FINC 5880- Mid Term Exam

Multiple Choice
Identify the choice that best completes the statement or answers the question.

____ 1. From the lessee viewpoint, the riskiness of the cash flows, with the possible exception of the residual value, is about the same as the riskiness of the lessee's
a. capital budgeting project cash flows.
b. debt cash flows.
c. pension fund cash flows.
d. sales.
e. equity cash flows.

____ 2. Which of the following factors would <u>increase</u> the likelihood that a company would call its outstanding bonds at this time?
a. A provision in the bond indenture lowers the call price on specific dates, and yesterday was one of those dates.
b. The flotation costs associated with issuing new bonds rise.
c. The firm's CFO believes that interest rates are likely to decline in the future.
d. The firm's CFO believes that corporate tax rates are likely to be increased in the future.
e. The yield to maturity on the company's outstanding bonds increases due to a weakening of the firm's financial situation.

____ 3. Which of the following actions should Reece Windows take if it wants to <u>reduce</u> its cash conversion cycle?
a. Take steps to reduce the DSO.
b. Start paying its bills sooner, which would reduce the average accounts payable but not affect sales.
c. Sell common stock to retire long-term bonds.
d. Sell an issue of long-term bonds and use the proceeds to buy back some of its common stock.
e. Increase average inventory without increasing sales.

____ 4. Which of the following is **<u>NOT</u>** a reason why companies move into international operations?
a. To develop new markets for the firm's products.
b. To better serve their primary customers.
c. Because important raw materials are located abroad.
d. To increase their inventory levels.
e. To take advantage of lower production costs in regions where labor costs are relatively low.

____ 5. Operating leases often have terms that include
a. full amortization over the life of the lease.
b. very high penalties if the lease is canceled.
c. restrictions on how much the leased property can be used.
d. much longer lease periods than for most financial leases.
e. maintenance of the equipment by the lessor.

____ 6. Consider two very different firms, M and N. Firm M is a mature firm in a mature industry. Its annual net income and net cash flows are both consistently high and stable. However, M's growth prospects are quite limited, so its capital budget is small relative to its net income. Firm N is a relatively new firm in a new and growing industry. Its markets and products have not stabilized, so its annual operating income fluctuates considerably. However, N has substantial growth opportunities, and its capital budget is expected to be large relative to its net income for the foreseeable future. Which of the following statements is correct?

a. Firm M probably has a higher dividend payout ratio than Firm N.
b. If the corporate tax rate increases, the debt ratio of both firms is likely to decline.
c. The two firms are equally likely to pay high dividends.
d. Firm N is likely to have a clientele of shareholders who want to receive consistent, stable dividend income.
e. Firm M probably has a lower debt ratio than Firm N.

____ 7. Which of the following is <u>NOT</u> commonly regarded as being a credit policy variable?

a. Collection policy.
b. Credit standards.
c. Cash discounts.
d. Payments deferral period.
e. Credit period.

____ 8. Firms generally choose to finance temporary current operating assets with short-term debt because

a. short-term interest rates have traditionally been more stable than long-term interest rates.
b. a firm that borrows heavily on a long-term basis is more apt to be unable to repay the debt than a firm that borrows short term.
c. the yield curve is normally downward sloping.
d. short-term debt has a higher cost than equity capital.
e. matching the maturities of assets and liabilities reduces risk under some circumstances, and also because short-term debt is often less expensive than long-term capital.

____ 9. Which of the following is generally **<u>NOT</u>** true and an advantage of going public?

a. Increases the liquidity of the firm's stock.
b. Makes it easier to obtain new equity capital.
c. Establishes a market value for the firm.
d. Makes it easier for owner-managers to engage in profitable self-dealings.
e. Facilitates stockholder diversification.

____ 10. Which of the following statements is most CORRECT?

a. Capitalizing a lease means that the firm issues equity capital in proportion to its current capital structure, in an amount sufficient to support the lease payment obligation.
b. The fixed charges associated with a lease can be as high as, but never greater than, the fixed payments associated with a loan.
c. Capital, or financial, leases generally provide for maintenance by the lessor.
d. A key difference between a capital lease and an operating lease is that with a capital lease, the lease payments provide the lessor with a return of the funds invested in the asset plus a return on the invested funds, whereas with an operating lease the lessor depends on the residual value to realize a full return of and on the investment.
e. Firms that use "off balance sheet" financing, such as leasing, would show lower debt ratios if the effects of their leases were reflected in their financial statements.

____ 11. The firm's target capital structure should be consistent with which of the following statements?

a. Minimize the cost of debt (r_d).
b. Obtain the highest possible bond rating.

c. Minimize the cost of equity (r_s).
d. Minimize the weighted average cost of capital (WACC).
e. Maximize the earnings per share (EPS).

____ 12. A lease versus purchase analysis should compare the cost of leasing to the cost of owning, assuming that the asset purchased
a. is financed with long-term debt.
b. is financed with debt whose maturity matches the term of the lease.
c. is financed with a mix of debt and equity based on the firm's target capital structure, i.e., at the WACC.
d. is financed with retained earnings.
e. is financed with short-term debt.

____ 13. Myron Gordon and John Lintner believe that the required return on equity increases as the dividend payout ratio is decreased. Their argument is based on the assumption that
a. investors require that the dividend yield and capital gains yield equal a constant.
b. capital gains are taxed at a higher rate than dividends.
c. investors view dividends as being less risky than potential future capital gains.
d. investors value a dollar of expected capital gains more highly than a dollar of expected dividends because of the lower tax rate on capital gains.
e. investors are indifferent between dividends and capital gains.

____ 14. If the inflation rate in the United States is greater than the inflation rate in Britain, other things held constant, the British pound will
a. Depreciate against the U.S. dollar.
b. Remain unchanged against the U.S. dollar.
c. Appreciate against other major currencies.
d. Appreciate against the dollar and other major currencies.
e. Appreciate against the U.S. dollar.

____ 15. Suppose one U.S. dollar can purchase 144 yen today in the foreign exchange market. If the yen depreciates by 8.0% tomorrow, how many yen could one U.S. dollar buy tomorrow?
a. 155.5 yen
b. 144.0 yen
c. 133.5 yen
d. 78.0 yen
e. 72.0 yen

____ 16. Heavy use of off-balance sheet lease financing will tend to
a. make a company appear less risky than it actually is because its stated debt ratio will appear lower.
b. affect a company's cash flows but not its degree of risk.
c. have no effect on either cash flows or risk because the cash flows are already reflected in the income statement.
d. affect the lessee's cash flows but only due to tax effects.
e. make a company appear more risky than it actually is because its stated debt ratio will be increased.

____ 17. Which of the following statements about listing on a stock exchange is most CORRECT?
a. Any firm can be listed on the NYSE as long as it pays the listing fee.
b. Listing provides a company with some "free" advertising, and it may enhance the firm's prestige and help it do more business.

c. Listing reduces the reporting requirements for firms, because listed firms file reports with the exchange rather than with the SEC.
d. The OTC is the second largest market for listed stock, and it is exceeded only by the NYSE.
e. Listing is a decision of more significance to a firm than going public.

____ 18. Reynolds Paper Products Corporation follows a strict residual dividend policy. All else equal, which of the following factors would be most likely to lead to an <u>increase</u> in the firm's dividend per share?
a. The company increases the percentage of equity in its target capital structure.
b. The number of profitable potential projects increases.
c. Congress lowers the tax rate on capital gains. The remainder of the tax code is not changed.
d. Earnings are unchanged, but the firm issues new shares of common stock.
e. The firm's net income increases.

____ 19. Which of the following statements is most CORRECT?
a. Private placements occur most frequently with stocks, but bonds can also be sold in a private placement.
b. Private placements are convenient for issuers, but the convenience is offset by higher flotation costs.
c. The SEC requires that all private placements be handled by a registered investment banker.
d. Private placements can generally bring in funds faster than is the case with public offerings.
e. In a private placement, securities are sold to private (individual) investors rather than to institutions.

____ 20. A lockbox plan is
a. used to identify inventory safety stocks.
b. used to slow down the collection of checks our firm writes.
c. used to speed up the collection of checks received.
d. used primarily by firms where currency is used frequently in transactions, such as fast food restaurants, and less frequently by firms that receive payments as checks.
e. used to protect cash, i.e., to keep it from being stolen.

____ 21. Which of the following actions would be likely to <u>shorten</u> the cash conversion cycle?
a. Change the credit terms offered to customers from 3/10 net 30 to 1/10 net 50.
b. Begin to take discounts on inventory purchases; we buy on terms of 2/10 net 30.
c. Adopt a new manufacturing process that saves some labor costs but slows down the conversion of raw materials to finished goods from 10 days to 20 days.
d. Change the credit terms offered to customers from 2/10 net 30 to 1/10 net 60.
e. Adopt a new manufacturing process that speeds up the conversion of raw materials to finished goods from 20 days to 10 days.

____ 22. Which of the following events is likely to encourage a company to raise its target debt ratio, other things held constant?
a. An increase in the personal tax rate.
b. An increase in the company's operating leverage.
c. The Federal Reserve tightens interest rates in an effort to fight inflation.
d. The company's stock price hits a new high.
e. An increase in the corporate tax rate.

____ 23. Financial Accounting Standards Board (FASB) Statement #13 requires that for an unqualified audit report, financial (or capital) leases must be included in the balance sheet by reporting the
a. residual value as a liability.
b. present value of future lease payments as an asset and also showing this same amount as an

offsetting liability.

c. undiscounted sum of future lease payments as an asset and as an offsetting liability.
d. undiscounted sum of future lease payments, less the residual value, as an asset and as an offsetting liability.
e. residual value as a fixed asset.

____ 24. Which of these items will not generally be affected by an increase in the debt ratio?
a. Total risk.
b. Financial risk.
c. Market risk.
d. The firm's beta.
e. Business risk.

____ 25. Which of the following statements is **NOT** CORRECT?
a. "Going public" establishes a firm's true intrinsic value and ensures that a liquid market will always exist for the firm's shares.
b. Publicly owned companies have sold shares to investors who are not associated with management, and they must register with and report to a regulatory agency such as the SEC.
c. When stock in a closely held corporation is offered to the public for the first time, the transaction is called "going public," and the market for such stock is called the new issue market.
d. It is possible for a firm to go public and yet not raise any additional new capital.
e. When a corporation's shares are owned by a few individuals who own most of the stock or are part of the firm's management, we say that the firm is "closely, or privately, held."

____ 26. Which of the following statements is correct?
a. One advantage of the residual dividend policy is that it leads to a stable dividend payout, which investors like.
b. An increase in the stock price when a company decreases its dividend is consistent with signaling theory as postulated by MM.
c. If the "clientele effect" is correct, then for a company whose earnings fluctuate, a policy of paying a constant percentage of net income will probably maximize the stock price.
d. Stock repurchases make the most sense at times when a company believes its stock is undervalued.
e. Firms with a lot of good investment opportunities and a relatively small amount of cash tend to have above average payout ratios.

____ 27. Which of the following will cause an increase in net working capital, other things held constant?
a. A cash dividend is declared and paid.
b. Merchandise is sold at a profit, but the sale is on credit.
c. Long-term bonds are retired with the proceeds of a preferred stock issue.
d. Missing inventory is written off against retained earnings.
e. Cash is used to buy marketable securities.

____ 28. Based on the information below for Benson Corporation, what is the optimal capital structure?
a. Debt = 50%; Equity = 50%; EPS = \$3.05; Stock price = \$28.90.
b. Debt = 60%; Equity = 40%; EPS = \$3.18; Stock price = \$31.20.
c. Debt = 80%; Equity = 20%; EPS = \$3.42; Stock price = \$30.40.
d. Debt = 70%; Equity = 30%; EPS = \$3.31; Stock price = \$30.00.
e. Debt = 40%; Equity = 60%; EPS = \$2.95; Stock price = \$26.50.

____ 29. In the real world, dividends

a. are usually more stable than earnings.
b. fluctuate more widely than earnings.
c. tend to be a lower percentage of earnings for mature firms.
d. are usually changed every year to reflect earnings changes, and these changes are randomly higher or lower, depending on whether earnings increased or decreased.
e. are usually set as a fixed percentage of earnings, e.g., at 40% of earnings, so if EPS = $2.00, then DPS will equal $0.80. Once the percentage is set, then dividend policy is on "automatic pilot" and the actual dividend depends strictly on earnings.

____ 30. Which of the following items should a company report directly in its monthly cash budget?
a. Cash proceeds from selling one of its divisions.
b. Accrued interest on zero coupon bonds that it issued.
c. New shares issued in a stock split.
d. New shares issued in a stock dividend.
e. Its monthly depreciation expense.

____ 31. Which of the following statements concerning common stock and the investment banking process is **NOT** CORRECT?
a. If a firm sells 1,000,000 new shares of Class B stock, the transaction occurs in the primary market.
b. Listing a large firm's stock is often considered to be beneficial to stockholders because the increases in liquidity and reputation probably outweigh the additional costs to the firm.
c. Stockholders have the right to elect the firm's directors, who in turn select the officers who manage the business. If stockholders are dissatisfied with management's performance, an outside group may ask the stockholders to vote for it in an effort to take control of the business. This action is called a tender offer.
d. The announcement of a large issue of new stock could cause the stock price to fall. This loss is called "market pressure," and it is treated as a flotation cost because it is a cost to stockholders that is associated with the new issue.
e. The preemptive right gives each existing common stockholder the right to purchase his or her proportionate share of a new stock issue.

____ 32. Which of the following is **NOT** associated with (or does not contribute to) business risk? Recall that business risk is affected by a firm's operations.
a. Sales price variability.
b. The extent to which operating costs are fixed.
c. The extent to which interest rates on the firm's debt fluctuate.
d. Input price variability.
e. Demand variability.

____ 33. If it takes $0.71 U.S. dollars to purchase one Swiss franc, how many Swiss francs can one U.S. dollar buy?
a. 0.50
b. 0.71
c. 1.00
d. 1.41
e. 2.81

____ 34. Which of the following statements best describes the optimal capital structure? The optimal capital structure is the mix of debt, equity, and preferred stock that maximizes the company's ____.
a. stock price.
b. cost of equity.
c. cost of debt.

d. cost of preferred stock.
e. earnings per share (EPS).

____ 35. Poff Industries' stock currently sells for $120 a share. You own 100 shares of the stock. The company is contemplating a 2-for-1 stock split. Which of the following best describes what your position will be after such a split takes place?
a. You will have 200 shares of stock, and the stock will trade at or near $60 a share.
b. You will have 100 shares of stock, and the stock will trade at or near $60 a share.
c. You will have 50 shares of stock, and the stock will trade at or near $120 a share.
d. You will have 50 shares of stock, and the stock will trade at or near $60 a share.
e. You will have 200 shares of stock, and the stock will trade at or near $120 a share.