Final Term Papers

Fall 2009 (Session 03b)

MGT201

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

The DuPont Approach breaks down the earning power on shareholders' book value (ROE) as follows: ROE = _____.

- **Net profit margin × Total asset turnover × Equity multiplier**
- Total asset turnover × Gross profit margin × Debt ratio
- Total asset turnover × Net profit margin
- Total asset turnover × Gross profit margin × Equity multiplier

ROE = (Profit margin)*(Asset turnover)*(Equity multiplier) = (Net profit/Sales)*(Sales/Assets)*(Assets/Equity)

Question No: 2 (Marks: 1) - Please choose one

Which group of ratios shows the extent to which the firm is financed with debt?

- Liquidity ratios
- **Debt ratios**
- Coverage ratios
- Profitability ratios

A ratio that indicates what proportion of debt a company has relative to its assets. The measure gives an idea to the leverage of the company along with the potential risks the company faces in terms of its debt-load.

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

Interest paid (earned) on both the original principal borrowed (lent) and previous interest earned is often referred to as _____.

- Present value
- Simple interest
- Future value
- **Compound interest**

When the compound interest calculation is used, interest is calculated on the original principal plus all interest accrued to that point in time. Since interest is paid on interest as well as on the amount borrowed, the effective interest rate is greater than the nominal interest rate. The compound interest rate method is often used by banks and savings institutions in determining interest they pay on savings deposits "loaned" to the institutions by the depositors.

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Question No: 4 (Marks: 1) - Please choose one

A capital budgeting technique that is NOT considered as discounted cash flow method is:

- ► **Payback period**
- ► Internal rate of return
- ► Net present value
- ► Profitability index

Payback cannot be calculated if the positive cash inflows do not eventually outweigh the cash outflows. That is why payback (like IRR) is of little use when used with a pure "costs only" it does not take into account the concept of time value of money. The cash flows are considered regardless of the time in which they are occurring. You must have noticed that we have not used any interest rate while making calculation

Question No: 5 (Marks: 1) - Please choose one

You are selecting a project from a mix of projects, what would be your first selection in descending order to give yourself the best chance to add most to the firm value, when operating under a single-period capital-rationing constraint?

- ► **Profitability index (PI)**
- ► Net present value (NPV)
- ► Internal rate of return (IRR)
- ► Payback period (PBP)

Question No: 6 (Marks: 1) - Please choose one

Which of the following is a legal agreement between the corporation issuing bonds and the bondholders that establish the terms of the bond issue?

- ► **Indenture**
- ► Debenture
- ► Bond
- ► Bond trustee

Indenture": Long Legal Agreement between the Issuer (or Borrower) and the Bond Trustee (Generally a bank of financial institution that acts as the representative for all Bondholders). Basically protects Bondholders from mis-management by the bond issuer, default, other security holders, etc.

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Question No: 7 (Marks: 1) - Please choose one

What is yield to maturity on a bond?

► It is below the coupon rate when the bond sells at a discount, and equal to the coupon rate when the bond sells at a premium

► **The discount rate that will set the present value of the payments equal to the bond price**

► It is based on the assumption that any payments received are reinvested at the coupon rate

► None of the given options

Question No: 8 (Marks: 1) - Please choose one

The value of direct claim security is derived from which of the following?

► Fundamental analysis

► **Underlying real asset**

► Supply and demand of securities in the market

► All of the given options

Question No: 9 (Marks: 1) - Please choose one

_____ is equal to (common shareholders' equity/common shares outstanding).

► **Book value per share**

► Liquidation value per share

► Market value per share

► None of the above

Question No: 10 (Marks: 1) - Please choose one

The present value of growth opportunities (PVGO) is equal to

I) The difference between a stock's price and its no-growth value per share

II) The stock's price

III) Zero if its return on equity equals the discount rate

IV) The net present value of favorable investment opportunities

► I and IV

► II and IV

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► **I, III, and IV**
► II, III, and IV

Question No: 11 (Marks: 1) - Please choose one

Which of the following statement about portfolio statistics is **CORRECT**?

- **A portfolio's expected return is a simple weighted average of expected returns of the individual securities comprising the portfolio.**
- A portfolio's standard deviation of return is a simple weighted average of individual security return standard deviations.
- The square root of a portfolio's standard deviation of return equals its variance.
- The square root of a portfolio's standard deviation of return equals its coefficient of variation.

Question No: 12 (Marks: 1) - Please choose one

Which of the following is NOT a major cause of unsystematic risk.

► New competitors
► New product management
► **Worldwide inflation**
► Strikes

Question No: 13 (Marks: 1) - Please choose one

Which of the following is the characteristic of a well diversified portfolio?

► Its market risk is negligible
► **Its unsystematic risk is negligible**
► Its systematic risk is negligible
► All of the given options

Question No: 14 (Marks: 1) - Please choose one

Which of the following factor(s) do **NOT** affects the movements in the market index?

► Macroeconomic factors
► Socio political factors
► **Social factors**
► All of the given options

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Question No: 15 (Marks: 1) - Please choose one

If stock is a part of totally diversified portfolio then its company risk must be equal to:

- ► **0**
- ► 0.5
- ► 1
- ► -1

Question No: 16 (Marks: 1) - Please choose one

How much return would be offered by the stock whose (risk and return) pair lies below the SML?

► No return
► **Lower return**
► Average return
► Excessive return

Any Stock whose (Risk, Return) Pair lies BELOW THE SML is offering a Return that is lower than the Market.

Question No: 17 (Marks: 1) - Please choose one

Market risk is measured in terms of the _____ of the market portfolio or index.

► Variance
► Covariance
► **Standard deviation**
► Correlation coefficient

Market Risk is measured in terms of the Standard Deviation (or Volatility) of the Market Portfolio or Index

Question No: 18 (Marks: 1) - Please choose one

What is the meaning of the term "arbitrage"?

► Buying low and selling high
► **Earning risk-free economic profits**
► Negotiating for favorable brokerage fees

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►Hedging your portfolio through the use of options

Arbitrage is exploiting security mispricing by the simultaneous purchase and sale to gain economic profits without taking any risk. A capital market in equilibrium rules out arbitrage opportunities

Question No: 19 (Marks: 1) - Please choose one

Which of the following is the market where tangible or physical asset change hand?

►Money market
►Capital market
►Real asset market
►Equity market

The real asset market where the real or tangible asset or physical asset change hand .for example, you have cotton exchange where raw bales of cotton change hands .computer hardware and many other examples are available. For example, Cotton Exchange, Gold Market, Kapra Market Property (land, house, apartment, warehouse) ,Computer hardware, Used Cars, Wheat, Sugar, Vegetables, etc.

Question No: 20 (Marks: 1) - Please choose one

Which of the following is related to the use Lower financial leverage?

►Fixed cost
►Variable cost
►Debt financing
►Common equity financing

Question No: 21 (Marks: 1) - Please choose one

Which of the following will be confronted by the management in deciding the optimal level of current assets for the firm?

►A trade-off between profitability and risk
►A trade-off between liquidity and risk
►A trade-off between equity and debt
►A trade-off between short-term versus long-term borrowing

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Question No: 22 (Marks: 1) - Please choose one

Which of the following is an example of a natural hedge?

►**The prices and costs are both determined in the global market place.**

►The prices are determined in the global market place and costs are determined in the domestic market place.

►The costs are determined in the global market place and prices are determined in the domestic market place.

►None of the given options is correct

Natural hedges are generated when both prices and costs are determined in similar market places.

Question No: 23 (Marks: 1) - Please choose one

For which of the following strategy; economies of scale, market share dominance, and technological advances are reasons most likely to be offered to justify?

►Financial acquisition

►**Strategic acquisition**

►Divestiture

►Supermajority merger approval provision

Question No: 24 (Marks: 1) - Please choose one

Which of the following is incorrect regarding the costs and benefits of holding inventories and cash?

►The benefit of higher inventory levels is the reduction in order costs associated with restocking and the reduced chances of running out of material.

►The costs of higher inventory levels are the carrying costs, which include the cost of space, insurance, spoilage, and the opportunity cost of the capital tied up in inventory.

►Cash provides liquidity, but it doesn't pay interest. Securities pay interest, but you can't use them to buy things.

►**As financial manager you want to hold cash up to the point where the incremental or marginal benefit of liquidity is 25% higher than the cost of holding cash, that is, the interest that you could earn on securities.**

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Question No: 25 (Marks: 1) - Please choose one

Which of the following is the dividend that is normally paid to shareholders?

- Stock split
- Stock dividend
- Extra dividend
- **Regular dividend**

Question No: 26 (Marks: 1) - Please choose one

A technique that tells us the number of years required to recover our initial cash investment based on the project's expected cash flows is:

- **Pay back period**
- Internal rate of return
- Net present value
- Profitability index

In this technique, we try to figure out how long it would take to recover the invested capital through positive cash flows of the business.

Question No: 27 (Marks: 1) - Please choose one

A proposal is accepted if payback period falls within the time period of 3 years. According to the given criteria which of the following project will be accepted?

	Payback period
Project A	1.66
Project B	2.66
Project C	3.66

- Project A
- Project B
- Project C
- **Project A & B**

Question No: 28 (Marks: 1) - Please choose one

Assume a company had Rs.1 billion in free cash flow last year, and it is expected to grow that cash flow at 3% into perpetuity. Assuming a 9% cost of equity, what is the present value of the company?

- **Rs. 12.08 billion**
- Rs. 18.15 billion
- Rs. 14.16 billion
- Rs. 16.67 billion

Question No: 29 (Marks: 1) - Please choose one

What is the present value of Rs.1,000 to be paid at the end of 5 years if the interest rate is 8% compounded annually?

- **Rs. 680.58**
- Rs. 1,462.23
- Rs. 322.69
- Rs. 401.98

$FV = PV \times (1 + i)^n$

$PV = FV / (1 + i)^n$

$= 1000 / (1 + 0.08)^5$

$= 680.27$

Question No: 30 (Marks: 1) - Please choose one

What will be the market risk premium for stock C if the average share of stock C has a required return of 15% and treasury bonds yield is 10%?

- **5%**
- 10%
- 15%
- 25%

15%-10%= 5%

The difference between the expected return on a market portfolio and the risk-free rate.

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Question No: 31 (Marks: 1) - Please choose one

All of the following are used in calculation of required return on a particular stock using SML equation **EXCEPT**:

- Risk free rate
- Market risk premium
- Stock's beta
- **Stock's price**

SML Equation (assumes Efficient Stock Pricing, Risk, and Return)
rA = rRF + (rM - rRF) β A .

Question No: 32 (Marks: 1) - Please choose one

On which of the following ground, the Arbitrage Pricing Model is different from the Capital Asset Pricing Model?

- It places more emphasis on market risk
- It minimizes the importance of diversification
- **It recognizes multiple systematic risk factors**
- It recognizes multiple unsystematic risk factors

Question No: 33 (Marks: 1) - Please choose one

According to Traditionalist Theory, when a 100% Equity Firm takes on more and more debt, which of the following phenomenon is observed?

- Share Price first falls, then reaches minimum and finally rises
- Share Price first rises, then reaches minimum and finally falls
- **Share Price first rises, then reaches maximum and finally falls**
- None of the given options

Total Market Value of Firm (V = D + E = Market Value of Debt + Market Value of Equity) first rises (because of Interest Tax Shield savings), then reaches a maximum point (optimal capital structure), and finally falls (because of excessive fall in Net Income and Equity value because of interest payments).

Question No: 34 (Marks: 1) - Please choose one

Which of the following formula represents the yield to maturity?

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- Interest yield + Market price
- Capital gain yield + Book value
- **Interest yield + Capital gain yield**
- Market price + Capital gain yield

YTM= interest yield +capital gain yield and it is representative of over all cost of debt in the form of bond.

Question No: 35 (Marks: 1) - Please choose one

Bird-in-the-hand dividend theory was proposed by which of the following?

- Miller Modigliani
- **Myron Gordon and John Lintner**
- Henry Fayol
- William John and Lehman

Bird in the Hand (Gordon & Lintner) Theory

Question No: 36 (Marks: 1) - Please choose one

XYZ Corporation has offered its shareholders the option that their dividends will be used to purchase additional shares of this corporation. This offer of XYZ Corporation is referred as:

- Stock repurchases
- **Dividend reinvestment**
- Stock dividends
- Stock splits

Dividend Reinvestment Plans (DRIP): Firms give stockholders option to automatically reinvest cash dividends by buying more of the same stock

Question No: 37 (Marks: 1) - Please choose one

When IRR < WACC it means that:

- Investment is acceptable as required rate of return is less then cost of capital
- **Investment is not acceptable as required rate of return is less then cost of capital**
- Investment is acceptable as required rate of return is equal to the cost of capital

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- None of the given options is true

Link for Reference

Question No: 38 (Marks: 1) - Please choose one

Which of the following statement depicts the disadvantage of issuing debt?

- Debt financing leads toward unlimited liability
- **If company doesn't pay interest, it can be close down**
- It can improve the return on equity
- Not fixed payment of interest is required by investors

Disadvantage of Too Much Debt: Firm becomes more Risky so Lenders and Banks Charge Higher Interest Rates and Greater Chance of Bankruptcy

Question No: 39 (Marks: 1) - Please choose one

The decisions regarding capital structure of a firm are mainly concerned with which of the following?

- Assets side of balance sheet
- **Liabilities side of balance sheet**
- Expense side of profit and loss account
- Incomes side of profit and loss account

Capital Structure and Corporate Financing - Long Term LIABILITIES Side of Balance Sheet

Question No: 40 (Marks: 1) - Please choose one

If Current assets = Rs. 16,000,

Current liabilities= Rs. 10,000

Inventory= Rs. 2500

Calculate quick ratio for the firm?

- **1.35**
- 6.0
- 1.60
- 0.25

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A desirable quick ratio can range from (0.8:1) to (1.5:1) depending on the nature of the business.

= (Current Assets – Inventory) / Current Liabilities

= (16000-2500)/10000

= 1.35

Question No: 41 (Marks: 1) - Please choose one

If an investor is risk averse, then which of the following options best suits him?

- ► Debentures
- ► Common stock
- ► **T –Bills**
- ► Preferred stock

It is important to remember that we have the option of investing in the T-bill portfolio which offers a risk free rate of return

Question No: 42 (Marks: 1) - Please choose one

Capital structure theory is presented by which of the following?

- ► Robert Alan Hill
- ► **Modigliani & Miller**
- ► Brigham & Houston
- ► Van Horne & Gittman

Answer provided by Capital Structure Theory.

Modigliani - Miller:

• Fathers of Corporate Finance

Question No: 43 (Marks: 1) - Please choose one

Which of the following is true regarding financial leverage?

- ► Whenever a firm's equity increases faster than its debt, financial leverage increases
- ► **Investors can undo the effects of the firm's capital structure by using home-made leverage**
- ► Increasing financial leverage will always increase the EPS for stockholders

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► The level of financial leverage that produces the minimum firm value is the most beneficial to stockholders

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Question No: 44 (Marks: 1) - Please choose one

If a firm wants to use short-term bank loan to finance its temporary current assets and even to buy some of its permanent current inventory, then which of the following policy it is going to adopt?

► **Moderate working capital policy**
► Conservative working capital policy
► Aggressive working capital policy
► Any of the given policy

• Balance of Long and Short-term Financing.

• Long Term Financing for Fixed and Permanent Current Assets. Use Short Term Financing for Permanent Current Assets. Use Spontaneous Current Liability Financing for Temporary Current Assets

Question No: 45 (Marks: 1) - Please choose one

Which of the following statements depicts the trade-off theory in a better way?

► It states a tradeoff between the costs and benefits of debt financing
► **It states the tradeoff between the debt financing and equity financing**
► There is tradeoff between assets and liabilities of the firm
► There is tradeoff between revenues and expenses of the firm

Question No: 46 (Marks: 1) - Please choose one

Modigliani and Miller presented capital structure theory in which of the following years?

► 1950
► **1958**
► 1963
► 1965

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Cost of Capital, Corporate Finance and the Theory of Investment" Revolutionary Article Published by Professors Modigliani & Miller in American Economic Review in June 1958. Won Nobel Prize

Question No: 47 (Marks: 1) - Please choose one

In which of the following, synergies are not expected?

- ► Operating merger
- ► **Financial merger**
- ► Vertical Merger
- ► Horizontal Merger

• Pure Financial Merger - Operations remain independent

• Operating Merger - Operations are Integrated & Changed & Synergies Expected

Question No: 48 (Marks: 1) - Please choose one

"Company X wants to merge with Company Y but Company X's management is resisting the merger. Company X asks the shareholders of Company Y to tender their shares in exchange the offered price." This statement refers to which of the following?

- ► Horizontal Merger
- ► Vertical Merger
- ► **Hostile Merger**
- ► Conglomerate Merger

Reference 4 Specific Types of Mergers:

• Horizontal Merger: merger of 2 competitors - can lead to Monopoly

• Vertical Merger: merger of a supplier with a buyer

• Co generic Merger: merger of firms in same industry

• Conglomerate Merger: merger of firms in unrelated industries

Question No: 49 (Marks: 1) - Please choose one

What happens to the total risk when leverage increases at a slow rate?

- ► Total risk increases with slow rate than the leverage
- ► Total risk increases with decreasing rate
- ► Total risk remains the same

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► **Total risk increases faster than the leverage**

Question No: 50 (Marks: 1) - Please choose one

According to _____, the firm's cost of equity increases with greater debt financing, while the WACC first decreases and then increases.

► M&M Proposition I with taxes
► M&M Proposition I without taxes
► The traditional theory of capital structure
► **M&M Proposition II without taxes**

Question No: 51 (Marks: 1) - Please choose one

Which of the following is incorrect regarding Modigliani and Miller's (MM's) famous debt irrelevance proposition?

► It states that firm value can't be increased by changing capital structure
► MM show that the extra return and extra risk balance out, leaving shareholders no better or worse off
► MM's argument rests on simplifying assumptions i.e. efficient capital markets and ignores taxes and costs of financial distress
► **Firm value increases when more debt is used**

As companies take more debt they are exposed to more financial risk.

Question No: 52 (Marks: 1) - Please choose one

Which of the following refers to a unique type of Japanese corporate organization based on a close partnership between government and businesses?

► **Keiretsu**
► Chaebols
► Lean and mean
► Options

A grouping of Japanese firms through historic associations and equity interlocks such that each firm maintains its operational independence (definition of keiretsu)

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Question No: 53 (Marks: 1) - Please choose one

Calculate the Forward Rate for Rupee if the interest on 1 Year Maturity in Pakistan is 10% and in Australia is 6% and the current spot rate is Rs.76/ AUD.

- Rs. 6 per AUD
- Rs. 76 per AUD
- **Rs. 79 per AUD**
- Rs. 456 per AUD

F = S (Rs. /AUD$) (1+ i Rs.) / (1+ i AUD$)
= 76(1+0.1)/ (1+0.06)
=78.87

Question No: 54 (Marks: 1) - Please choose one

Calculate the Forward Rate for Rupee using Interest Rate Parity if the interest on 1 Year Maturity in Pakistan is 10% and on Euro is 6% and the forward rate is Rs.124/ EUR.

- Rs. 6 per EUR
- Rs. 120 per EUR
- **Rs. 124 per EUR**
- Rs. 1240 per EUR

F = S (Rs. /AUD$) (1+ i Rs.) / (1+ i AUD$)
There some technical problem with question
It should give spot rate if they wanted to calculate forward rate. If we assume 124 as spot rate then its answer for forward rate should be 128.67
How it can be possible with parity of 10% and 6% after one year euro has the same value of 124Rs.

= F = S (Rs.) (1+ i Rs.) / (1+ i euro)
= (124) (1+0.1) / (1+0.06) = 128.6792

or if we assume it ask us to calculate the spot Rate and 124 is assumed as forward rate in that case answer could be 120

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Question No: 55 (Marks: 3)

Tax shield for the calculation of cost of debt but not for the calculation of the equity stock. Why? Give reason.

Because you can get tax exemption on the interest payment, in case of debt financing. But you are not entitled for any Tax shield in case of equity.

Question No: 56 (Marks: 5)

Ahsan Enterprises, an all-equity firm, is considering a proposal of new capital investment. Analysis has indicated that the proposed investment has a beta of 0.5 and will generate an expected return of 7%. The firm currently has a required return of 10.75% and a beta of 1.25. The investment, if undertaken, will double the firm's total assets.

Requirement:

If r_{RF} is 7% and the market risk premium is 3%, should the firm undertake the investment?

Beta = .5

Expected Rate of return = 7%

Required rate of return = 10.75

Beta = 1.25%

Ahsan Enterprises uses only equity capital, so its cost of equity is also its corporate cost of capital, or WACC.

WACC = 10.75 %

"The investment, if undertaken, will double the firm's total assets" tells us that exactly same amount will be injected

So after the injection of new investment with beta of .5, impact on overall beta will be

.5 * (1.25) + .5*(.5) = .875

Now we will calculate the Required Rate of return with new beta

RR = WACC = risk free rate of return + (Market rate of return - risk free rate of return)*beta

WACC = 7% + (7% - 3%)*.875 = 10.50%

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= .5*10.50 + .5*7 =

Due to new investment cost of capital reduced from 10.75% to 10.50%

Overall expected rate of return must be more then 10.50% but new investment is giving us the expected rate of return of 7%

Now we will see expected return after injection of new investment
.5(10.75)+ .5(7) = 8.87%
as it is less then 10.50 so we should drop it.

Question No: 57 (Marks: 5)

Mergers can be classified in two broad categories i.e. Financial and Operating merger. Differentiate between these two.

Financial Merger	**Operating Merger**
The operations remains independent	The operations are integrated and changed and synergies expected.

Question No: 58 (Marks: 10)

Using the Capital Asset Pricing Model (CAPM), determine the required return on equity for the following situations:

Situations	**Expected return on market portfolio**	**Risk- free rate**	**Beta**
1	16%	12%	1.00
2	18%	8%	0.80
3	15%	14%	0.70

What generalization can you make?

Required Rate of return = risk free rate of return + (market return- risk free rate)* beta

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1. = 12% + (16%-12%)*1 = 16%
2. = 8% + (18%-8%)*.8 = 16%
3. = 14% + (15%-14%)*.7 = 14.7%

Generalization: as beta of 1 in case of our security No.1 It is fully diversified and its return is 16% which exactly equal to market portfolio return. Any value of beta above the 1 can increase the rate of return but same it will increase the Risk as well.

Question No: 59 (Marks: 10)

What are stock dividends and stock splits? Explain with the help of examples and how do these affect stock prices?

(3+3+4 marks)

Stock Dividend: They are used to control the share price if it rises too fast. They bring share price down to within an optimal price range so that more investors can afford to trade in it and trading volume rises.

Example: Company offers 10% stock dividend to all shareholders. It means that if you own 100 shares than company will give you 10 more shares free of cost. Number of shares increases but total value of firm is unchanged.

Stock Split: They are used to share price if it rises too fast. Number of share outstanding increase. They are used to increase Float.

Example: Company with 1000 shares outstanding to outside shareholders declares 2-for-1 stock split. Means that the number of shares outstanding will increase to 2000 shares (i.e. 100% increase). Number of shares rises but firm value unchanged.

Effect of Stock Dividend and Stock Splits on prices:

Prices rises immediately afterwards because investors take them to be positive signals about the company's future. But if company does not declares higher earnings and dividends in near future, price will come back down again.

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