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FINALTERM EXAMINATION
Spring 2010
MGT201- Financial Management (Session - 4)

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

How "Shareholder wealth" is represented in a firm?

- ► The amount of salary paid to its employees
- ► The market price per share of the firm's common stock
- ► The number of people employed in the firm
- ► The book value of the firm's assets less the book value of its liabilities

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

In preparing a forecast balance sheet, it is likely that either cash or _____ will serve as a "plug figure" or balancing factor to ensure that assets equal liabilities plus shareholders' equity.

- ► Retained earnings
- ► Accounts receivable
- ► Shareholders' equity
- ► Notes payable (short-term borrowings)

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

As interest rates go up, the present value of a stream of fixed cash flows _____.

- ► Goes down
- ► Goes up
- ► Stays the same
- ► Can not be found

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

Mortgage bonds are secured by real property whose value is generally _____ than that of the value of the bonds issue?.

- ► Higher
- ► Lower
- ► Equal
- ► Higher or lower

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

Which of the following is **NOT** the present value of the bond?

- ► Intrinsic value
- ► Market price
- ► Fair price
- ► Theoretical price

Question No: 6 (Marks: 1) http://vustudents.ning.com - Please choose one

Which of the following is designated by the individual investor's optimal portfolio?

- ► The point of tangency with the opportunity set and the capital allocation line
- ► The point of highest reward to variability ratio in the opportunity set
- ► The point of tangency with the indifference curve and the capital allocation line
- ► The point of the highest reward to variability ratio in the indifference curve

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

Which of the following value of the shares changes with investor's perception about the company's future and supply and demand situation?

- ► Par value
- ► Market value
- ► Intrinsic value
- ► Face value

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

Which of the following factors might affect stock returns?

- ► The business cycle
- ► Interest rate fluctuations
- ► Inflation rates
- ► All of the above

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

In which of the following approach you need to bring all the projects to the same length in time?

- ► MIRR approach
- ► Going concern approach
- ► Common life approach
- ► Equivalent annual approach

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

What will happen to the expected return on a stock with a beta of 1.5 and a market risk premium of 9% if the Treasury bill yield increases from 3% to 5%?

- ► The expected return will increase by 2.0%
- ► The expected return will remain unchanged
- ► The expected return will increase by 1.0%
- ► The expected return will increase by 3.0%

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

Which of the following is the beta for the market portfolio?

- ► 0.25
- ► -1.0
- ► 1.0
- ► 0.5

Question No: 12 (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

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

How can you limit company-specific risks?

- ► Invest in that company's bonds
- ► Invest in a variety of stocks
- ► Invest in securities that do well in a recession
- ► Invest in securities that do well in a boom

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

If risk and return combination of any stock is above the SML, what does it mean?

- ► It is offering lower rate of return as compared to the efficient stock
- ► It is offering higher rate of return as compared to the efficient stock
- ► Its rate of return is zero as compared to the efficient stock
- ► It is offering rate of return equal to the efficient stock

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

If we invest in many securities which are _____to each other then it is possible to reduce overall risk for your investment.

- ► Comparable

► Parallel
► Highly correlated
► Negatively correlated

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

Why market values are often used in computing the weighted average cost of capital?

► This is the simplest way to do the calculation
► This is consistent with the goal of maximizing shareholder value
► This is required in the U.S. by the Securities and Exchange Commission
► None of the given options

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

What does the law of conservation of value implies?

► The mix of senior and subordinated debt does not affect the value of the firm
► The mix of convertible and non-convertible debt does not affect the value of the firm
► The mix of common stock and preferred stock does not affect the value of the firm
► All of the given options

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

Which of the following has the same meaning as the working capital to financial analyst?

► Total assets
► Fixed assets
► Current assets
► Current assets minus current liabilities

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

How should a successful acquisition be evaluated in the long-run?

► The acquisition is successful if the acquirer is able to increase its earnings per share (EPS), relative to what it would have been without the acquisition.
► The acquisition is successful if the acquirer is able to reduce its debt-to-total asset ratio, and hence risk, relative to what it would have been without the acquisition.
► The acquisition is successful if the acquirer is able to diversify its asset base and reduce its overall risk.
► The acquisition is successful if the market price of the acquirer's stock increases over what it would have been without the acquisition.

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

What would be the result when there is an increase in the number of shares outstanding by reducing the par value of stock?

- ► Stock split
- ► Stock dividend
- ► Extra dividend
- ► Regular dividend

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

The _____ is the proportion of earnings that are paid to common shareholders in the form of a cash dividend.

- ► Retention rate
- ► 1 plus the retention rate
- ► Growth rate
- ► Dividend payout ratio

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

Why are dividend changes and not the absolute level of dividends perceived to be more important to shareholders?

- ► Managers only change dividends under threatening conditions
- ► Dividend changes are thought to signal future expectations
- ► MM state that the absolute level of dividends is irrelevant
- ► Changes determine whether borrowing must occur

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

A preferred stock will pay a dividend of Rs. 3.50 in the upcoming year, and every year thereafter, i.e., dividends are not expected to grow. You require a return of 11% on this stock. Use the constant growth model to calculate the intrinsic value of this preferred stock.

- ► Rs. 0.39
- ► Rs. 0.56
- ► Rs. 31.82
- ► Rs. 56.25

Reference:

PV = DIV1/ **rPE** = 3.5 / 11% = 3.5/**0.11** = Rs 31.82

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

In which of the following rate fluctuations can convert a good investment decision into a bad one.

► Inflation rate
► Interest rate
► Poverty rate
► Currency rates

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

In a market where the SML (Security Market Line) has steep slope, most of the investors are:

► Risk lover
► Risk averse
► Gamblers
► None of the given options

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

In term of diversification, the efficient portfolios must lie on which of the following?

► Capital market line
► Money market line
► Security market line
► None of the given options

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

Which of the following is the reason that a single overall cost of capital is often used to evaluate projects?

► It acknowledges that most new investment projects offer about the same expected return
► It is the only way to measure a firm's required return
► It acknowledges that most new investment projects have about the same degree of risk
► It avoids the problem of computing the required rate of return for each investment proposal

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

Which of the following is also called the opportunity cost of capital?

► Assumed rate of return
► Internal rate of return
► Required rate of return
► Expected rate of return

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

What would be the major threat to a company when it is purely debt financed?

► Investors can interfere in the management of the company
► It has to pay fixed amount of interest

- Investors becomes the owners of the company
- It has to pay dividends

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

According to Traditionalist Theory, when an un-leveraged firm takes on more and more debt, which of the following phenomenon is observed?

- Cost of Capital increases, reaches a minimum point, and then falls
- Cost of Capital decreases, reaches a minimum point, and then rises
- Cost of Capital increases, reaches a maximum point, and then rises
- None of the given options

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

Company ABC offers its stockholders 10 % stock dividends and Mr. S is one of its stockholders being the owner of 250 stocks. How many shares Mr. S has after availing the stock dividend?

- 25
- 50
- 275
- 250

Reference:
250*0.1 = 25 + 250 = 275

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

Which of the following can be defined as "additional risk faced by common stockholders if firms take debt."?

- Unsystematic risk
- Systematic risk
- Business risk
- Financial risk

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

Which of the following is **NOT** a current asset investment policy in practice?

- Fat Cat
- Pay Back Period
- Moderate Policy
- Lean & Mean

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

Which of the following industries is considered as capital intensive?

- Pharmaceutical industry
- Textile industry
- Information technology
- Automobile industry

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

Leveraged capital structure is suitable for which kind of companies?

- ► For co-operative societies
- ► For large companies who are earning high volume of sales revenue
- ► For medium companies whose sales are average
- ► For small companies whose sales are low

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

Company C sells its customers on the term 3/15, net 30 bases. What does it mean?

- ► 3% discount for customers who pay within 30 days
- ► 3% discount for customers who pay within 15 days
- ► 15% discount for customers who pay within 30 days
- ► None of the given options

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

What is the average collection period of the firm if it makes 50% of sales on 40 day credit and 50% on 50 day credit?

- ► 40 days
- ► 45 days
- ► 50 days
- ► 90 days

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Reference:
(0.5 x 40) + (0.5 + 50)
20 + 25
45 Days

Question No: 38 (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

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

In calculations regarding lease, net advantage of leasing is the difference between which of the following?

- ► Present value of net cash flows and present value of cost of leasing
- ► Present value of cost of owning the asset and present value of cost of leasing
- ► Present value of cost of owning the asset and present value of net cash flows
- ► None of the given options

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

Under efficient market, the effect of debt on WACC can be represented with the help of which of the following?

- ► Straight line
- ► U shaped curve
- ► Concave
- ► Time to time fluctuation

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

Which of the following statements is true about business risk?

- ► The financial risk of a firm decreases when it takes on a risky project
- ► The financial risk of a firm increases when it takes on more equity
- ► The business risk of a firm increases when it takes on a risky project
- ► The business risk of a firm increases when it takes on more debt

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

Which of the following refers to taking over a company and then selling its parts at a profit as the sum of target company's parts is worth less than the worth of those individual parts.

- ► Cherry picking
- ► Divestiture
- ► Spin-off
- ► Asset stripping

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

Which one of the following is correct for the forward exchange rate?

- ► It is an agreed price at which two currencies are exchanged immediately
- ► It is an agreed price at which two currencies will be exchanged at some future date
- ► It is an agreed price at which two currencies will be exchanged on a specific future date and location
- ► It is an agreed price at which two currencies are exchanged at specific location immediately

Question No: 44 (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

Reference:

F = S (Rs. / AUD) (1+ i Rs.) / (1+ I AUD)
= (76) (1+0.1) / (1+0.06)
= Rs.79 / AUD.

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

How much a hand bag costs you in Kuwaiti Dinar (KWD) if its price in Pakistan Rupee is Rs. 1770; keeping in mind the spot rate of Rs. 1 is 295 KWD?

- ► 0.167 KWD
- ► 6 KWD
- ► 295 KWD
- ► 522150 KWD

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

Which of the following document is not prepared while making a financial plan?

- ► Cash budget
- ► Pro-forma balance sheet
- ► Pro-forma income statement
- ► Cash flow statement

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

Which of the following describes a set of projects where only one project can be selected?

- ► Mutually exclusive projects
- ► Supplementary projects
- ► Complementary projects
- ► Independent projects

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

For finite investment in preferred stock the valuation formula will be:

- ► P_o = DIV1 / r_{PE}
- ► P_o = Interest yield +dividend yield
- ► $P_o = DIV1 / (1+r_{PE})^t + P_n / (1+r_{PE})^t$
- ► $P_o \times P_n / (1+r_{PE})^t = DIV1 / (1+r_{PE})^t$

Question No: 49 (Marks: 3)

What are the effects of leverage on WAAC?

Answer: <u>Real Markets Effects of leverage on WACC</u>:

- **Increase in leverage causes a large increase in cost of equity**
- **Increase in leverage causes relatively small increase in cost of debt as compared to cost of equity**

- **As leverage increases WACC 1st falls because of tax saving shield.**
- **With further increase in leverage WACC fall to its minimum point which is the optimal point for capital structure**

Question No: 50 (Marks: 3)

Management Buyouts is a form of buyouts. Explain this term in your own words.

Solution:-

Management buyouts are similar in all major legal aspects to any other acquisition of a company. The particular nature of the MBO lies in the position of the buyers as managers of the company, and the practical consequences that follow from that. In particular, the due diligence process is likely to be limited as the buyers already have full knowledge of the company available to them. The seller is also unlikely to give any but the most basic warranties to the management, on the basis that the management know more about the company than the sellers do and therefore the sellers should not have to warrant the state of the company.

Question No: 51 (Marks: 5)

Company XYZ wants to issue more Common Stock of Face Value Rs 12. Next Year the Dividend is expected to be Rs. 3 per share assuming a Dividend Growth Rate of 10% pa.

The Lawyer's fee and Stock Brokers' Commissions will cost Rs 1 per share. Investors are confident about Company ABC so the Common Share is floated at a Market Price of Rs 18 (i.e. Premium of Rs 6).

If the Capital Structure of Company ABC is entirely Common Equity, then what is the Company's WACC? Use New Stock Issuance Approach to calculate the results.

Solution:-

DIVI = 3

Po = 18

g = 10%

r = (DIV1/Po) + g

r = 3/18 + 0.10

r = 0.1666 + 0.1

r = 0.2666 *100

r = 26.67%

Net Proceeds = Flotation Price - Flotation Costs
Net Proceeds = 18 – 1
Net Proceeds = 17

DIVI = 3
NP = 17
g = 10%

r =(DIV1/NP) + g
r = 3/17 + 0.10
r = 0.176 + 0.1
r = 0.276 *100
r = 27.64%

Question No: 52 (Marks: 5)

What is the purpose of residual dividend model and what is the procedure to be followed while using this model?

Solution:-
Residual Dividend Model
• Residual Dividend Model: Best Practical Model for numerical calculations of optimal Dividend Policy. Sets Long-Term Target Dividend Payout Ratio from which to back-calculate short-term Dividends.
• Steps in Residual Dividend Model (RDM):
– Forecast Capital Budget, Earnings, Cash Flows (for next 5 years)
• Conservatism: To be on safe side, underestimate the Free Cash Flows
– Determine Target optimal Capital Structure (or Practically Speaking, "Range" for Debt
Ratio) and forecast required Equity (for next 5 years)
– Use Retained Earnings (internal capital) to finance most of the required Equity because
RE is less costly than external financing (higher transaction costs). Retained earnings cost less than loans to acquire finance.
– Leftover or "Residual" Earnings can be safely paid Out as Dividends in Long Term.
Then divide this into Small Yet Regular (may be quarterly) and Steadily Increasing Dividend Payouts.

Question No: 53 (Marks: 5)

Differentiate forward market and future market.

Solution:

The **forward market** is the over-the-counter financial market in contracts for future delivery, so called forward contracts. Forward contracts are personalized between parties (i.e., delivery time and amount are determined between seller and customer). The forward market is a general term used to describe the informal market by which these contracts are entered into. Standardized forward contracts are called futures contracts and traded on a futures exchange.

A **futures market** or **derivatives exchange** is a central financial exchange where people can trade standardized futures contracts; that is, a contract to buy specific quantities of a commodity or financial instrument at a specified price with delivery set at a specified time in the future.

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