equity.
c. The corporate valuation model can be used to find the value of a division.
d. An important step in applying the corporate valuation model is forecasting the firm's pro forma financial statements.
e. Free cash flows are assumed to grow at a constant rate beyond a specified date in order to find the horizon, or terminal, value.

35. Jefferson City Computers has developed a forecasting model to estimate its AFN for the upcoming year. All else being equal, which of the following factors is most likely to lead to an increase of the additional funds needed (AFN)?

a. A sharp increase in its forecasted sales.
b. A switch to a just-in-time inventory system and outsourcing production.
c. The company reduces its dividend payout ratio.
d. The company switches its materials purchases to a supplier that sells on terms of 1/5, net 90, from a supplier whose terms are 3/15, net 35.
e. The company discovers that it has excess capacity in its fixed assets.