

MIDTERM EXAMINATION
Spring 2011
FIN622- Corporate Finance (Session - 6)

Question No:1 -- Please choose one

Which of the following is a tool that identifies the strengths, weaknesses, opportunities and threats of an organization?

- ▶ **SWOT Analysis -**
- ▶ Trend Analysis
- ▶ Fundamental Analysis
- ▶ Technical Analysis

Question No:2 -- Please choose one

Which of the following statements is TRUE regarding Profitability Index?

- ▶ It ignores time value of money
- ▶ It ignores future cash flows
- ▶ **It ignores the scale of investment -**
- ▶ It ignores return on investment

Question No: 3 (Marks: 1) - Please choose one

Which of the following statements applies to intrinsic value of a security?

- ▶ **Intrinsic value of a security always exceeds its book value. -**

Intrinsic Value (also known as fundamental value) refers to the actual value of a security based on an underlying perception of its true value due to both tangible and intangible factors. The value may differ from the current market value. As a result, value investors use an array of analytical techniques to estimate the value of the security in the hope finding investments where the true value of the investment exceeds its current market value. It can be calculated by summing the future income generated by the assets, and discounting it to the present value.

- ▶ Intrinsic value of a security rises when the liquidation value falls.
- ▶ Intrinsic value of a security is the price around which its market value should closely fluctuate.
- ▶ Intrinsic value of a security is its closing market value when it is actively traded.

Question No: 4 -- Please choose one

A Company's common stock is currently selling at Rs.3.00 per share, its quarterly dividend is Rs.0.07, and the stock is expected to rise to Rs.3.30 in a year. What is its expected rate of return?

- ▶ 9.3%
- ▶ **19.3% -**
- $3.30 - 3.00 = 0.30$**
- $0.07 * 4 = 0.28 + 0.30 = 0.58$**
- $58 / 3 = 0.1933 * 100 = 19.33\%$**
- ▶ 10.0%
- ▶ 11.0%

Question No: 5 -- Please choose one

For a firm with a Degree of Operating Leverage of 3.5, an increase in sales of 6% will:

- ▶ Increase pre-tax profits by 3.5%
- ▶ Decrease pre-tax profits by 3.5%.
- ▶ **Increase pre-tax profits by 21.0%. -**

- ▶ Increase pre-tax profits by 1.71%.

Question No: 6 -- Please choose one

Which of the following best illustrates the problem imposed by capital rationing?

- ▶ Accepting projects with the highest NPVs first
- ▶ Accepting projects with the highest IRRs first
- ▶ **By passing projects that have positive NPVs -**
- ▶ Bypassing projects that have positive IRRs

Question No: 7 -- Please choose one



A project would be financially feasible in which of the following situations?

- ▶ If Internal Rate of Return of a project is greater than zero
- ▶ If Net Present Value of a project is less than zero
- ▶ If the project has Profitability Index less than one
- ▶ **If the project has Profitability Index greater than one -**
The PI would be larger than 1 for positive NPV projects and less than 1 for negative NPV projects.

Question No: 8 -- Please choose one

Suppose a stock is selling today for Rs.35 per share. At the end of the year, it pays a dividend of Rs.2.00 per share and sells for Rs.39.00. What is the dividend yield on this stock?

- ▶ 2%
- ▶ 3%
- ▶ 4%
- ▶ **5% -**

Dividend yield = Annual dividends per share / price per share
 $= 2 / 35$
 $= 0.057 = 5\%$

Question No: 9 -- Please choose one

Which of the following is considered as a risk free financial asset?

- ▶ **Government T-bills -**
<http://www.investopedia.com/terms/r/riskfreeasset.asp>
- ▶ Junk bonds
- ▶ Preferred stock
- ▶ Secured bonds

Question No: 10 -- Please choose one

Which of the following is a necessary condition for issuing shares through Initial

Public Offerings (IPO's)?

- ▶ The firm must have a stable dividend policy
- ▶ The firm must have a low cost of capital
- ▶ The firm must have a low level of debt
- ▶ **The firm must be listed on the stock exchange -**

Question No: 11 -- Please choose one

Which one of the following statements applies to Dividend Growth Model?

- ▶ It is difficult to understand and use
- ▶ It is used for non-listed companies
- ▶ It is used for debt securities also
- ▶ **It do not consider risk level of a security -**

Question No: 12 -- Please choose one

Which of the following *best* define the term 'Capital Structure'?

- ▶ The proportion of equity used by a firm
- ▶ **The proportion of debt and equity capital used by a firm -**

In finance, capital structure refers to the way a corporation finances its assets through some combination of equity, debt, or hybrid securities. A firm's capital structure is then the composition or 'structure' of its liabilities.

- ▶ The proportion of long-term liabilities used by a firm

- ▶ The proportion of short-term bank loan used by a firm

Question No: 13 -- Please choose one

A Pure Play method of selecting a discount rate is most suitable in which of the following situations?

- ▶ When the intended investment project has a Non-conventional stream of cash flows
- ▶ When the intended investment project is a replacement project
- ▶ **When the intended investment project belongs to industry other than the firms operating in -**
- ▶ When the intended investment project has a conventional stream of cash flows

Question No: 14 -- Please choose one

Which of the following is a dividend that is paid in the form of additional shares, rather than a cash payout?

- ▶ **Stock Dividend -**
From mgt 201 handouts page # 159

Stock Dividends

- Used to control the share price if it rises too fast. Brings share price down to within an “Optimal Price Range” so that more investors can afford to trade in it and trading volume rises. This is a commonly held belief.
- Payment in the form of stock to existing shareholders. Can be declared frequently.
- Example: Company offers 10% stock dividend to all shareholders. Means that if you own 100 shares then company will give you 10 more shares free of cost. Number of shares increases but Total Value of Firm is unchanged.
- ▶ Cum Dividend
- ▶ Ex Dividend
- ▶ Extra Dividend

Question No: 15 -- Please choose one

Which of the following is a proposition of Miller and Modigliani theory of Capital structure?

- ▶ **Value of a firm is independent of its capital structure -**
- ▶ Value of a firm is independent of its level of debt
- ▶ Value of a firm is dependent of its cost of capital
- ▶ Value of a firm is independent on its level of equity finances

Question No: 16 -- Please choose one

Which of the following transactions would occur in a primary financial market?

- ▶ **Initial public offering -**
- ▶ Buying mutual funds certificates
- ▶ Selling old shares
- ▶ Buying bonds issued in previous year

Question No: 17 -- Please choose one

What will be the effect of reduction in the cost of capital on the accounting breakeven level of revenues?

- ▶ It raises the break-even level.
- ▶ It reduces the break-even level.
- ▶ **It has no effect on the break-even level. -**

► This cannot be determined without knowing the length of the investment horizon.

Question No: 18 -- Please choose one

Which of the following statements is TRUE regarding Balance Sheet of a firm?

► It reports how much of the firm's earnings were retained in the business rather than paid out in dividends.

► It reports the impact of a firm's operating, investing, and financing activities on cash flows over an accounting period.

► **It shows the firm's financial position at a specific point in time.**

-

► It summarizes the firm's revenues and expenses over an accounting period.

Question No: 19 -- Please choose one

All of the following are the disadvantages of a Corporate form of an organization EXCEPT:

► Double taxation

► Limited liability

► **Legal restrictions -**

► None of the given options

Question No: 20 -- Please choose one

Which of the following would be a consequence of a high Inventory Turnover Ratio?

► Low level of inventory and frequent stock-outs

► Seasonal elements peculiar to the business

► **Efficient inventory management -**

► Any of the given option

Question No: 21 -- Please choose one

Suppose you invested Rs. 8,000 in a savings account paying 5 percent interest a year, compounded annually. How much amount your account will have at the end the end of four years?

► Rs.10,208

► **Rs.9,728 -**

► Rs.10,880

► Rs.9,624

Question No: 22 -- Please choose one

Which of the following is the main source of income for the buyer of a zero-coupon bond?

► Price appreciation

► A rate of return equal to zero over the life of the bond

► Variable dividends instead of a fixed interest payment annually

► **All interest payments in one lump sum at maturity -**

Zero coupon bonds, also called strip coupons, residuals, sentinels or just strips, are innovative fixed income products offering compound interest and a guaranteed future value if held to maturity.

Zero coupon bonds are bonds which do not pay periodic coupons, or so-called "interest payments". These bonds are purchased at a discount from what they will be worth when they mature. The holder of a zero coupon bond is entitled to receive a single payment, usually of a specified sum of money at a specified time in the

future An investor who has a regular bond receives income from coupon payments, which are usually made semi-annually. The investor also receives the principal or face value of the investment when the bond matures.

Question No: 23 -- Please choose one

Which of the following techniques of stock evaluation considers quantitative factors as well as qualitative factors for valuation?

- ▶ Technical Analysis
- ▶ **Fundamental Analysis -**
- ▶ Constant Growth Model
- ▶ No Growth Model

The biggest part of fundamental analysis involves delving into the financial statements. Also known as quantitative analysis, this involves looking at revenue, expenses, assets, liabilities and all the other financial aspects of a company. Fundamental analysts look at this information to gain insight on a company's future performance. A good part of this tutorial will be spent learning about the balance sheet, income statement, cash flow statement and how they all fit together.

But there is more than just number crunching when it comes to analyzing a company. This is where qualitative analysis comes in - the breakdown of all the intangible, difficult-to-measure aspects of a company. Finally, we'll wrap up the tutorial with an intro on valuation and point you in the direction of additional tutorials you might be interested in.

Question No: 24 -- Please choose one

Which of the following statements is CORRECT regarding the fundamental analysis?

- ▶ Fundamental analysts use only Economic indicators to evaluate a stock
- ▶ Fundamental analysts use only financial information to evaluate a company's stocks

▶ **Fundamental analysts use financial and non-financial information to evaluate a company's stocks -**

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Fundamental Analysis is a security or stock valuation method that uses financial and economic analysis to evaluate businesses or to predict the movement of security prices such as stock prices or bond prices.

- ▶ Fundamental analysts use only non-financial information to evaluate a company's stocks

Question No: 25 -- Please choose one

Which of the following could be used to calculate the cost of common equity?

- ▶ Interpolation method
- ▶ Dividend discount model
- ▶ YTM (Yield-to-Maturity) method
- ▶ **Capital structure valuation -**

Capital structure of a typical company may consist of ordinary shares, preference stock, short term and long-term loan, bonds and leases. These components in capital structure have their own cost and if we add all the individual components cost after adjusting with the weight age of each, the resultant value is known as weighted cost of capital. In order to compute the WACC we need to calculate the individual

components cost. First of all we take up the Equity part of the capital and will see how we can compute the cost of equity.

Question No: 26 -- Please choose one

Which of the following is a long-term source of financing for a firm?

► **Corporate bonds -**

A **corporate bond** is a bond issued by a corporation. It is a bond that a corporation issues to raise money in order to expand its business. [1]The term is usually applied to longer-term debt instruments,

► Money market instruments

► Trade credit

► Accounts payables

Question No: 27 -- Please choose one

Since the capital budgeting techniques use cash flows instead of accounting flows, therefore, the financial manager must add back which one of the following to the analysis?

► The cost of fixed assets

► The cost of accounts payable

► Investments

► **Depreciation -**

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Profit before interest and income taxes xx,xxx

Add back depreciation xx,xxx

Add back amortization of goodwill

Question No: 28 -- Please choose one

Which of the following statements is correct for a project with a positive Net Present Value (NPV)?

► **Internal rate of return (IRR) exceeds the cost of capital -**

► Accepting the project has an indeterminate effect on shareholders

► The discount rate exceeds the cost of capital

► The profitability index equals one

Question No: 29 (Marks: 3)

Why weighted average cost of capital (WACC) should be used as discount rate for analyzing the financial viability of a project?

Question No: 30 (Marks: 3)

Suppose you have 40% of your portfolio invested in firm A, 30% in firm B, 20% in firm C, and 10% in firm D. You know that the betas for these firms are, respectively, 1.2, 1.4, 0.8, and 1.1. Calculate your portfolio beta.

Question No: 31 (Marks: 5)

Differentiate between accounting breakeven point and economic break even point.

Question No: 32 (Marks: 5)

Why capital asset pricing model (CAPM) is more suitable to calculate the cost of

equity as compared to dividend growth model? Discuss