FINC 5000- Introduction to Corporate Finance
Mid Term Exam

Student: ______________________________

1. Which of the following statements is CORRECT?

a. One of the disadvantages of incorporating a business is that the owners then become subject to liabilities in the event the firm goes bankrupt.
b. Sole proprietorships are subject to more regulations than corporations.
c. In any type of partnership, every partner has the same rights, privileges, and liability exposure as every other partner.
d. Sole proprietorships and partnerships generally have a tax advantage over many corporations, especially large ones.
e. Corporations of all types are subject to the corporate income tax.

2. Cheers Inc. operates as a partnership. Now the partners have decided to convert the business into a regular corporation. Which of the following statements is CORRECT?

a. Assuming Cheers is profitable, less of its income will be subject to federal income taxes.
b. Cheers will now be subject to fewer regulations.
c. Cheers' shareholders (the ex-partners) will now be exposed to less liability.
d. Cheers' investors will be exposed to less liability, but they will find it more difficult to transfer their ownership.
e. Cheers will find it more difficult to raise additional capital.

3. Which of the following is a primary market transaction?

a. You sell 200 shares of IBM stock on the NYSE through your broker.
b. IBM issues 2,000,000 shares of new stock and sells them to the public through an investment banker.
c. You buy 200 shares of IBM stock from your brother. The trade is not made through a broker--you just give him cash and he gives you the stock.
d. One financial institution buys 200,000 shares of IBM stock from another institution. An investment banker arranges the transaction.
e. You invest $10,000 in a mutual fund, which then uses the money to buy $10,000 of IBM shares on the NYSE.

4. The primary operating goal of a publicly-owned firm interested in serving its stockholders should be to

a. Maximize the stock price per share over the long run, which is the stock's intrinsic value.
b. Maximize the firm's expected EPS.
c. Minimize the chances of losses.
d. Maximize the firm's expected total income.
e. Maximize the stock price on a specific target date.

5. Which of the following would be most likely to lead to <u>higher</u> interest rates on all debt securities in the economy?

a. Households start saving a larger percentage of their income.
b. The economy moves from a boom to a recession.
c. The level of inflation begins to decline.
d. Corporations step up their expansion plans and thus increase their demand for capital.
e. The Federal Reserve uses monetary policy in an attempt to stimulate the economy.

6. Which of the following could explain why a business might choose to operate as a corporation rather than as a sole proprietorship or a partnership?

a. Corporations generally find it relatively difficult to raise large amounts of capital.
b. Less of a corporation's income is generally subjected to taxes than would be true if the firm were a partnership.
c. Corporate shareholders escape liability for the firm's debts, but this factor may be offset by the tax disadvantages of the corporate form of organization.
d. Corporate investors are exposed to unlimited liability.
e. Corporations generally face relatively few regulations.

7. Other things held constant, which of the following actions would <u>increase</u> the amount of cash on a company's balance sheet?

a. The company repurchases common stock.
b. The company pays a dividend.
c. The company issues new common stock.
d. The company gives customers more time to pay their bills.
e. The company purchases a new piece of equipment.

8. Which of the following items is <u>NOT</u> included in current assets?

a. Accounts receivable.
b. Inventory.
c. Bonds.
d. Cash.
e. Short-term, highly liquid, marketable securities.

9. Which of the following items <u>cannot be found</u> on a firm's balance sheet under current liabilities?

a. Accounts payable.
b. Short-term notes payable to the bank.
c. Accrued wages.
d. Cost of goods sold.
e. Accrued payroll taxes.

10. On its 2010 balance sheet, Barngrover Books showed $510 million of retained earnings, and exactly that same amount was shown the following year. Assuming that no earnings restatements were issued, which of the following statements is CORRECT?

a. If the company lost money in 2010, they must have paid dividends.
b. The company must have had zero net income in 2010.
c. The company must have paid out half of its earnings as dividends.
d. The company must have paid no dividends in 2010.
e. Dividends could have been paid in 2010, but they would have had to equal the earnings for the year.

11. Aubey Aircraft recently announced that its net income increased sharply from the previous year, yet its net cash flow from operations declined. Which of the following could explain this performance?

The company's operating income declined.
The company's expenditures on fixed assets declined.
The company's cost of goods sold increased.
The company's depreciation and amortization expenses declined.
The company's interest expense increased.

12. Which of the following statements is CORRECT?

a. In the statement of cash flows, a <u>decrease</u> in accounts receivable is reported as a <u>use</u> of cash.
b. Dividends do not show up in the statement of cash flows because dividends are considered to be a financing activity, not an operating activity.
c. In the statement of cash flows, a <u>decrease</u> in accounts payable is reported as a <u>use</u> of cash.
d. In the statement of cash flows, depreciation charges are reported as a use of cash.
e. In the statement of cash flows, a <u>decrease</u> in inventories is reported as a <u>use</u> of cash.

13. Considered alone, which of the following would <u>increase</u> a company's current ratio?

a. An increase in net fixed assets.
b. An increase in accrued liabilities.
c. An increase in notes payable.
d. An increase in accounts receivable.
e. An increase in accounts payable.

14. Companies E and P each reported the same earnings per share (EPS), but Company E's stock trades at a higher price. Which of the following statements is CORRECT?

a. Company E probably has <u>fewer</u> growth opportunities.
b. Company E is probably judged by investors to be <u>riskier</u>.

c. Company E must have a higher market-to-book ratio.
d. Company E must pay a lower dividend.
e. Company E trades at a higher P/E ratio.

15. A firm's new president wants to strengthen the company's financial position. Which of the following actions would make it financially stronger?

a. Increase accounts receivable while holding sales constant.
b. Increase EBIT while holding sales constant.
c. Increase accounts payable while holding sales constant.
d. Increase notes payable while holding sales constant.
e. Increase inventories while holding sales constant.

16. Which of the following statements is CORRECT?

a. If a security analyst saw that a firm's days' sales outstanding (DSO) was higher than the industry average and was also increasing and trending still higher, this would be interpreted as a sign of strength.
b. If a firm increases its sales while holding its accounts receivable constant, then, other things held constant, its days' sales outstanding (DSO) will increase.
c. There is no relationship between the days' sales outstanding (DSO) and the average collection period (ACP). These ratios measure entirely different things.
d. A reduction in accounts receivable would have no effect on the current ratio, but it would lead to an increase in the quick ratio.
e. If a firm increases its sales while holding its accounts receivable constant, then, other things held constant, its days' sales outstanding will decline.

17. Taggart Technologies is considering issuing new common stock and using the proceeds to reduce its outstanding debt. The stock issue would have no effect on total assets, the interest rate Taggart pays, EBIT, or the tax rate. Which of the following is likely to occur if the company goes ahead with the stock issue?

a. The ROA will decline.
b. Taxable income will decrease.
c. The tax bill will increase.
d. Net income will decrease.
e. The times interest earned ratio will decrease.

18. Which of the following statements is CORRECT?

a. The cash flows for an ordinary (or deferred) annuity all occur at the beginning of the periods.
b. If a series of unequal cash flows occurs at regular intervals, such as once a year, then the series is by definition an annuity.
c. The cash flows for an annuity due must all occur at the ends of the periods.
d. The cash flows for an annuity must all be equal, and they must occur at regular intervals, such as once a year or once a month.
e. If some cash flows occur at the beginning of the periods while

others occur at the ends, then we have what the textbook defines as a variable annuity.

19. Your bank account pays a 6% nominal rate of interest. The interest is compounded quarterly. Which of the following statements is CORRECT?

a. The periodic rate of interest is 1.5% and the effective rate of interest is 3%.
b. The periodic rate of interest is 6% and the effective rate of interest is greater than 6%.
c. The periodic rate of interest is 1.5% and the effective rate of interest is greater than 6%.
d. The periodic rate of interest is 3% and the effective rate of interest is 6%.
e. The periodic rate of interest is 6% and the effective rate of interest is also 6%.

20. Which of the following statements regarding a 30-year monthly payment amortized mortgage with a nominal interest rate of 10% is CORRECT?

a. The monthly payments will decline over time.
b. A smaller proportion of the last monthly payment will be interest, and a larger proportion will be principal, than for the first monthly payment.
c. The total dollar amount of principal being paid off each month gets smaller as the loan approaches maturity.
d. The amount representing interest in the first payment would be higher if the nominal interest rate were 7% rather than 10%.
e. Exactly 10% of the first monthly payment represents interest.

21. Which of the following bank accounts has the highest effective annual return?

a. An account that pays 8% nominal interest with monthly compounding.
b. An account that pays 8% nominal interest with annual compounding.
c. An account that pays 7% nominal interest with daily (365-day) compounding.
d. An account that pays 7% nominal interest with monthly compounding.
e. An account that pays 8% nominal interest with daily (365-day) compounding.

22. Which of the following events would make it more likely that a company would choose to call its outstanding callable bonds?

a. The company's bonds are downgraded.
b. Market interest rates rise sharply.
c. Market interest rates decline sharply.
d. The company's financial situation deteriorates significantly.
e. Inflation increases significantly.

23. Under normal conditions, which of the following would be most likely to increase the coupon rate required to enable a bond to be issued at par?

a. Adding additional restrictive covenants that limit management's actions.
b. Adding a call provision.
c. The rating agencies change the bond's rating from Baa to Aaa.
d. Making the bond a first mortgage bond rather than a debenture.
e. Adding a sinking fund.

24. Bond A has a 9% annual coupon, while Bond B has a 7% annual coupon. Both bonds have the same maturity, a face value of $1,000, and an 8% yield to maturity. Which of the following statements is CORRECT?

a. Bond A's capital gains yield is greater than Bond B's capital gains yield.
b. Bond A trades at a discount, whereas Bond B trades at a premium.
c. If the yield to maturity for both bonds remains at 8%, Bond A's price one year from now will be higher than it is today, but Bond B's price one year from now will be lower than it is today.
d. If the yield to maturity for both bonds immediately decreases to 6%, Bond A's bond will have a larger percentage increase in value.
e. Bond A's current yield is greater than that of Bond B.

25. Stock A's beta is 1.5 and Stock B's beta is 0.5. Which of the following statements must be true about these securities? (Assume market equilibrium.)

a. When held in isolation, Stock A has more risk than Stock B.
b. Stock B must be a more desirable addition to a portfolio than A.
c. Stock A must be a more desirable addition to a portfolio than B.
d. The expected return on Stock A should be greater than that on B.
e. The expected return on Stock B should be greater than that on A.

26. Which of the following statements is CORRECT?

a. An investor can eliminate virtually all market risk if he or she holds a very large and well diversified portfolio of stocks.
b. The higher the correlation between the stocks in a portfolio, the lower the risk inherent in the portfolio.
c. It is impossible to have a situation where the market risk of a single stock is less than that of a portfolio that includes the stock.
d. Once a portfolio has about 40 stocks, adding additional stocks will not reduce its risk by even a small amount.
e. An investor can eliminate virtually all diversifiable risk if he or she holds a very large, well diversified portfolio of stocks.

27. Inflation, recession, and high interest rates are economic events that are best characterized as being

a. systematic risk factors that can be diversified away.
b. company-specific risk factors that can be diversified away.
c. among the factors that are responsible for market risk.
d. risks that are beyond the control of investors and thus should not be considered by security analysts or portfolio managers.
e. irrelevant except to governmental authorities like the Federal Reserve.

28. During the coming year, the market risk premium ($r_M - r_{RF}$), is expected to fall, while the risk-free rate, r_{RF}, is expected to remain the same. Given this forecast, which of the following statements is CORRECT?

a. The required return will increase for stocks with a beta less than 1.0 and will decrease for stocks with a beta greater than 1.0.
b. The required return on all stocks will remain unchanged.
c. The required return will fall for all stocks, but it will fall more for stocks with higher betas.
d. The required return for all stocks will fall by the same amount.
e. The required return will fall for all stocks, but it will fall less for stocks with higher betas.

29. The risk-free rate is 6%; Stock A has a beta of 1.0; Stock B has a beta of 2.0; and the market risk premium, rM - rRF, is positive. Which of the following statements is CORRECT?

a. If the risk-free rate increases but the market risk premium stays unchanged, Stock B's required return will increase by more than Stock A's.
b. Stock B's required rate of return is twice that of Stock A.
c. If Stock A's required return is 11%, then the market risk premium is 5%.
d. If Stock B's required return is 11%, then the market risk premium is 5%.
e. If the risk-free rate remains constant but the market risk premium increases, Stock A's required return will increase by more than Stock B's.

30. Assume that the risk-free rate is 5%. Which of the following statements is CORRECT?

a. If a stock has a negative beta, its required return under the CAPM would be less than 5%.
b. If a stock's beta doubled, its required return under the CAPM would also double.
c. If a stock's beta doubled, its required return under the CAPM would more than double.
d. If a stock's beta were 1.0, its required return under the CAPM would be 5%.
e. If a stock's beta were less than 1.0, its required return under the CAPM would be less than 5%.

31. If in the opinion of a given investor a stock's expected return

exceeds its required return, this suggests that the investor thinks

a. the stock is experiencing supernormal growth.
b. the stock should be sold.
c. the stock is a good buy.
d. management is probably not trying to maximize the price per share.
e. dividends are not likely to be declared.

32. If markets are in equilibrium, which of the following conditions will exist?

a. Each stock's expected return should equal its realized return as seen by the marginal investor.
b. Each stock's expected return should equal its required return as seen by the marginal investor.
c. All stocks should have the same expected return as seen by the marginal investor.
d. The expected and required returns on stocks and bonds should be equal.
e. All stocks should have the same realized return during the coming year.

33. The preemptive right is important to shareholders because it

a. allows managers to buy additional shares below the current market price.
b. will result in higher dividends per share.
c. is included in every corporate charter.
d. protects the current shareholders against a dilution of their ownership interests.
e. protects bondholders, and thus enables the firm to issue debt with a relatively low interest rate.

34. Which of the following statements is CORRECT?

a. Preferred stockholders have a priority over bondholders in the event of bankruptcy to the income, but not to the proceeds in a liquidation.
b. The preferred stock of a given firm is generally less risky to investors than the same firm's common stock.
c. Corporations cannot buy the preferred stocks of other corporations.
d. Preferred dividends are not generally cumulative.
e. A big advantage of preferred stock is that dividends on preferred stocks are tax deductible by the issuing corporation.

35. Francis Inc.'s stock has a required rate of return of 10.25%, and it sells for $57.50 per share. The dividend is expected to grow at a constant rate of 6.00% per year. What is the expected year-end dividend, D1?

a. $2.20
b. $2.44
c. $2.69
d. $2.96
e. $3.25