# Final Term Papers

## Fall 2009 (Session 03)

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# MGT201

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

Which type of responsibilities are primarily assigned to Controller and Treasurer respectively?

- ► **Operational; financial management**
- ► Financial management; accounting
- ► Accounting; financial management
- ► Financial management; operations

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

Which of the following statement (in general) is correct?

- ► A low receivables turnover is desirable
- ► **The lower the total debt-to-equity ratio, the lower the financial risk for a firm**
- ► An increase in net profit margin with no change in sales or assets means a weaker ROI
- ► The higher the tax rate for a firm, the lower the interest coverage ratio

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

Which group of ratios measures a firm's ability to meet short-term obligations?

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

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

Which group of ratios measures how effectively the firm is using its assets?

- ► Liquidity ratios
- ► Debt ratios
- ► Coverage ratios
- ► **Activity ratios**

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

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



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

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

Interest payments, principal payments, and cash dividends are _____ the typical budgeting cash-flow analysis because they are _____ cash flows.

- Included in; financing
- **Excluded from; financing**
- Included in; operating
- Excluded from; operating

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

Which of the following make the calculation of NPV difficult?

- Estimated cash flows
- Discount rate
- Anticipated life of the business
- **All of the given options**

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

If a company issues bonus shares, what will be its effect on the debt equity ratio?

- It will improve
- It will deteriorate
- **No effect**
- None of the given options

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

For most firms, P/E ratios and risk_____.

- Will be directly related
- **Will have an inverse relationship**
- Will be unrelated



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► Will both increase as inflation increases

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

Which of the following is the variability of return on stocks or portfolios not explained by general market movements. It is avoidable through diversification?

► Systematic risk
► Standard deviation
► **Unsystematic risk**
► Financial risk

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

The wider the range of possible outcomes i.e._____.

► **The greater the variability in potential Returns that can occur, the greater the Risk**
► The greater the variability in potential Returns that can occur, the lesser the Risk
► The greater the variability in potential Returns that can occur, the level of risk remain constant
► None of the given options

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

Assume that the expected returns of the portfolios are the same but their standard deviations are given in the options given below, which of the option represent the most risky portfolio according to standard deviation?

► 1.5%
► 2.0%
► 3.0%
► **4.0%**

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

Which of the following is a drawback of percentage of sales method?

► It is a rough approximation
► There is change in fixed asset during the forecasted period
► Lumpy assets are not taken into account



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► **All of the given options**

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

The objective of financial management is to maximize _____ wealth.

► Stakeholders
► **Shareholders**
► Bondholders
► Directors

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

Which of the following is correct regarding the opportunity cost of capital for a project?

► The opportunity cost of capital is the return that investors give up by investing in the project rather than in securities of equivalent risk.
► Financial managers use the capital asset pricing model to estimate the opportunity cost of capital
► The company cost of capital is the expected rate of return demanded by investors in a company.
► **All of the given options**

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

Which of the following is equal to the market risk, beta, of a security?

► **The covariance between the security's return and the market return divided by the variance of the market's returns**
► The covariance between the security and market returns divided by the standard deviation of the market's returns
► The variance of the security's returns divided by the covariance between the security and market returns
► The variance of the security's returns divided by the variance of the market's returns

**Question No: 17 ( 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



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- **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: 18 ( 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: 19 ( Marks: 1 ) - Please choose one**

Why common stock of a company must provide a higher expected return than the debt of the same company?

- There is less demand for stock than for bonds
- There is greater demand for stock than for bonds
- **There is more systematic risk involved for the common stock**
- There is a market premium required for bonds

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

The ABC Company relies on preferred stock, bonds, and common stock for its long-term financing. Rank in ascending order (i.e., 1 = lowest, while 3 = highest) the likely after-tax component costs of the ABC's long-term financing.

- 1 = bonds; 2 = common stock; 3 = preferred stock
- 1 = bonds; 2 = preferred stock; 3 = common stock
- **1 = common stock; 2 = preferred stock; 3 = bonds**
- 1 = preferred stock; 2 = common stock; 3 = bonds

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

Which of the following is **NOT** a recognized approach for determining the cost of equity?

- Dividend discount model approach
- **Before-tax cost of preferred stock plus risk premium approach**



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- Capital-asset pricing model approach
- Before-tax cost of debt plus risk premium approach

**Question No: 22 ( 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

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

Your firm has a philosophy that is analogous to the hedging (maturity matching) approach. Which of the following is the most appropriate non-spontaneous form for financing the excess seasonal current asset needs?

- Trade credit
- 6-month bank notes
- Accounts payable
- **Common stock equity**

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

Which of the following is the common currency created by the group of European countries?

- The EU currency
- The European Union
- The EMU
- **The Euro**

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

Which of the following statements is most correct as it relates to the recording of a capital lease?

- The capital lease is shown on the lessee's balance sheet as an asset and amortized over the asset's useful life.



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► **The capital lease is listed as an asset on the lessor's balance sheet and amortized over lease term.**

► A capital lease is listed as an asset on the lessee's balance sheet and must be amortized over the lease period.

► A capital lease is listed as an asset on the lessee's balance sheet and must be amortized over the asset's useful life.

**Question No: 26 ( 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: 27 ( Marks: 1 ) - Please choose one**

Which of the following signals is most likely to elicit a decrease in share price for slow growth utility company that currently pays a small dividend?

► A repurchase of 5% of the firm's stock
► An unexpected increase in the regular quarterly dividend
► **An unexpected decrease in the regular quarterly dividend**
► Borrowing funds in order to pay a cash dividend

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

The presence of which of the following costs is **NOT** used as a major argument against the M&M arbitrage process?

► Transaction costs
► **Insurance costs**
► Bankruptcy costs
► Agency costs

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

Which term would most likely be associated with the phrase "actions speak louder than words?"



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- Incentive signaling
- Shareholder wealth maximization
- **Financial signaling**
- Optimal capital structure

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

When taxes are considered, the value of a levered firm equals the value of the_____.

- Unlevered firm
- Unlevered firm plus the value of the debt
- **Unlevered firm plus the present value of the tax shield**
- Unlevered firm plus the value of the debt plus the value of the tax shield

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

When financial disaster is looming, why management may borrow to invest in projects having a negative expected NPV?

- The firm's beta is now negative
- Taxes are no longer a concern
- The interest tax shield will cover the loan costs
- **The lender bears all the risk**

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

What is the present value of Rs.6,500 to be paid at the end of 8 years if the interest rate is 10% compounded annually?

- **Rs.3,032**
- Rs.3,890
- Rs.3,190
- Rs.4,301

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

What is the present value of Rs.717 to be paid at the end of 2 years if the interest rate is 9% compounded annually?

- **Rs.604**
- Rs.417

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- Rs.715
- Rs.556

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

All of the following are the components of CML (capital market line) equation EXCEPT:

- Risk free rate of return
- Risk of the market
- Risk of stock portfolio
- **Net present value**

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

In NPV (Net Present Value) calculations, which of the following is used?

- Excepted rate of return
- **Required rate of return**
- Both expected rate of return and Required rate of return
- None of the given options

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

If Share A's Beta = +2.0 then it represents which of the following?

- **Share is twice as risky (or volatile) as the KSE market**
- Share is exactly as risky (or volatile) as the KSE market
- Share is half as risky (or volatile) as the KSE market
- Share would be exactly as volatile as the KSE market BUT in the opposite way

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

Beta coefficient is actually the slope of the line that shows the relationship between which of the following?

- Stock required rate of return on x-axis and market rate of return on y-axis
- Stock required rate of return on y-axis and market rate of return on x-axis
- **Stock expected rate of return on y-axis and market rate of return on x-axis**
- Stock required rate of return on y-axis and stock expected rate of return on x-axis



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

Which of the following is/are ideal source(s) of capital for profitable firms because of no transaction costs?

- ► Sizeable Cash
- ► Retained Earnings
- ► **Both Sizeable Cash and Retained Earnings**
- ► None of the given options

**Question No: 39 ( 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: 40 ( Marks: 1 ) - Please choose one**

In the WACC equation ($r_D x_D + r_E x_E + r_P x_P$), $\mathbf{x_E}$ represents which of the following?

- ► Weight or Fraction of Total Capital value raised from bonds
- ► Weight or Fraction of Total Capital value raised from preferred stock
- ► **Weight or Fraction of Total Capital value raised from common stock**
- ► Weight or Fraction of Total Capital value raised from debentures

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

In the WACC equation ($r_D x_D + r_E x_E + r_P x_P$), $\mathbf{x_D}$ represents which of the following?

- ► **Weight or Fraction of Total Capital value raised from bonds**
- ► Weight or Fraction of Total Capital value raised from preferred stock
- ► Weight or Fraction of Total Capital value raised from common stock
- ► Weight or Fraction of Total Capital value raised from retained earnings

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

Which of the following represents the tax shield?



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- **Interest on capital**
- Dividends to shareholders
- Retained earnings
- Establishment expenses

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

On declaration date of dividend, if ABC Company announces dividend higher than the previous years, which of the following phenomenon is likely to be observe?

- Stock price falls
- **Stock price rises**
- Stock price remains the same
- None of the given options

**Question No: 44 ( 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
- None of the given options is true

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

ABC Company moves from a "conservative" working capital policy to an "aggressive" policy. Which of the following results it should expect to achieve?

- Liquidity to decrease, whereas expected profitability would increase
- **Expected profitability to increase, whereas risk would decrease**
- Liquidity would increase, whereas risk would also increase
- Risk as well as profitability to decrease

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

Mr. A, a sole proprietor has purchased the raw material on credit; this transaction has generated which of the following?

- Permanent Financing
- **Spontaneous Financing**



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- Short-term Loan
- All of the given options

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

Capital structure that minimizes the WACC is also a structure that maximizes the firm's_____.

- Earnings before interest & taxes (EBIT)
- Earning after tax (EAT)
- **Earning per share (EPS)**
- Return on equity (ROE)

**Question No: 48 ( 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: 49 ( Marks: 1 ) - Please choose one**

A car manufacturing firm buys steel from a steel mill. Both these entities combined together to form a new firm. It is referred to which of the following?

- Horizontal Merger
- **Vertical Merger**
- Congeneric Merger
- Conglomerate Merger

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

Which of the following is a form of divestiture in which a subsidiary or division becomes an independent company?

- Sell-off
- **Spin-off**
- Liquidation



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► Merger

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

From which of the following equations, net income can be calculated?

► **NI = (EBIT - $x_D$ $r_D$) (1 - Tc)**
► NI = (EAT - $x_D$ $r_D$) (1 - Tc)
► NI = (EBIT + $x_D$ $r_D$) (1 - Tc)
► NI = (EBIT - $x_D$ $r_D$) / (1 - Tc)

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

Which of the following is the formula to calculate the tax shield?

► **Corporate tax rate x Market value of debt**
► Corporate tax rate / Market value of debt
► Corporate tax rate + Market value of debt
► Corporate tax rate - Market value of debt

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

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

► It is the effective exchange rate for a foreign currency for delivery at a specific location on a specific future date
► **It is the effective exchange rate for a foreign currency for immediate delivery at a specific location**
► It is the effective exchange rate for a foreign currency for delivery at a specific future date
► It is the effective exchange rate for a foreign currency for delivery on the current day

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

What is the primary principle for money changers?

► Ask rate should be less than bid rate
► **Ask rate should be greater than bid rate**
► Ask rate should be equal to bid rate
► Bid rate should be greater than ask rate



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**Question No: 55 ( Marks: 3 )**

**If interest tax shields are valuable, why don't all taxpaying firms borrow as much as possible?**

Tax shield give us benefit up to certain level but as leverage increases Firm becomes more Risky so Lenders and Banks Charge Higher Interest Rates and Greater Chance of Bankruptcy.

**Question No: 56 ( Marks: 5 )**

**There are different methods to raise capital within the organization. Briefly explain the advantages of equity financing into the business.**

Equity financing gives the flexibility we don't need to pay fix amount. In case of bond or debt we need to pay fixed interest in case of failure there is threat of Defaulter. Mostly the advantages of equity finance are reaped by the small business enterprises. In some case debt rate is too high that time equity help you to get cheaper capital financing.

**Question No: 57 ( Marks: 5 )**

**What is long-term financing? Explain the factors that can affect the decision of a manager while deciding about long term financing?**

Long term financing is a kind of financing which is provided for a period of more than one year.

Permanent Financing comes in two forms:

• Long-term Loans - Bonds It has Low Risk for Firm but has High Cost normally more than one year.

• Common Equity or Stock its Less Risk for Firm but Highest Cost.

If a company is using long-term financing it has higher cost of financing due high interest cost of long term loans despite high cost we have low risk, due to surety of access to money for a longer period. Current liabilities as a source of financing are not reliable as you have no surety whether you will have same amount of money available next month for financing or not.

**Question No: 58 ( Marks: 10 )**

**What is a credit policy and what factors an organization should consider while designing its credit policy and how can a firm use 5/10, net 30 basis and carrying charges in its credit policy?**

**Credit Policy:** It is the credit adjusted given to customer based upon payment history.



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Factors considered for credit:

Assessment of Credit-worthiness of each credit customer

Minimize duration of credit and Value.

Give incentives to Customers to pay cash and to pay quickly

Suppose if someone pays later then last date of payment he/she will pay extra 1% etc.

**"Sell on 5/10.net 30 basis"**

30 basis Means customer will pay full cash value within 30 days. 5/10.net means 5% discount for customers who will pay within 10 days. It will be like incentive to customer who will pay early.

Impost some extra charge in the form of carry charges in case of later payment

**Question No: 59 ( Marks: 10 )**

Firms A and B are identical except their use of debt and the interest rates they pay. Firm A has more debt and thus must pay a higher interest rate.

**Requirement:**

**Based on the data given below, how much higher or lower will be the A's ROE that of B, i.e., what is $ROE_A$ - $ROE_B$?**

| Applicable to Both Firms | Firm A's Data | Firm LD's Data |
|---|---|---|
| Assets Rs. 3,000,000 | Debt ratio 70% | Debt ratio 20% |
| EBIT Rs.500, 000 | Int. rate 12% | Int. rate 10% |
| Tax rate 35% | | |

For company A 20% leverage so equity will be 30% of 3,000,000 = 900000

EBIT = 500,000

Interest (12% of 500,000) = (6000)

EBT 494,000

Tax (35% of EBT) (148200)

Net income 345,800

Expected ROE (=NI/Equity) 345,800/ (900000) = 38.42%



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For company B 20% leverage so equity will be 80% of 3,000,000 = 2400000

EBIT = 500,000
Interest (10% of 500,000) = (5000)
EBT 495,000
Tax (35% of EBT) (148500)
Net income 346,500
Expected ROE (=NI/Equity) 346500/ (2400000) = 14.43%

**$ROE_A$ – $ROE_B$ = 38.42 – 14.43**
**= 23.99**

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