Part A:

There are 25 questions in Part A, each of 2.4 points. Each of the questions has only ONE correct answer.

1. Which of the following statements is true for a stock that sells now for $60, pays an annual dividend of $4.00, and experienced a 20% return on investment over the past year? Its price one year ago was:
   A. $42.00
   B. $46.15
   C. $48.46
   D. $53.33

2. An estimation of the opportunity cost of capital for projects that have an "average" level of risk is the rate of return on:
   A. Treasury bills.
   B. the market portfolio.
   C. the market portfolio minus the rate of return on Treasury bills.
   D. Treasury bonds plus a maturity premium.

3. The standard deviations of individual stocks are generally higher than the standard deviation of the market portfolio because individual stocks:
   A. offer higher returns.
   B. have more systematic risk.
   C. have no diversification of risk.
   D. do not have unique risk.

4. An investor was expecting a 18% return on his portfolio with beta of 1.25 before the market risk premium increased from 8% to 10%. Based on this change, what return will now be expected on the portfolio?
   A. 20.0%
   B. 20.5%
   C. 22.5%
   D. 26.0%

5. A stock's risk premium is equal to the:
   A. expected market return times beta.
   B. Treasury bill yield plus expected market return.
   C. risk-free rate plus expected market risk premium.
   D. expected market risk premium times beta.

6. What would you recommend to an investor who is considering an investment which, according to its beta, plots *below* the security market line (SML)?
   A. Invest; return is high relative to risk.
   B. Don't invest; risk is high relative to return.
   C. Invest; stocks revert to the SML over time.
   D. Don't invest; stocks below the SML have too much unique risk.

7. What is the WACC for a firm using 55% equity with a required return of 15%, 35% debt with a required return of 8%, 10% preferred stock with a required return of 10%, and a tax rate of 35%?
   A. 10.72%
   B. 11.07%
   C. 11.70%
   D. 12.05%

8. What is the book value per share of equity for a firm with $1 million in net common equity, $50,000 in authorized share capital, 25,000 shares issued, and 20,000 shares outstanding?
   A. $38.00
   B. $40.00
   C. $47.50
   D. $50.00

9. Bonds that have been sold only to a limited number of institutional investors are considered:
   A. secured bonds.
   B. convertible bonds.
   C. private placements.
   D. indexed bonds.

10. Which of the following is true regarding convertible securities:
   A. A convertible bondholder is forced to convert at a specific time.
   B. The convertible option on a bond gives the owner the right to buy shares from a company at a set price.
   C. The owner of a warrant option will benefit if the firm's stock does poorly.
   D. The owner of a warrant option will benefit if the firm's stock does well.

11. When securities are issued under a rights issue:
   A. existing shareholders have the opportunity to expand their holdings.
   B. shares are offered to the public at a discount.
   C. the existing shares will increase in price.
   D. current shareholders have the right to resell their stock to the issuer.

12. If the announcement of a new equity offering causes current equity values to drop, then signaling theory would predict that:
    A. supply of equity will outstrip demand.
    B. management knows the issue to be overpriced.
    C. the firm has no attractive investment opportunities.
    D. underwriters charge too high a spread.

13. The "winner's curse" is a reminder that:
    A. successful bidders may often overpay for an object.
    B. underwriters charge excessive fees.
    C. stocks are much riskier than bonds.
    D. underpricing an issue is a cost to existing owners.

14. An increase in a firm's financial leverage will:
    A. increase the variability in earnings per share.
    B. reduce the operating risk of the firm.
    C. increase the value of the firm in a non-MM world.
    D. increase the WACC.

15. Financial risk refers to the:
    A. risk of owning equity securities.
    B. risk faced by equityholders when debt is used.
    C. general business risk of the firm.
    D. possibility that interest rates will increase.

16. An implicit cost of adding debt to the capital structure is that it:
    A. adds interest expense to the operating statement.
    B. increases the required return on equity.
    C. reduces the expected return on assets.
    D. decreases the firm's beta.

17. The "trade-off theory" of capital structure suggests that:
    A. firms add leverage whenever interest rates are low.
    B. firms with higher risk should use less debt.
    C. firms should use 50% debt and 50% equity.
    D. firms should use debt to overcome high par values of stock.

18. According to pecking order theory, managers will often choose to finance with:
    A. new equity rather than debt, due to bankruptcy costs.
    B. debt rather than new equity, to avoid reduced share price.
    C. debt rather than retained earnings, to lower the WACC.
    D. new equity rather than debt, to strengthen EPS.

19. As a firm's debt/equity ratio approaches zero, the firm's expected return on equity approaches:
   A. the expected return on debt.
   B. the expected return on assets.
   C. its maximum.
   D. zero.

20. What would you expect to happen to the price of a share of stock on the day it goes ex-dividend? The price should:
   A. increase by the amount of the dividend.
   B. decrease by the amount of the dividend.
   C. decrease by one-half the amount of the dividend.
   D. remain constant.

21. An increase in dividends might not increase price and may actually decrease stock price if:
   A. the dividend increase cannot be sustained.
   B. the firm does not maintain an exact dividend payout ratio.
   C. the firm has too much retained earnings.
   D. markets are weak-form efficient.

22. A dividend clientele effect assumes that:
   A. investors prefer higher rather than lower dividends.
   B. shareholders are indifferent regarding dividends.
   C. investors have specific dividend preferences.
   D. investors are making "homemade" dividends.

23. Dividend changes are typically viewed by investors as signals of future changes in:
   A. investment.
   B. the firm's WACC.
   C. earnings.
   D. the clientele effect.

24. A stock's beta measures the:
   A. average return on the stock.
   B. variability in the stock's returns compared to that of the market portfolio.
   C. difference between the return on the stock and return on the market portfolio.
   D. market risk premium on the stock.

25. Studies have shown that, on average, new security issues are:
   A. subject to flotation costs of approximately 32%.
   B. overpriced by the amount of the spread.
   C. underpriced.
   D. overpriced to reward venture capitalists.

Part B:

There are 10 questions in Part B, each of 4 points.

Question 1

What is an agency problem? Give two examples of decisions by managers that lead to agency costs.

Question 2

Construct a balance sheet for Sophie's Sofas given the following data. What is shareholders' equity?

Cash balances = $10,000
Inventory of sofas = $200,000
Store and property = $100,000
Accounts receivable = $22,000
Accounts payable = $17,000
Long-term debt = $170,000

Question 3

Explain why accounting income generally will differ from a firm's cash inflows.

Question 4

Suppose your firm is going to finance a new project 100% with retained earnings. Your boss claims that since the earnings are already being retained and that since no outside financing is required, the project should be evaluated at the risk-free rate of return. Is this appropriate? Why?

Question 5

A 2-year maturity bond with face value of $1,000 makes annual coupon payments of $80 and is selling at face value. What will be the rate of return on the bond if its yield to maturity at the end of the year is 6%?

Question 6

Castles in the Sand generates a rate of return of 20% on its investments and maintains a plowback ratio of 0.30. Its earnings this year will be $4 per share. Investors expect a 12% rate of return on the stock.

a. Find the price and P/E ratio of the firm.
b. What happens to the P/E ratio if the plowback ratio is reduced to 0.20? Why?
c. Show that of plowback equals zero, the earnings-price ratio, E/P, falls to the expected rate of return on the stock.

Question 7

You are a manager with an investment budget of $8 million. You may invest in the following projects. Investment and cash-flow figures are in millions of dollars.

Project	Discount Rate, %	Investment	Annual Cash Flow	Project Life, Years
A	10	3	1	5
B	12	4	1	8
C	8	5	2	4
D	8	3	1.5	3
E	12	3	1	6

a. Why might these projects have different discount rates?
b. Which projects should the manager choose?
c. Which projects will be chosen if there is no capital rationing?

Question 8

A firm is considering an investment in a new manufacturing plant. The site already is owned by the company, but existing buildings would need to be demolished. Which of the following should be treated as incremental cash flows?

a. The market value of the site.
b. The market value of the existing buildings.
c. Demolition costs and site clearance.
d. The cost of a new access road put in last year.
e. Lost cash flows on other projects due to executive time spent on the new facility.

Question 9

An auto plant that costs $100 million to build can produce a new line of cars that will produce cash flows with a present value of $140 million if the line is successful but only $50 million if it is unsuccessful. You believe that the probability of success is only about 50%. You learn whether the line is successful immediately after building the plant.

a. Would you build the plant?
b. Suppose that the plant can be sold for $95 million to another automaker if the auto line is not successful. Now would you build the plant?

Question 10

Give two examples of the types of costs incurred by firms in financial distress.

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