Chapters: 1, 2, 3, 4, 5, 6, 7, 8, 9, 11, 12, and 13

1) A C corporation earns $4.50 per share before taxes. The corporate tax rate is 35%, the personal tax rate on dividends is 20%, and the personal tax rate on non-dividend income is 39%. What is the total amount of taxes paid if the company pays a $2.00 dividend?
   A) $2.48       B) $1.98       C) $0.90       D) $1.58

2) Why in general do financial managers make financial decisions in a corporation, rather than the owners making these decisions themselves?
   A) The interests of the various owners may conflict with each other.
   B) It is best for the control of the finances of a corporation to be in the hands of a disinterested third party.
   C) The owners may not be U.S. citizens or residents.
   D) There are often many owners, and they can often change as they buy and sell stock.

3) Which of the following is NOT a function of the board of directors?
   A) answering to shareholders of the company
   B) monitoring the performance of the company
   C) determining how top executives should be compensated
   D) day-to-day running of the company

4) Which of the following is a measure of the aggregate price level of collections of pre-selected stocks?
   A) Euronext       B) NYSE       C) S&P 500       D) NASDAQ

5) Which of the following is not a role of financial institutions?
   A) Printing money for borrowers.
   B) Moving funds from savers to borrowers.
   C) Spreading out risk-bearing.
   D) Moving funds though time.

6) In the United States, publicly traded companies can choose whether or not they wish to release periodic financial statements.
   A) True       B) False

7) A company that produces drugs is preparing a balance sheet. Which of the following would be most likely to be considered a long-term asset on this balance sheet?
   A) a patent for a drug held by the company
   B) the cash reserves of the company
   C) commercial paper held by the company
   D) the inventory of chemicals used to produce the drugs made by the company
8) Refer to the balance sheet above. If in 2006 Luther has 10.2 million shares outstanding and these shares are trading at $16 per share, then Luther’s market-to-book ratio would be closest to:

A) 0.39  
B) 0.76  
C) 1.29  
D) 2.57

9) Which of the following statements regarding the income statement is INCORRECT?

A) The first line of an income statement lists the revenues from the sales of products or services.  
B) The income statement shows the earnings and expenses at a given point in time.  
C) The income statement shows the flow of earnings and expenses generated by the firm between two dates.  
D) The last or ‘bottom’ line of the income statement shows the firm’s net income.
### Luther Corporation

**Consolidated Income Statement**

*Year ended December 31 (in $ millions)*

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total sales</td>
<td>610.1</td>
<td>578.3</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(500.2)</td>
<td>(481.9)</td>
</tr>
<tr>
<td>Gross profit</td>
<td>109.9</td>
<td>96.4</td>
</tr>
<tr>
<td>Selling, general, and administrative expenses</td>
<td>(40.5)</td>
<td>(39.0)</td>
</tr>
<tr>
<td>Research and development</td>
<td>(24.6)</td>
<td>(22.8)</td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td>(3.6)</td>
<td>(3.3)</td>
</tr>
<tr>
<td>Operating income</td>
<td>41.2</td>
<td>31.3</td>
</tr>
<tr>
<td>Other income</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>Earnings before interest and taxes (EBIT)</td>
<td>41.2</td>
<td>31.3</td>
</tr>
<tr>
<td>Interest income (expense)</td>
<td>(25.1)</td>
<td>(15.8)</td>
</tr>
<tr>
<td>Pretax income</td>
<td>16.1</td>
<td>15.5</td>
</tr>
<tr>
<td>Taxes</td>
<td>(5.5)</td>
<td>(5.3)</td>
</tr>
<tr>
<td>Net income</td>
<td>10.6</td>
<td>10.2</td>
</tr>
<tr>
<td>Price per share</td>
<td>$16</td>
<td>$15</td>
</tr>
<tr>
<td>Shares outstanding (millions)</td>
<td>10.2</td>
<td>8.0</td>
</tr>
<tr>
<td>Stock options outstanding (millions)</td>
<td>0.3</td>
<td>0.2</td>
</tr>
</tbody>
</table>

**Stockholders’ Equity**

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stockholders’ Equity</td>
<td>126.6</td>
<td>63.6</td>
</tr>
<tr>
<td>Total Liabilities and Stockholders’ Equity</td>
<td>533.1</td>
<td>386.7</td>
</tr>
</tbody>
</table>

10) Refer to the income statement above. Luther’s operating margin for the year ending December 31, 2005 is closest to:

A) 1.8%  
B) 2.7%  
C) 5.4%  
D) 16.7%

11) Allen Company bought a new copy machine to be depreciated straight line for three years for use by sales personnel. Where would this purchase be reflected on the Statement of Cash Flows?

A) It would be an addition to property, plant and equipment, so it would be an investing activity.  
B) It would be an addition to cash, so would be reflected in the change in cash.  
C) It would be an expense on the income statement, so it would be reflected in operating cash flows.  
D) None of the above answers is correct.

12) If the risk-free rate of interest ($r_f$) is 6%, then you should be indifferent between receiving $250 today or $200 in two years. If the interest rate is 5%, what is the present value of these cash flows?

A) $250.00 in one year.  
B) $265.00 in one year.  
C) $235.85 in one year.  
D) none of the above

13) A dollar today and a dollar in one year may be considered to be equivalent.

A) True  
B) False

14) An investment will pay you $100 in one year and $200 in two years. If the interest rate is 5%, what is the present value of these cash flows?

A) $285.71  
B) 258.32  
C) $276.65  
D) $305.00
15) A homeowner in a sunny climate has the opportunity to install a solar water heater in his home for a cost of $2400. After installation the solar water heater will produce a small amount of hot water every day, forever, and will require no maintenance. How much must the homeowner save on water heating costs every year if this is to be a sound investment? (The interest rate is 9% per year.)

A) $262 B) $216 C) $248 D) $240

16) Which of the following would be LEAST likely to lower the interest rate that a bank offers a borrower?
A) The expected inflation rate is expected to be low.
B) The investment will be for a long period of time.
C) The borrower is judged to have a low degree of risk.
D) The number of borrowers seeking funds is low.

17) The effective annual rate (EAR) for a loan with a stated APR of 8% compounded monthly is closest to:
A) 8.33% B) 8.00% C) 8.30% D) 8.24%

18) You are considering purchasing a new truck that will cost you $34,000. The dealer offers you 1.9% APR financing for 48 months (with payments made at the end of the month). Assuming you finance the entire $34,000 and finance through the dealer, your monthly payments will be closest to:
A) $736 B) $708 C) $1086 D) $594

19) Term: 1 year 2 years 3 years 5 years 10 years 20 years
Rate: 5.00% 5.20% 5.40% 5.50% 5.76% 5.9%

Given the above term structure of interest rates, which of the following is most likely in the future?
Option I. Interest rates will rise.
Option II. Economic growth will slow.
Option III. Long-term rates will fall relative to short term rates.
A) Options I and II B) Option II only C) Option III only D) Option I only

20) Which of the following is true about the face value of a bond?
A) It is the amount that is repaid at maturity.
B) It is the notional amount we use to compute coupon payments.
C) It is usually denominated in standard increments, such as $1,000.
D) All of the above are true.

21) Which of the following statements is FALSE?
A) Treasury bills are U.S. government bonds with a maturity of up to one year.
B) The amount of each coupon payment is determined by the coupon rate of the bond.
C) The simplest type of bond is a zero-coupon bond.
D) Prior to its maturity date, the price of a zero-coupon bond is always greater than its face value.

22) What is the yield to maturity of a ten-year, $1000 bond with a 5.2% coupon rate and semiannual coupons if this bond is currently trading for a price of $884?
A) 6.23% B) 5.02% C) 6.82% D) 12.46%

23) Which of the following statements are true?
A) A fall in bond prices causes interest rates to fall.
B) A rise in interest rates causes bond prices to fall.
C) Bond prices and interest rates are not connected.
D) A fall in interest rates causes a fall in bond prices.
24) A corporate bond which receives a BBB rating from Standard and Poor’s is considered
   A) an investment grade bond.  B) a defaulted bond.
   C) a high-yield bond.  D) a junk bond.

25) Which of the following formulas is INCORRECT?
   A) \( g = \text{retention rate} \times \text{return on new investment} \)
   B) \( r_E = \frac{\text{Div}_1}{P_0} - g \)
   C) \( \text{Div}_t = \text{EPS}_t \times \text{Dividend Payout Rate} \)
   D) \( P_0 = \frac{\text{Div}_1}{r_E - g} \)

26) Von Bora Corporation (VBC) is expected to pay a $2.00 dividend at the end of this year. If you expect VBC’s
    dividend to grow by 5% per year forever and VBC’s equity cost of capital is 13%, then the value of a share of
    VBS stock is closest to:
    A) $40.00  B) $25.00  C) $11.10  D) $15.40

27) Stocks that do not pay a dividend must have a value of $0.
   A) True  B) False

28) An auto-parts company is deciding whether to sponsor a racing team for a cost of $1 million. The sponsorship
    would last for three years and is expected to increase cash flows by $580,000 per year. If the discount rate is
    7.5%, what will be the change in the value of the company if it chooses to go ahead with the sponsorship?
    A) $508,305  B) $740,000  C) $863,000  D) $808,786

29) Which of the following statements is FALSE?
    A) If the cost of capital estimate is more than the internal rate of return (IRR), the net present value (NPV) will
       be positive.
    B) The internal rate of return (IRR) can provide information on how sensitive your analysis is to errors in the
       estimate of your cost of capital.
    C) In general, the difference between the cost of capital and the internal rate of return (IRR) is the maximum
       amount of estimation error in the cost of capital estimate that can exist without altering the original
       decision.
    D) If you are unsure of your cost of capital estimate, it is important to determine how sensitive your analysis
       is to errors in this estimate.

30) According to Graham and Harvey’s 2001 survey (Figure 8.2 in the text), the most popular decision rules for
    capital budgeting used by CFOs are:
    A) IRR, NPV, Payback period  B) MIRR, IRR, Payback period
    C) NPV, IRR, MIRR  D) Profitability index, NPV, IRR

31) Internal rate of return (IRR) can reliably be used to choose between mutually exclusive projects.
   A) True  B) False

32) Which of the following decision rules is best defined as the amount of time it takes to pay back the initial
    investment?
   A) profitability index  B) payback period
   C) net present value (NPV)  D) internal rate of return (IRR)
33) How does the capital budgeting process begin?
   A) by analyzing alternate projects
   B) by forecasting the future consequences for the firm of each potential project
   C) by evaluating the net present value (NPV) of each project’s cash flows
   D) by compiling a list of potential projects

34) Cameron Industries is purchasing a new chemical vapor depositor in order to make silicon chips. It will cost $6 million to buy the machine and $10,000 to have it delivered and installed. Building a clean room in the plant for the machine will cost an additional $3 million. The machine is expected to have a working life of six years. If straight-line depreciation is used, what are the yearly depreciation expenses in this case?
   A) $1,000,000   B) $1,501,667   C) $1,001,667   D) $1,500,000

35) Which of the following statements is FALSE?
   A) Many projects use a resource that the company already owns.
   B) As a practical matter, to derive the forecasted cash flows of a project, financial managers often begin by forecasting earnings.
   C) Only include as incremental expenses in your capital budgeting analysis the additional overhead expenses that arise because of the decision to take on the project.
   D) When evaluating a capital budgeting decision, we generally include interest expense.

36) Which of the following adjustments should NOT be made when computing free cash flow from incremental earnings?
   A) subtracting increases in Net Working Capital
   B) adding depreciation
   C) subtracting all non-cash expenses
   D) subtracting depreciation expenses from taxable earnings

37) Which of the following statements is FALSE?
   A) When evaluating a capital budgeting project, financial managers should make the decision that maximizes net present value (NPV).
   B) Sensitivity analysis reveals which aspects of the project are most critical when we are actually managing the project.
   C) The break-even level of an input is the level for which the investment has an internal rate of return (IRR) of zero.
   D) The most difficult part of capital budgeting is deciding how to estimate the cash flows and the cost of capital.

38) Historically, stocks have delivered a ______ return on average compared to Treasury bills but have experienced ______ fluctuations in values.
   A) higher, lower   B) lower, higher   C) higher, higher   D) lower, lower

39) You own shares in Yahoo that were purchased at a price of $21 per share. Microsoft has offered to purchase Yahoo and buy your shares at a price of $31 per share. What will be your return if you tender your shares to Microsoft and the deal is completed?
   A) 43.34%   B) 49.65%   C) 47.62%   D) 33.45%
40) Which of the following statements is FALSE?
   A) Riskier investments must offer investors higher average returns to compensate them for the extra risk they are taking on.
   B) Volatility seems to be a reasonable measure of risk when evaluating returns on large portfolios and the returns of individual securities.
   C) Investments with higher volatility have rewarded investors with higher average returns.
   D) Investments with higher volatility should have a higher risk premium and, therefore, higher returns.

41) The risk that inflation rates are likely to increase in the next year is an example of common risk.
   A) True                                   B) False

42) In general, it is possible to eliminate ________ risk by holding a large portfolio of assets.
   A) systematic                             B) unsystematic and systematic
   C) unsystematic                           D) none of the above

43) When we combine stocks in a portfolio, the amount of risk that is eliminated depends on the degree to which the stocks face common risks and move together.
   A) True                                   B) False

44) You expect General Motors (GM) to have a beta of 1.3 over the next year and the beta of Exxon Mobil (XOM) to be 0.9 over the next year. Also, you expect the volatility of General Motors to be 40% and that of Exxon Mobil to be 30% over the next year. Which stock has more systematic risk? Which stock has more total risk?
   A) XOM, GM                                B) XOM, XOM
   C) GM, GM                                 D) GM, XOM

45) Your estimate of the market risk premium is 7%. The risk-free rate of return is 3.5% and General Motors has a beta of 1.3. According to the Capital Asset Pricing Model (CAPM), what is its expected return?
   A) 12.6%                                  B) 11.3%                                    C) 12.9%                                    D) 12.1%

46) The relative proportion of debt, equity, and other securities that a firm has outstanding constitute its
   A) current ratio.                         B) capital structure.                       C) asset ratio.                              D) none of the above

47) The fact that the interest paid on debt is a tax-deductible expense increases the cost of debt financing.
   A) True                                   B) False

48) Ford Motor Company is discussing new ways to recapitalize the firm and raise additional capital. Its current capital structure has a 20% weight in equity, 10% in preferred stock, and 70% in debt. The cost of equity capital is 14%, the cost of preferred stock is 10%, and the pretax cost of debt is 9%. What is the weighted average cost of capital for Ford if its marginal tax rate is 30%?
   A) 8.21%                                  B) 7.87%                                  C) 9.21%                                  D) 8.89%

49) Divisional costs of capital are more appropriate when evaluating a project for a line of business when the types of business in a firm are
   A) different.                             B) similar.                              C) mature businesses.                       D) new businesses.

50) Internal financing is more costly than external financing because of issuance costs.
   A) True                                   B) False
Answer Key
Testname: SAMPLEFINAL

1) B
2) D
3) D
4) C
5) A
6) FALSE
7) A
8) C
9) B
10) C
11) A
12) B
13) FALSE
14) C
15) B
16) B
17) C
18) A
19) D
20) D
21) D
22) C
23) B
24) A
25) B
26) B
27) FALSE
28) A
29) A
30) A
31) FALSE
32) B
33) D
34) C
35) D
36) D
37) C
38) C
39) C
40) B
41) TRUE
42) C
43) TRUE
44) C
45) A
46) B
47) FALSE
48) A
49) A
50) FALSE