

VU Learning HUB

ACC501 Quiz File

Chapter-wise Solved MCQs

vulearninghub.xyz

Lesson 1: Business Finance

1. Which of the following is ONE of the four basic areas of finance outlined in the handout? A) Managerial Accounting B) Investments C) Cost Control D) Tax Auditing
2. What primary question does Business Finance address? A) How to set personal retirement savings goals B) What long-term investments the firm should engage in C) How to audit government regulatory compliance D) How to manage international trade quotas
3. Financial assets such as stocks and bonds are primarily dealt with under which area of finance? A) International Accounting B) Investments C) Cost Accounting D) Human Resource Management
4. Which of the following is a career opportunity directly listed under investments? A) Tax Manager B) Cost Accountant C) Security Analysis D) Credit Manager

Answer Key

1. B — Investments is identified as one of the four basic areas of finance alongside Business Finance, Financial Institutions, and International Finance.
2. B — Business Finance addresses long-term investment decisions, raising capital, and managing short-term cash flows.
3. B — The area of investments specifically deals with financial assets such as stocks and bonds.
4. C — Security analysis, portfolio management, and stock brokerage are explicit career opportunities listed under investments.

Lesson 2: Why Study Finance?

1. Why is a knowledge of finance vital for marketing professionals? A) Marketers must calculate corporate tax liabilities for shareholders B) Marketers work with budgets and require cost-benefit analysis for programs and product pricing C) Marketers handle corporate bankruptcy liquidations D) Marketers prepare official regulatory financial filings
2. What is defined as the process of planning and managing a firm's long-term investments? A) Working Capital Management B) Capital Budgeting C) Capital Structure D) Financial Accounting
3. Which of the following is one of the three core financial management decisions? A) Inventory Valuation B) Capital Structure C) Auditing Standards D) Market Segmentation
4. What is the primary concern of a financial manager when evaluating capital budgeting decisions? A) Historical cost of fixed assets B) Size, timing, and risk of expected future cash flows C) Par value of common stock D) Depreciation methods used by industry competitors

Answer Key

1. B — Finance is vital in marketing because marketers work with budgets, pricing, and cost-benefit analysis of projects.
2. B — Capital budgeting is explicitly defined as the process of planning and managing a firm's long-term investments.
3. B — The three main financial management decisions are Capital Budgeting, Capital Structure, and Working Capital Management.

4. B — Evaluating the size, timing, and risk of expected future cash flows forms the essence of capital budgeting.

Lesson 3: The Corporate Firm

1. Which form of business organization is described as the standard method for solving problems in raising large amounts of cash? A) Sole Proprietorship B) General Partnership C) Corporation D) Limited Partnership
2. What is a primary advantage of a sole proprietorship? A) Unlimited life of the business B) Single owner keeps all profits and income is taxed once as personal income C) Limited liability for all operational debts D) Easy transfer of ownership interest
3. In a limited partnership, what is the liability status of limited partners? A) Unlimited liability for all business obligations B) Liability is limited to their financial contribution C) Jointly liable for all general partners' personal debts D) Fully liable for corporate tax penalties
4. What is the Agency Problem in a corporate firm? A) A conflict between tax authorities and internal auditors B) A conflict of interest between stockholders (principals) and managers (agents) C) A dispute between bondholders and commercial banks D) A disagreement over market share between competitors

Answer Key

1. C — The corporate form of business is the standard method for solving problems encountered in raising large amounts of cash.
2. B — A sole proprietorship is easy to start and allows the single owner to keep all profits while being taxed once as personal income.
3. B — Limited partners do not actively participate in management, and their liability is limited to their contribution.
4. B — The agency problem refers to the conflict of interest between stockholders (principals) and firm managers (agents).

Lesson 4: The Firm and The Financial Markets

1. What type of financial market is involved when a corporation issues new securities and cash flows directly from investors to the firm? A) Secondary Market B) Primary Market C) Money Market Exchange D) Over-the-Counter Dealer Resale Market
2. Transactions involving the resale of "used" securities between investors occur in which market? A) Primary Market B) Secondary Market C) Money Creation Market D) Initial Public Offering (IPO) Market
3. According to the balance sheet identity, Total Assets are strictly equal to: A) Total Liabilities minus Stockholders' Equity B) Total Liabilities plus Stockholders' Equity C) Current Assets plus Net Working Capital D) Fixed Assets minus Retained Earnings
4. How do auction markets differ from dealer markets? A) Auction markets operate without any central trading location B) Trading in a given auction exchange takes place at a single site on the floor of the exchange C) Dealer markets do not maintain any security inventory D) Auction market transaction prices are kept strictly confidential

Answer Key

1. B — In the primary market, new securities are issued by the corporation, flowing cash directly from investors to the firm.
2. B — Secondary markets involve the sale of previously issued ("used") securities from one investor to another.
3. B — The balance sheet identity states that Assets equal Liabilities plus Stockholder's Equity.
4. B — Auction markets take place at a single site on the exchange floor, whereas dealer markets operate over-the-counter.

Lesson 5: The Income Statement

1. While the balance sheet can be viewed as a snapshot of a firm, the income statement is best described as a: A) Static balance ledger B) Video recording covering a specific period of time C) Tax exemption certificate D) Liquidity schedule
2. What is the fundamental accounting definition of income? A) Assets – Liabilities B) Revenue – Expenses C) Operating Cash Flow + Depreciation D) Sales – Dividends
3. Under Generally Accepted Accounting Principles (GAAP), the realization principle dictates that revenue is recognized: A) Only when cash is physically collected B) At the time of sale when the earning process is complete C) When dividends are declared by the board of directors D) At the end of the fiscal tax year
4. On the income statement, which expense item is treated as a non-cash item? A) Interest Expense B) Cost of Goods Sold C) Depreciation D) Current Taxes

Answer Key

1. B — The income statement measures performance over a period of time, like a video recording relative to a balance sheet snapshot.
2. B — The accounting definition of income is Revenue minus Expenses.
3. B — The realization principle recognizes revenue when the earning process is complete at the time of sale, regardless of when cash is collected.
4. C — Depreciation is a non-cash item recorded on the income statement.

Lesson 6: Depreciation as a Tax Shield

1. Although depreciation is a non-cash expense, what crucial financial function does it perform? A) Increases gross revenue directly B) Serves as a tax shield by reducing taxable income C) Decreases long-term debt liabilities D) Directly generates cash inflows from customers
2. How can the tax shield generated by depreciation be calculated directly? A) Depreciation $\times$ EBIT B) Depreciation $\times$ Corporate Tax Rate C) Net Income $\div$ Depreciation D) Operating Cash Flow $\div$ Tax Rate
3. When calculating Operating Cash Flow (OCF), why is interest expense excluded? A) Interest is a non-cash expense B) Interest is a financing expense, not an operating expense C) Interest is added to net fixed assets D) Interest is already included in current assets

4. Which item is added back to EBIT when calculating Operating Cash Flow (OCF)? A) Dividends Paid B) Depreciation C) Capital Spending D) Additions to Net Working Capital

Answer Key

1. B — Depreciation provides the important function of shielding part of a firm's income from taxation.
2. B — The depreciation tax shield is calculated directly as Depreciation multiplied by the Corporate Tax Rate.
3. B — Interest expense is excluded from OCF because it is a financing expense rather than an operating expense.
4. B — Operating Cash Flow is calculated as EBIT plus Depreciation minus current taxes.

Lesson 7: The Statement of Cash Flows

1. What official accounting statement explains the changes in accounting cash over a specific period? A) The Balance Sheet B) The Statement of Retained Earnings C) The Statement of Cash Flows D) The Trial Balance

2. Which of the following is ONE of the three main components of the Statement of Cash Flows? A) Cash flow from credit management B) Cash flow from investing activities C) Cash flow from tax refunds D) Cash flow from inventory valuation

3. Cash flow from investing activities primarily involves changes in which area? A) Short-term payables and receivables B) Capital assets (acquisition and sale of fixed assets) C) Dividends paid to common stockholders D) Short-term bank loans

4. How do you begin calculating cash flow from operating activities on the Statement of Cash Flows? A) Start with total sales revenue and subtract current assets B) Start with Net Income, add back noncash items like depreciation, and adjust for changes in current assets and liabilities C) Start with Long-Term Debt and add interest paid D) Start with Retained Earnings and subtract dividends

Answer Key

1. C — The Statement of Cash Flows is the official accounting statement that explains changes in accounting cash.
2. B — The three components are cash flows from operating activities, investing activities, and financing activities.
3. B — Cash flow from investing activities involves changes in capital assets, such as fixed asset acquisitions and sales.
4. B — Calculating cash flow from operations begins with net income, adds back noncash expenses like depreciation, and adjusts for NWC changes.

Lesson 8: Common-Size Statements

1. A standardized financial statement that expresses each line item as a percentage instead of dollar amounts is known as a: A) Comparative Balance Sheet B) Common-Size Statement C) Cash Flow Statement D) Pro Forma Income Statement

2. On a common-size balance sheet, all items are typically expressed as a percentage of: A) Total Sales Revenue B) Total Assets C) Net Income D) Total Current Liabilities

3. On a common-size income statement, all items are typically expressed as a percentage of: A) Total Assets B) Net Sales C) Total Equity D) Retained Earnings

4. Why is inventory considered the least liquid current asset when evaluating the Quick (Acid-Test) Ratio? A) Inventory cannot be converted into cash under any circumstances B) Book values of inventory are least reliable and quality/obsolescence is not guaranteed C) Inventory is already included in fixed assets D) Inventory is taxed at a higher rate than cash

Answer Key

1. B — A common-size statement standardizes financial statements by presenting all items in percentages.
2. B — On common-size balance sheets, items are shown as a percentage of total assets.
3. B — On common-size income statements, items are presented as a percentage of sales.
4. B — Inventory is least liquid because book values are least reliable and items may be damaged, obsolete, or lost.

Lesson 9: Ratio Analysis

1. If a firm uses \$1 in cash to pay down \$1 in current liabilities when its current ratio is 2.0 (\$4 current assets / \$2 current liabilities), what happens to the current ratio? A) It decreases to 1.0 B) It remains unchanged at 2.0 C) It increases to 3.0 D) It drops to zero

2. Long-term solvency ratios (financial leverage ratios) are primarily designed to address a firm's ability to: A) Sell inventory quickly B) Meet its long-term financial obligations C) Pay dividends to shareholders D) Minimize corporate income taxes

3. What does the Times Interest Earned (TIE) or Interest Coverage Ratio measure? A) The firm's ability to cover its short-term inventory purchases B) The firm's ability to cover its interest payment obligations C) The percentage of net income paid out as dividends D) The turnover rate of accounts payable

4. The Equity Multiplier can be calculated as Total Assets divided by Total Equity, or alternatively as: A) $1 - \text{Total Debt Ratio}$ B) $1 + \text{Debt-Equity Ratio}$ C) $\text{Total Debt} / \text{Net Income}$ D) $\text{Current Assets} / \text{Current Liabilities}$

Answer Key

1. C — Paying equal liabilities when the current ratio is > 1 increases the ratio (from $\$4/\$2 = 2$ to $\$3/\$1 = 3$).
2. B — Long-term solvency ratios address a firm's long-run ability to meet its obligations.
3. B — Times Interest Earned measures the firm's ability to cover its interest obligations.
4. B — The Equity Multiplier equals $\text{Total Assets} / \text{Total Equity}$, which is also equal to $1 + \text{Debt-Equity ratio}$.

Lesson 10: Ratio Analysis (Cont...)

1. The Capital Intensity Ratio is defined as the reciprocal of Total Asset Turnover and measures: A) The profit generated per dollar of debt B) The dollar investment in assets needed to generate \$1 in sales C) The ratio of current assets to fixed assets D) The number of days required to collect accounts receivable

2. How is Profit Margin calculated? A) $\text{Operating Cash Flow} / \text{Total Equity}$ B) $\text{Net Income} / \text{Sales}$ C) $\text{Gross Profit} / \text{Fixed Assets}$ D) $\text{EBIT} / \text{Total Assets}$

3. What does Return on Assets (ROA) measure? A) Profit per dollar of sales B) Profit per dollar of total assets C) Total debt per dollar of equity D) Market value per dollar of book value
4. A Market-to-Book ratio of less than 1.0 generally indicates that the firm: A) Has created substantial value for its stockholders B) Has not been successful overall in creating value for its stockholders C) Maintains a zero-debt financial structure D) Has an infinitely high dividend payout ratio

Answer Key

1. B — The Capital Intensity Ratio is the reciprocal of total asset turnover and indicates asset investment required for \$1 in sales.
2. B — Profit Margin is computed as Net Income divided by Sales.
3. B — Return on Assets (ROA) measures profit generated per dollar of total assets.
4. B — A Market-to-Book value less than 1 suggests the firm has not been successful overall in creating shareholder value.

Lesson 11: The Du Pont Identity

1. According to the Du Pont Identity, Return on Equity (ROE) can be decomposed into which three component ratios? A) Current Ratio, Quick Ratio, and Net Profit Margin B) Profit Margin, Total Asset Turnover, and Equity Multiplier C) Debt-Equity Ratio, Times Interest Earned, and Return on Assets D) Gross Profit Margin, Inventory Turnover, and Capital Intensity Ratio
2. What is the portion of Net Income not paid out as cash dividends called? A) Dividend Payout B) Plowback Ratio (Retention Ratio) C) Capital Gains Yield D) Interest Tax Shield
3. If a firm pays out 33% of its Net Income as dividends, what is its retention ratio? A) 33% B) 67% C) 100% D) 0%
4. Which of the following is NOT one of the four main factors determining a firm's sustainable growth rate? A) Profit Margin B) Total Asset Turnover C) Dividend Policy D) Historical Par Value of Stock

Answer Key

1. B — The Du Pont Identity expresses ROE as the product of Profit Margin, Total Asset Turnover, and Equity Multiplier.
2. B — The leftover net income after cash dividends is retained in the firm and is known as the retention ratio or plowback ratio.
3. B — The retention ratio is calculated as 1 minus the dividend payout ratio ($1 - 0.33 = 0.67$ or 67%).
4. D — A firm's sustainable growth rate depends explicitly on profit margin, total asset turnover, financial policy, and dividend policy.

Lesson 12: Using Financial Statements Information

1. What fundamental financial concept states that a dollar in hand today is worth more than a dollar promised at some time in the future? A) Realization Principle B) Time Value of Money C) Matching Principle D) Cost Accounting Identity
2. How is simple interest calculated over time? A) $\text{Principal} \times \text{Interest Rate} \times \text{Time}$ B) $\text{Principal} \div (1 + \text{Interest Rate})$ C) $\text{Net Income} \times \text{Tax Rate}$ D) $\text{Total Assets} \times \text{Equity Multiplier}$

3. What is a key limitation when benchmarking financial statement information across international firms? A) Absence of double-entry accounting rules B) Differing accounting standards and procedures in different parts of the world C) Inability to calculate net working capital D) Uniform interest rates across all global central banks
4. How does compound interest differ from simple interest? A) Compound interest is calculated only on the initial principal B) Compound interest earns interest on both the original principal and interest accumulated from prior periods C) Compound interest is used only for short-term periods under 90 days D) Compound interest ignores the time period variable

Answer Key

1. B — The time value of money refers to the fact that a dollar today is worth more than a dollar promised in the future.
2. A — Simple interest is calculated by multiplying principal (P) by interest rate (r) and time (t).
3. B — Financial statement comparison is complicated by different accounting standards and procedures across countries.
4. B — Compound interest credits interest on accumulated principal plus prior credited interest over time.

Lesson 13: Future Value

1. What is Future Value (FV)? A) The current discounted worth of a cash flow B) The amount an investment will grow to over a period of time at a given interest rate C) The initial amount deposited at time zero D) The tax savings generated by depreciation
2. In the multi-period future value formula $FV = C_0 \times (1+r)^t$, what is the expression $(1+r)^t$ called? A) Present Value Interest Factor B) Future Value Interest Factor (FVIF) C) Capital Intensity Factor D) Annuity Discount Coefficient
3. If \$100 is invested at a 10% compound interest rate for 3 years, what will its ending future value be? A) \$130.00 B) \$133.10 C) \$146.41 D) \$110.00
4. For short-term certificates of deposit (under one year), financial institutions typically calculate total proceeds using: A) Perpetuity discounting B) Simple interest formula adapted for fractional year periods C) Equity multiplier compounding D) MACRS depreciation schedules

Answer Key

1. B — Future value refers to the cash value an investment will grow to over time at a specified interest rate.
2. B — The expression $(1+r)^t$ is defined as the future value interest factor.
3. B — Compounding \$100 at 10% yields \$110 in Year 1, \$121 in Year 2, and \$133.10 at the end of Year 3.
4. B — For interest periods less than one year, simple interest using a fractional year ($t/365$) is standard practice.

Lesson 14: Evaluating Investments

1. What is Present Value (PV)? A) The cash value an investment will accumulate in 10 years B) The current value of future cash flows discounted at an appropriate discount rate C) The total dividend yield plus capital gains yield D) The book value of fixed assets minus accumulated depreciation

2. Calculating the present value of a future cash flow to determine its worth today is commonly called: A) Compounding forward analysis B) Discounted Cash Flow (DCF) valuation C) Ratio standardization D) Financial leverage restructuring
3. According to the Rule of 72, approximately how long will it take an investment to double at a 10% annual rate of return? A) 5.0 years B) 7.2 years C) 10.0 years D) 12.0 years
4. What is the relationship between the Present Value factor $1/(1+r)^t$ and the Future Value factor $(1+r)^t$? A) They are identical B) The present value factor is the reciprocal of the future value factor C) The present value factor is always twice the future value factor D) There is no mathematical relationship between them

Answer Key

1. B — Present value is the current value of future cash flows discounted at an appropriate interest rate.
2. B — Finding the present value of future cash flows is known as discounted cash flow (DCF) valuation.
3. B — Under the Rule of 72, time to double money is approximately $72/r\% = 72/10 = 7.2$ years.
4. B — The present value factor $1/(1+r)^t$ is the mathematical reciprocal of the future value factor $(1+r)^t$.

Lesson 15: Annuities

1. A series of constant or level cash flows that occur at the END of each period for a fixed number of periods is defined as a(n): A) Perpetuity B) Ordinary Annuity C) Annuity Due D) Pure Discount Loan
2. How does an Annuity Due differ from an Ordinary Annuity? A) Cash flows occur at the beginning of each period rather than the end B) Cash flows continue indefinitely forever C) Cash flows vary in amount every period D) Principal is repaid as a single lump sum at maturity
3. What is the mathematical relationship between the value of an Annuity Due and an Ordinary Annuity? A) Annuity Due Value = Ordinary Annuity Value $\div (1+r)$ B) Annuity Due Value = Ordinary Annuity Value $\times (1+r)$ C) Annuity Due Value = Ordinary Annuity Value + Principal D) Annuity Due Value = Ordinary Annuity Value $\times r$
4. In the present value of an annuity formula $PVA = C \times [1 - [1/(1+r)^t]]/r$, the term in brackets is called: A) Present Value Interest Factor of an Annuity (PVIFA) B) Capital Intensity Coefficient C) Retention Ratio D) Effective Annual Rate

Answer Key

1. B — An ordinary annuity is a series of constant cash flows occurring at the end of each period for a fixed duration.
2. A — An annuity due features cash flows that occur at the beginning of each period.
3. B — The value of an annuity due is equal to the ordinary annuity value multiplied by $(1+r)$.
4. A — The bracketed expression in the annuity formula is the Present Value Interest Factor of an Annuity (PVIFA).

Lesson 16: Perpetuities

1. What is a perpetuity in business finance? A) A cash flow stream that increases at a variable rate for 10 years B) A constant stream of cash flows that continues indefinitely forever C) A

single lump-sum payment received at maturity D) An annuity whose payments occur only at the beginning of each quarter

2. How is the Effective Annual Rate (EAR) calculated given a quoted annual interest rate and m compounding periods per year? A) $\text{EAR} = \text{Quoted Rate} \times m$ B) $\text{EAR} = (1 + \text{Quoted Rate}/m)^m - 1$ C) $\text{EAR} = \text{Quoted Rate}/(1+m)$ D) $\text{EAR} = (1 + \text{Quoted Rate}) \times m - 1$

3. What is the key distinction between the Annual Percentage Rate (APR) and the Effective Annual Rate (EAR)? A) APR includes continuous compounding, while EAR ignores compounding B) APR is the rate per period multiplied by periods per year, whereas EAR reflects the actual annual interest accounting for compounding C) APR applies only to corporate bonds, while EAR applies only to stock dividends D) APR is always higher than EAR for any compounding frequency

4. Which type of loan requires the borrower to pay interest each period and repay the entire principal amount as a single lump sum in the future? A) Pure Discount Loan B) Interest-Only Loan C) Amortized Loan with fixed principal deductions D) Growing Perpetuity Loan

Answer Key

1. B — A perpetuity is an annuity in which the level stream of cash flows continues indefinitely forever.
2. B — The formula for calculating EAR from a quoted rate with m compounding periods per year is $(1 + \text{Quoted rate}/m)^m - 1$.
3. B — APR is the quoted rate per period times the number of periods, whereas EAR measures the true annual rate after compounding.
4. B — An interest-only loan calls for the borrower to pay interest each period and repay the full principal at maturity.

Lesson 17: Bonds

1. What is the stated principal or par value of a corporate bond that is repaid at maturity? A) Coupon Rate B) Face Value C) Yield to Maturity D) Call Premium

2. The regular interest payments promised by a bond issuer to the bondholder are known as: A) Dividends B) Coupons C) Capital gains D) Retained earnings

3. When market interest rates rise above a bond's coupon rate, what happens to the bond's price? A) The price increases above face value B) The price declines below face value, causing it to sell at a discount C) The price remains unchanged at par value D) The coupon rate automatically increases to match the market rate

4. The interest rate required in the financial market for a bond is referred to as its: A) Coupon Rate B) Yield to Maturity (YTM) C) Dividend Yield D) Capital Intensity Ratio

Answer Key

1. B — Face value (or par value) is the principal amount of a bond that is repaid at the end of the loan term.
2. B — The stated interest payments made on a bond are called coupons.
3. B — When interest rates rise, the present value of remaining cash flows declines, leading the bond to sell at a discount.
4. B — Yield to maturity is the market-required rate of return on a bond.

Lesson 18: Valuing A Bond

1. According to general bond valuation principles, a bond's total market value equals the sum of which two components? A) Present value of current assets and present value of equity B) Present value of coupon payments (annuity) and present value of face value (lump sum) C) Future value of dividends and future value of operating cash flows D) Book value of debt and market value of inventory
2. When valuing a bond that pays semiannual coupons, how are the parameters adjusted? A) Double the annual coupon, double the YTM, and divide the maturity years by 2 B) Halve the annual coupon, halve the YTM per period, and double the number of periods C) Multiply the face value by 2 and leave all other variables unchanged D) Use simple interest calculations for the entire term
3. All other factors being equal, how does time to maturity affect a bond's interest rate risk? A) Longer maturity bonds have lower interest rate risk B) Longer maturity bonds have greater interest rate risk C) Time to maturity has no effect on interest rate risk D) Interest rate risk disappears completely for 30-year bonds
4. All other factors being equal, which type of bond is more sensitive to changes in market interest rates? A) A bond with a higher coupon rate B) A bond with a lower coupon rate C) A bond selling above par value D) A zero-risk government treasury bill

Answer Key

1. B — A bond's value is calculated by adding the present value of its coupon annuity to the present value of its face value lump sum.
2. B — For semiannual coupon bonds, the coupon payment and required rate are halved while the time periods are doubled.
3. B — All else equal, the longer the time to maturity, the greater the bond's price sensitivity to interest rate changes.
4. B — Bonds with lower coupon rates have greater interest rate risk because their value depends more on the distant face value.

Lesson 19: Bond Pricing Theorems

1. What is the fundamental relation between bond prices and market interest rates? A) They move in the same direction B) They move in opposite directions C) They are completely independent of each other D) They move proportionally with the inflation rate only
2. If a bond's coupon rate is greater than the market's required return (YTM), the bond will sell at: A) A discount B) A premium (market value greater than par value) C) Par value D) Zero value
3. Given two bonds that are identical except for their maturity, how do their prices react to a given change in interest rates? A) The shorter-term bond price changes more B) The longer-term bond price changes more C) Both bond prices change by the exact same dollar amount D) Neither bond price reacts to interest rate changes
4. Why is calculating the Yield to Maturity (YTM) for a coupon bond from its market price typically done using trial and error? A) Financial markets do not allow exact mathematical calculations B) The unknown rate r appears in both the annuity factor and the lump-sum discounting factor, preventing direct algebraic isolation C) YTM changes continuously every

second D) Par values fluctuate daily**Answer Key**

1. B — Bond prices and market interest rates always move in opposite directions.
2. B — When a bond's coupon rate is greater than the market's required return, its market price exceeds par value (premium bond).
3. B — The price of a longer-term bond changes more than that of a shorter-term bond for a given change in interest rates.
4. B — Solving for YTM algebraically is complex because the rate is in both annuity and lump-sum terms, requiring trial and error.

Lesson 20: The Bond Indenture

1. What is the bond indenture? A) A government tax receipt issued to corporate borrowers B) A legal contract between the bond-issuing corporation and the bondholders C) An equity trading contract on the stock exchange floor D) A short-term commercial loan agreement
2. Who is appointed by the corporate issuer to represent and protect the bondholders' interests? A) A credit rating analyst B) A trustee (such as a trust company or bank) C) The Chief Financial Officer D) A primary market dealer
3. A provision in the indenture that allows the issuing firm to repurchase or "call" part or all of the bond issue at stated prices before maturity is called a: A) Put provision B) Call provision C) Sinking fund provision D) Protective covenant
4. What do corporate bond ratings assigned by agencies such as Moody's or Standard & Poor's measure? A) Interest rate risk B) The creditworthiness of the issuer and the possibility of default C) Expected capital gains yield D) Inflation risk premium

Answer Key

1. B — The bond indenture is the legal agreement between the corporate issuer and the lenders specifying all terms of the issue.
2. B — A trustee is hired to monitor compliance with the indenture and represent bondholders.
3. B — A call provision gives the company the right to buy back bonds before maturity at a specified price.
4. B — Bond ratings assess creditworthiness and default risk, not interest rate risk.

Lesson 21: Different Types of Bonds

1. Which type of bond pays no periodic coupon and is offered at a price significantly lower than its stated par value? A) Floating-Rate Bond B) Income Bond C) Zero Coupon Bond D) Convertible Bond
2. A bond whose coupon payments are periodically adjusted relative to an interest rate index (such as Treasury bills) is called a: A) Zero Coupon Bond B) Floating-Rate Bond C) Pure Discount Bond D) Fixed-Rate Debenture
3. What relationship does the Fisher Effect describe? A) The relationship between the book value and market value of equity B) The exact relationship between nominal interest rates, real interest rates, and inflation C) The ratio of current assets to current liabilities D) The relationship between coupon rates and bond call premiums

4. If the nominal interest rate is 15.5% and the inflation rate is 5%, what is the exact real rate of return according to the Fisher Effect? A) 10.5% B) 10.0% C) 20.5% D) 7.75%

Answer Key

1. C — A zero coupon bond pays no periodic coupon and is offered at a deep discount below its face value.
2. B — Floating-rate bonds feature adjustable coupon payments tied to an underlying interest rate index.
3. B — The Fisher Effect defines the exact relationship between nominal return (R), real return (r), and inflation (h) as $1+R=(1+r)\times(1+h)$.
4. B — Solving $1.155/1.05=1.10$ yields an exact real return of 10%.

Lesson 22: Term Structure of Interest Rates

1. The term structure of interest rates represents the relationship between: A) Corporate bond coupons and stock dividend yields B) Short-term and long-term interest rates on default-free, pure discount bonds C) Preferred stock dividends and common stock capital gains D) Accounting net income and operating cash flow

2. Which factor primarily influences the overall level of interest rates rather than determining the shape of the term structure? A) Interest rate risk premium B) Real rate of interest C) Liquidity premium D) Taxability premium

3. The compensation investors demand for bearing the greater price fluctuation risk of longer-term bonds is called the: A) Default risk premium B) Interest rate risk premium C) Taxability premium D) Dividend yield premium

4. How does the Treasury yield curve differ from the term structure of interest rates? A) The yield curve is based on coupon bond yields, whereas the term structure is based on pure discount bonds B) The yield curve includes default risk, whereas the term structure does not C) The yield curve applies only to corporate debt, while the term structure applies only to municipal bonds D) There is no structural difference; both use identical debt instruments

Answer Key

1. B — The term structure reflects nominal interest rates on default-free, pure discount bonds across maturities.
2. B — The real rate of interest influences the overall level of interest rates rather than the shape of the curve.
3. B — An interest rate risk premium compensates investors for bearing price sensitivity on longer maturities.
4. A — The Treasury yield curve relies on coupon bond yields, whereas the term structure uses pure discount bonds.

Lesson 23: Zero Growth Stocks

1. How is a share of common stock with constant, unchanging dividend payments (zero growth) valued? A) As an ordinary perpetuity ($P_0=D/R$) B) As a zero coupon bond maturing in 30 years C) As a growing annuity with rate g D) By multiplying Earnings Per Share by the total debt ratio

2. If a company pays a constant dividend of \$10 per share indefinitely and the required rate of return is 20%, what is the value of the stock today? A) \$20 B) \$50 C) \$100 D) \$200

3. Under the Dividend Growth Model, what is the formula for the next expected dividend (D_1) given the dividend just paid (D_0) and growth rate (g)? A) $D_1 = D_0 / (1+g)$ B) $D_1 = D_0 \times (1+g)$ C) $D_1 = D_0 + R$ D) $D_1 = D_0 \times (R-g)$
4. What essential condition must hold for the constant dividend growth formula $P_0 = D_1 / (R-g)$ to be valid? A) The growth rate g must be strictly greater than the discount rate R B) The growth rate g must be strictly less than the required return R C) The stock must have a finite maturity period D) The dividend yield must equal zero

Answer Key

1. A — Zero growth stocks pay level dividends indefinitely, making them equivalent to ordinary perpetuities ($P_0 = D/R$).
2. B — Applying the perpetuity equation gives $P_0 = \$10 / 0.20 = \50 per share.
3. B — The expected period-one dividend is computed as $D_1 = D_0 \times (1+g)$.
4. B — The constant growth model requires that the dividend growth rate g be strictly less than the discount rate R .

Lesson 24: Non-Constant Growth Stocks

1. Under the Dividend Growth Model, the required total return (R) can be broken down into which two components? A) Current Ratio and Quick Ratio B) Dividend Yield (D_1/P_0) and Capital Gains Yield (g) C) Real rate of interest and inflation premium D) Operating Cash Flow and Net Income
2. If a stock sells for \$20 per share, its next expected dividend is \$1, and dividends grow at a constant 10% annually, what total return does it offer? A) 5% B) 10% C) 15% D) 20%
3. In corporate governance, what is a "proxy"? A) A preferred stock dividend arrearage B) A legal grant of authority by a shareholder allowing another party to vote their shares C) A tax penalty levied on retained capital gains D) An automatic reinvestment of dividends into new shares
4. How are corporate dividend payments treated for tax purposes by the issuing firm? A) Dividends are fully tax-deductible as an operating expense B) Dividends are paid out of after-tax income and are not tax-deductible for the issuing firm C) Dividends reduce the firm's capital intensity ratio on a dollar-for-dollar basis D) Dividends are completely exempt from taxation for all corporate recipients

Answer Key

1. B — Total return $R = D_1/P_0 + g$ consists of the dividend yield (D_1/P_0) and capital gains yield (g).
2. C — Dividend yield is $\$1/\$20 = 5\%$ and capital gains yield is 10%, resulting in a total return of 15%.
3. B — A proxy grants legal authority from a shareholder to another party to vote on their behalf.
4. B — Dividends are paid out of net income and are not tax-deductible for the paying corporation.

Lesson 25: Preferred Stock Features

1. Why is preferred stock described as having "preference" over common stock? A) Preferred shareholders hold superior voting power in board elections B) Preferred shareholders must receive their stated dividends before common shareholders receive any distributions C)

Preferred stock matures earlier than corporate notes and bonds D) Preferred stock dividend payments are tax-deductible for the issuing firm

2. If a firm omits a cumulative preferred stock dividend in a given year, what happens to the unpaid amount? A) It becomes a legal debt obligation triggering immediate bankruptcy B) It is carried forward as an arrearage that must be paid before common dividends can be distributed C) It is automatically converted into long-term debenture bonds D) It is permanently written off and forgiven

3. How are unpaid preferred stock dividends legally classified? A) Unpaid preferred dividends are binding debt obligations of the firm B) Unpaid preferred dividends are not debts of the firm, and directors can defer them indefinitely C) Unpaid preferred dividends are listed as current accounts payable D) Unpaid preferred dividends increase net working capital directly

4. What is the fundamental Net Present Value (NPV) decision rule for capital budgeting? A) Accept an investment if its NPV is negative and reject if positive B) Accept an investment if its Net Present Value is positive and reject if negative C) Accept an investment only if its NPV equals its initial cash outlay D) Accept an investment if its accounting return equals the corporate tax rate

Answer Key

1. B — Preferred stock preference requires stated preferred dividends to be paid in full prior to any common stock payouts.
2. B — Cumulative preferred dividends not paid accumulate as arrearages that block common dividend payments.
3. B — Unpaid preferred dividends do not constitute legal debt, allowing directors to defer them indefinitely.
4. B — The NPV rule states that projects with positive NPV should be accepted and those with negative NPV rejected.

Lesson 26: Using NPV

1. What is the primary Net Present Value (NPV) decision rule for capital budgeting? A) Accept an investment if NPV is zero, reject if positive B) Accept an investment if the net present value is positive and reject if it is negative C) Accept an investment if NPV is less than the payback cutoff period D) Accept an investment if NPV equals the initial cash outlay

2. How is the Payback Period defined? A) The total net present value divided by the initial cost B) The amount of time required for an investment to generate cash flows sufficient to recover its initial cost C) The discount rate that reduces future cash flows to zero D) The ratio of average accounting net income to average book value

3. Which of the following is a major flaw or disadvantage of the Payback Period rule? A) It is excessively difficult to calculate B) It ignores the time value of money, relies on an arbitrary cutoff date, and ignores cash flows beyond the cutoff point C) It cannot be used for short-term corporate projects D) It always leads to different decisions than NPV for independent projects

4. An investment requires an initial outlay of \$10,000 and generates expected cash flows over 5 years whose present value totals \$12,313 at a 10% discount rate. What is the Net Present Value (NPV)? A) \$2,313 B) \$12,313 C) -\$2,313 D) \$22,313

Answer Key

1. B — The NPV rule states that an investment should be accepted if its net present value is positive and rejected if negative.
2. B — Payback period is defined as the length of time required for an investment to generate cash flows to recover its initial cost.
3. B — Major drawbacks of the payback rule include ignoring the time value of money, arbitrary cutoffs, and cash flows after the cutoff date.
4. A — NPV is calculated as the present value of future cash flows minus the initial investment ($\$12,313 - \$10,000 = \$2,313$).

Lesson 27: Average Accounting Return and Internal Rate of Return

1. How is the Average Accounting Return (AAR) calculated? A) Average Net Income divided by Average Book Value B) Total Sales divided by Total Assets C) Present Value of Cash Inflows divided by Initial Outlay D) Net Income divided by Total Sales Revenue
2. How is the Internal Rate of Return (IRR) fundamentally defined? A) The required return that results in an NPV greater than 1.0 B) The single discount rate that results in a zero Net Present Value (NPV) when used on project cash flows C) The average accounting return divided by project life D) The market interest rate on corporate debt securities
3. Under what conditions do the IRR and NPV rules always yield identical accept/reject decisions? A) When cash flows are non-conventional and projects are mutually exclusive B) When cash flows are conventional (negative initial outlay followed by positive inflows) and projects are independent C) When the discount rate is equal to zero D) When payback period is greater than 5 years
4. What problem arises when applying the IRR rule to non-conventional cash flows (where cash flow signs change more than once)? A) IRR cannot be calculated under any circumstance B) Multiple internal rates of return can exist, causing the standard IRR rule to break down C) NPV becomes equal to the profitability index D) AAR automatically replaces IRR

Answer Key

1. A — Average Accounting Return (AAR) is defined as Average Net Income divided by Average Book Value.
2. B — The Internal Rate of Return (IRR) is the single discount rate that forces the project's NPV to equal zero.
3. B — IRR and NPV give identical decisions provided cash flows are conventional and projects are independent.
4. B — Non-conventional cash flows with multiple sign changes lead to multiple IRRs or misleading decision rules.

Lesson 28: Profitability Index

1. How is the Profitability Index (PI) defined? A) Initial Investment divided by Total Sales B) Present Value of future cash flows divided by the initial investment C) Net Income divided by Total Equity D) Total Cash Inflows minus Total Cash Outflows
2. What is the decision rule for the Profitability Index (PI)? A) Accept an investment if PI is less than 0.0 B) Accept an investment if PI exceeds 1.00 C) Accept an investment if PI equals 0.50 D) Accept an investment if PI is greater than the payback period

3. If an investment costs \$200 and the present value of its future cash flows is \$220, what is its Profitability Index? A) 0.90 B) 1.10 C) 20.00 D) 1.20
4. For mutually exclusive projects, why can relying strictly on Profitability Index (PI) rankings be misleading? A) PI ignores the time value of money completely B) PI measures relative value created per dollar invested rather than absolute dollar value created C) PI cannot be used when capital is scarce D) PI is only applicable to government or non-profit entities

Answer Key

1. B — The Profitability Index (or benefit-cost ratio) is the present value of future cash flows divided by the initial investment.
2. B — An investment is acceptable if its Profitability Index is greater than 1.00, which corresponds to a positive NPV.
3. B — PI is calculated as $\$220 / \$200 = 1.10$, indicating \$1.10 of present value generated per \$1.00 invested.
4. B — Like IRR, PI is a relative measure and may rank smaller projects with higher PI over larger projects that generate more total NPV.

Lesson 29: Making Capital Investment Decisions

1. What is a relevant cash flow for a proposed capital investment project? A) A past expense that cannot be recouped B) An incremental change in the firm's overall future cash flow resulting directly from the decision to take the investment C) Interest expense paid on existing corporate debt D) Sunk overhead costs allocated from corporate headquarters
2. How should sunk costs be treated in a capital budgeting evaluation? A) Included as part of the initial capital outlay B) Ignored because sunk costs have already been incurred and cannot be recouped C) Added back to operating cash flow as a non-cash item D) Discounted at the firm's cost of debt
3. If a firm uses a piece of land it already owns for a new project instead of selling it for its \$100,000 market value, how is that \$100,000 classified? A) Sunk cost B) Opportunity cost C) Financing cost D) Erosion cost
4. Why are interest paid and other financing costs excluded when calculating a project's operating cash flows? A) Interest is a non-operating income item B) Financing costs reflect how a project is funded, which is already accounted for in the discount rate (cost of capital) C) Interest expense is non-taxable under GAAP D) Interest paid is already added to net working capital

Answer Key

1. B — A relevant cash flow is an incremental cash flow representing the direct change in future cash flows caused by project acceptance.
2. B — Sunk costs have already occurred and cannot be recouped, so they are irrelevant to capital budgeting decisions.
3. B — Giving up the market value of an existing asset represents an opportunity cost that must be included as an outlay.
4. B — Interest paid is a financing flow, not an operating flow; financing impacts are accounted for via the required discount rate.

Lesson 30: Pro Forma Financial Statements

1. What are pro forma financial statements? A) Audited financial reports required for tax authorities B) Projected financial statements setting out anticipated revenues, expenses, assets, and liabilities for future periods C) Statements detailing historical cash flows over the last ten years D) Common-size balance sheets converted into local currency
2. According to the Tax Shield Approach, how is Operating Cash Flow (OCF) calculated? A) $OCF = (Sales - Costs) \times (1 - T) + Depreciation \times T$ B) $OCF = Net\ Income - Depreciation + Interest$ C) $OCF = EBIT \times (1 - T) - Depreciation$ D) $OCF = Gross\ Profit \times T + Fixed\ Costs$
3. How is Net Working Capital (NWC) typically treated over a project's full life cycle? A) Invested at Year 0 and written off as a permanent expense B) Invested at Year 0 (cash outflow) and recovered at project termination (cash inflow) C) Excluded from total cash flows because it is non-operational D) Treated as a financing cash inflow in every year
4. Given EBIT of \$8,000, Depreciation of \$7,000, and Taxes of \$2,720, what is the Operating Cash Flow (OCF) using the standard formula (EBIT + Depreciation – Taxes)? A) \$12,280 B) \$17,720 C) \$15,000 D) \$8,000

Answer Key

1. B — Pro forma statements are forward-looking, projected financial statements used for financial planning and capital budgeting.
2. A — Under the tax shield approach, $OCF = (Sales - Costs) \times (1 - T) + Depreciation \times T$.
3. B — NWC requires an initial investment up front and is recovered (freed up) as a cash inflow when the project terminates.
4. A — Standard OCF calculation gives $EBIT + Depreciation - Taxes = \$8,000 + \$7,000 - \$2,720 = \$12,280$.

Lesson 31: Depreciation

1. Under Modified ACRS (MACRS), how is annual depreciation calculated for an asset? A) By multiplying the asset's salvage value by a variable percentage B) By multiplying the cost of the asset by a fixed percentage established by its property class C) By subtracting accumulated depreciation from gross sales revenue D) By dividing the initial cost by the total market value of equity
2. In MACRS property classes, research equipment and automobiles are classified under which respective property classes? A) 3-year property and 5-year property B) 5-year property and 7-year property C) 7-year property and 3-year property D) 10-year property and 5-year property
3. What occurs for tax purposes when an asset is sold for a price that exceeds its ending book value? A) The difference is considered a capital loss and is tax-deductible B) The excess over book value represents excess depreciation that must be recaptured and taxed C) The full market price is added to net working capital without tax consequences D) The transaction is exempt from taxation under GAAP rules
4. If an asset originally costing \$160,000 has a book value of \$27,648 at the end of Year 4 and is sold for \$10,000, how is the difference treated for tax purposes? A) As a taxable excess depreciation gain of \$17,648 B) As a tax-deductible loss of \$17,648 C) As a capital gain taxed at a 50% rate D) As a non-operating financing cash inflow

Answer Key

1. B — MACRS depreciation is computed by multiplying the cost of the asset by a fixed percentage established for its property class.
2. A — Research equipment is assigned to the 3-year property class, while automobiles and computers belong to the 5-year class.
3. B — Selling an asset above its book value creates a tax payment because the excess over book value represents excess depreciation that must be recaptured.
4. B — When book value (\$27,648) exceeds market value (\$10,000), the difference of \$17,648 is treated as a loss for tax purposes.

Lesson 32: Returns

1. What are the two distinct components that make up the total return on an investment in common stock? A) Interest income and capital intensity ratio B) Dividend yield and capital gains yield C) Net profit margin and retention ratio D) Operating cash flow and tax shield
2. If you buy a stock for \$25, receive a \$2 dividend during the year, and sell it for \$35 at year-end, what is the capital gains yield? A) 8% B) 40% C) 48% D) 10%
3. Which statistical measures are most commonly used to quantify the spread or variability of historical investment returns? A) Quick ratio and current ratio B) Variance and standard deviation C) Net present value and internal rate of return D) Equity multiplier and debt-equity ratio
4. How is standard deviation mathematically derived from variance? A) By squaring the variance B) By taking the square root of the variance C) By dividing variance by the number of observation years D) By multiplying variance by the risk-free rate

Answer Key

1. B — Total percentage return on a stock is the sum of dividend yield and capital gains yield.
2. B — Capital gains yield is calculated as $((\$35 - \$25) / \$25 = \$10 / \$25 = 40\%)$.
3. B — Variance and its square root, standard deviation, are the primary measures used to evaluate return variability and risk.
4. B — Standard deviation is always defined as the positive square root of the variance.

Lesson 33: Variability of Returns

1. How is the expected return of an asset calculated when different economic states have assigned probabilities? A) By dividing the sum of all returns by the total number of economic states B) By multiplying each possible return by its probability of occurrence and summing the products C) By subtracting the risk-free rate from the maximum return in a boom D) By multiplying the standard deviation by the coefficient of variation
2. What is defined as the difference between the return on a risky investment and the return on a risk-free investment? A) Capital gains yield B) Risk premium C) Retention ratio D) Profitability index
3. If stock U has an expected return of 20% and the risk-free rate is 8%, what is the projected risk premium on stock U? A) 8% B) 12% C) 28% D) 2.5%

4. How is the expected return of a two-asset portfolio determined? A) By multiplying individual asset variances together B) As a weighted average of the expected returns on the individual assets in the portfolio C) By subtracting the lower expected return from the higher expected return D) By dividing total portfolio value by the market risk premium

Answer Key

1. B — Expected return under probabilistic economic states is computed by multiplying each state's return by its probability and summing them.
2. B — The risk premium is defined as the difference between the return on a risky asset and that on a risk-free investment.
3. B — Projected risk premium is calculated as $E(R_u) - R_f = 20\% - 8\% = 12\%$.
4. B — Portfolio expected return is the weighted average of the expected returns of the individual assets forming the portfolio.

Lesson 34: Portfolio

- 1. What are portfolio weights? A) The total market values of debt divided by net income B) The percentages of a total portfolio's value that are invested in each respective asset C) The ratio of unsystematic risk to systematic risk D) The interest rates assigned to corporate debentures**
- 2. Systematic risk (also known as market risk or non-diversifiable risk) is best described as a risk that: A) Affects only a single company or a small group of specific assets B) Influences a large number of assets across the entire market, such as changes in GDP, inflation, or interest rates C) Can be completely eliminated by holding 10 to 20 stocks D) Arises exclusively from internal corporate management disputes**
- 3. Unsystematic risk is also referred to as: A) Market risk or non-diversifiable risk B) Diversifiable risk, unique risk, or asset-specific risk C) Systematic risk or inflation risk D) Portfolio variance risk**
- 4. According to the Principle of Diversification, what happens to unsystematic risk as an investor spreads capital across many diverse assets? A) Unsystematic risk increases exponentially B) Unsystematic risk is essentially eliminated C) Unsystematic risk converts directly into systematic risk D) Unsystematic risk remains unchanged regardless of portfolio size**

Answer Key

1. B — Portfolio weights are defined as the percentages of a portfolio's total value invested in each asset.
2. B — Systematic risk affects a large number of assets and includes economy-wide factors like GDP, interest rates, and inflation.
3. B — Unsystematic risk is uniquely known as diversifiable risk, unique risk, or asset-specific risk.
4. B — Spreading investments across diverse assets essentially eliminates unsystematic risk through diversification.

Lesson 35: Cost of Capital

- 1. The cost of capital associated with a proposed investment depends primarily on: A) The source of the money raised B) The specific risk of the investment (the use of the money) C) The book value of historical retained earnings D) The par value of common stock**

2. Under the Dividend Growth Model, how is the cost of equity (RE) calculated? A) $RE = D_1/P_0 + g$ B) $RE = P_0/D_1 - g$ C) $RE = EBIT \times (1 - TC)$ D) $RE = D_0 \times (1 + R_f)$
3. When determining a firm's current cost of debt (RD), why is the coupon rate on outstanding debt irrelevant? A) Coupon rates are paid out of after-tax income B) The coupon rate reflects historical borrowing costs when bonds were issued rather than the required rate today C) Corporate bonds do not pay coupon interest D) Debt cost is strictly equal to the dividend yield
4. How is the cost of preferred stock (RP) calculated given a fixed annual dividend D and current stock price P0? A) $RP = D \times P_0$ B) $RP = D/P_0$ C) $RP = (P_0 - D)/P_0$ D) $RP = D/(1 - TC)$

Answer Key

1. B — The cost of capital depends on the risk of the investment (the use of money, not the source).
2. A — Solving the constant dividend growth formula yields $RE = D_1/P_0 + g$.
3. B — Coupon rate is irrelevant for current cost of debt because it reflects past rates when debt was issued, whereas market yield reflects current costs.
4. B — Because preferred stock pays a constant dividend forever like a perpetuity, its cost is $RP = D/P_0$.

Lesson 36: Weighted Average Cost of Capital

1. What is the Weighted Average Cost of Capital (WACC)? A) The interest rate charged by commercial banks on short-term lines of credit B) The overall required return the firm must earn on its existing assets to maintain stock value C) The average net profit margin earned on new product lines D) The sum of dividend yield and capital gains yield
2. When evaluating a new expansion project that has the same risk profile as the firm's existing operations, what discount rate should be used? A) The risk-free Treasury rate B) The Weighted Average Cost of Capital (WACC) C) The firm's historical coupon rate on corporate bonds D) The prime rate plus a 5% margin
3. Why can using book values instead of market values to determine capital structure weights lead to errors? A) Book values reflect past accounting history and often overstate the percentage of financing coming from debt when equity market value exceeds book value B) Book values are recalculated daily by stock exchanges C) Book values ignore corporate tax liabilities D) Book values apply only to preferred stock issues
4. In the standard WACC formula $WACC = (E/V) \times RE + (D/V) \times RD \times (1 - TC)$, why is the cost of debt multiplied by $(1 - TC)$? A) Debt payments are exempt from inflation adjustments B) Interest expense is tax-deductible, creating an interest tax shield that lowers the effective cost of debt C) Stockholders receive tax credits on corporate debt D) Depreciation is added back to debt liabilities

Answer Key

1. B — WACC represents the overall return a firm must earn on its existing assets to maintain stock value.
2. B — WACC is the appropriate discount rate for evaluating cash flows of projects with the same risk as overall firm operations.
3. A — Book values reflect historical accounting figures and can significantly overstate debt proportions when market value of equity exceeds book value.
4. B — Interest expense is tax-deductible, so the after-tax cost of debt is reduced to $RD \times (1 - TC)$.

Lesson 37: Capital Structure

1. What is the guiding principle when choosing a firm's optimal capital structure? A) Maximize total short-term liabilities B) Choose the debt-equity ratio that minimizes the WACC and maximizes firm value C) Maintain 100% equity financing at all times D) Minimize the total asset turnover ratio
2. How does financial leverage affect earnings per share (EPS) and return on equity (ROE)? A) Leverage completely eliminates risk for shareholders B) Financial leverage magnifies both gains and losses, increasing the variability of EPS and ROE C) Leverage keeps EPS and ROE constant regardless of changes in EBIT D) Leverage reduces operating cash flows to zero
3. What is the break-even EBIT in capital restructuring analysis? A) The level of EBIT where Net Income equals zero B) The level of EBIT where EPS under the debt-financed plan equals EPS under the all-equity plan C) The level of EBIT where sales revenue equals total fixed costs D) The level of EBIT where WACC reaches its maximum value
4. What is "homemade leverage"? A) Corporate borrowing arranged through international banking syndicates B) The use of personal borrowing or lending by individual investors to adjust their effective financial leverage C) Short-term trade credit granted by raw material suppliers D) Government-subsidized loans for small business expansion

Answer Key

1. B — The optimal capital structure is the debt-equity ratio that minimizes WACC and maximizes the total value of the firm.
2. B — Financial leverage acts to magnify shareholder returns, resulting in larger variability in EPS and ROE.
3. B — Break-even EBIT is the level of earnings before interest and taxes at which EPS is identical under both capital structures.
4. B — Homemade leverage refers to individuals borrowing or lending on their own account to alter their exposure to corporate financial leverage.

Lesson 38: M&M; Propositions

1. According to Modigliani & Miller (M&M;) Proposition I without taxes, what is the effect of capital structure on firm value? A) Firm value increases continuously with debt B) Capital structure is completely irrelevant, and the value of the levered firm equals the value of the unlevered firm ($V_L = V_U$) C) All-equity firms are always worth twice as much as levered firms D) Firm value is maximized when debt equals 100% of assets
2. According to M&M; Proposition II without taxes, what happens to the cost of equity (RE) as a firm increases its debt-equity ratio (D/E)? A) The cost of equity decreases linearly B) The cost of equity increases because the financial risk borne by equity holders rises C) The cost of equity remains constant while WACC increases D) The cost of equity drops to match the cost of debt
3. M&M; Proposition II shows that a firm's business risk depends on: A) The firm's debt-equity ratio B) The systematic risk inherent in the firm's operating activities and assets (RA) C) The personal income tax rates of individual investors D) The legal bankruptcy court costs
4. Under M&M; Proposition I WITH corporate taxes, why does the value of a levered firm exceed that of an unlevered firm? A) Debt carries no interest rate risk B) The present value of the

interest tax shield ($TC \times D$) adds value to the firm C) Corporate tax rates decrease to zero as debt rises D) Levered firms pay higher dividends to common shareholders

Answer Key

1. B — M&M; Proposition I (no taxes) states that capital structure is irrelevant and total firm value is unaffected by how financing is sliced.
2. B — M&M; Proposition II states that increasing leverage raises financial risk, causing the required return on equity to increase.
3. B — Business risk depends on the systematic risk of the firm's assets and operating activities.
4. B — With corporate taxes, the value of the levered firm equals the unlevered value plus the present value of the interest tax shield ($V_L = V_U + TC \times D$).

Lesson 39: Bankruptcy Costs

1. What are direct bankruptcy costs? A) Lost sales resulting from damaged customer confidence B) Out-of-pocket legal, administrative, and accounting expenses directly associated with bankruptcy proceedings C) Higher interest rates charged by suppliers during normal operations D) The cost of maintaining excess cash reserves
2. What are indirect bankruptcy costs (financial distress costs)? A) Fees paid to court-appointed bankruptcy trustees B) Costs incurred by a distressed firm trying to avoid bankruptcy, such as lost sales, employee turnover, and strained supplier relationships C) Dividend payments made to preferred stockholders D) Capital gains taxes paid on asset liquidations
3. According to the Static Theory of Capital Structure, a firm reaches its optimal capital structure (D^*) when: A) Total debt reaches 100% of total assets B) The tax gain from an additional dollar of debt is exactly offset by the increased cost from the higher probability of financial distress C) Financial distress costs drop to zero D) The cost of equity equals the cost of debt
4. At the optimal amount of borrowing (D^*) in the Static Theory model: A) Total firm value (V_L^*) is maximized and WACC is minimized B) Total firm value is minimized and WACC is maximized C) Debt equals zero and equity is maximized D) Interest tax shields are completely eliminated

Answer Key

1. B — Direct bankruptcy costs are legal and administrative expenses explicitly tied to bankruptcy proceedings.
2. B — Indirect bankruptcy costs stem from financial distress, including lost sales, key staff departure, and supplier reluctance.
3. B — The Static Theory posits that optimal debt is reached where the marginal tax benefit of debt equals the marginal cost of financial distress.
4. A — At the optimal debt level D^* , the firm value V_L^* is maximized and WACC is minimized.

Lesson 40: Operating Cycle and Cash Cycle

1. How is the Operating Cycle defined? A) The time elapsed between paying for inventory and collecting cash from sales B) The total time period from the initial purchase of raw material inventory to the ultimate collection of cash from customers C) The average period required to pay off short-term bank loans D) The duration of a firm's long-term fixed asset depreciation

schedule

2. What two periods make up the Operating Cycle? A) Accounts Payable Period and Cash Period B) Inventory Period and Accounts Receivable Period C) Credit Period and Discount Period D) MACRS Class Life and Amortization Period
3. How is the Cash Cycle mathematically calculated? A) Operating Cycle + Accounts Payable Period B) Operating Cycle – Accounts Payable Period C) Inventory Period – Accounts Receivable Period D) Accounts Receivable Period + Accounts Payable Period
4. All else equal, what effect does shortening a firm's cash cycle have on its financial performance? A) Reduces total asset turnover and lowers ROE B) Decreases required investment in inventory and receivables, raising total asset turnover, ROA, and ROE C) Increases the need for external short-term bank debt D) Eliminates the interest tax shield on corporate debt

Answer Key

1. B — The operating cycle spans the time from acquiring inventory through manufacturing and sales to collecting cash.
2. B — The operating cycle equals the sum of the Inventory Period and the Accounts Receivable Period.
3. B — The cash cycle equals the Operating Cycle minus the Accounts Payable Period.
4. B — A shorter cash cycle reduces ties in working capital, increasing total asset turnover and boosting ROA and ROE.

Lesson 41: Short-Term Financial Policy

1. Which short-term financial policy maintains a low ratio of current assets to sales and relies more heavily on short-term debt? A) Flexible Policy B) Restrictive Policy C) Compromise Policy D) Maturity Matching Policy
2. Carrying costs associated with current assets generally include: A) Trading or order costs to replenish inventory B) Costs to store, finance, and bear opportunity costs of holding assets C) Costs associated with lost sales from stock-outs D) Interest paid on long-term debentures
3. Shortage costs associated with current assets tend to: A) Increase as the level of current assets increases B) Decrease as the level of current assets increases C) Remain constant regardless of inventory levels D) Equal carrying costs at all levels of sales
4. What strategy involves financing temporary current assets with short-term debt and permanent current assets with long-term debt and equity? A) Maturity Hedging B) Capital Rationing C) Price Discrimination D) Zero-Balance Accounting

Answer Key

1. B — A restrictive short-term financial policy maintains a low ratio of current assets to sales and uses more short-term debt relative to long-term debt.
2. B — Carrying costs include storage, insurance, taxes, obsolescence, and the opportunity cost of capital tied up in current assets.
3. B — Shortage costs (such as order costs and lost sales/stock-out costs) decline as the level of current assets increases.

4. A — Maturity hedging matches asset maturities with financing maturities by using short-term debt for temporary current assets and long-term debt/equity for permanent assets.

Lesson 42: Short-Term Borrowing

1. What is a cash budget? A) A long-term forecast of capital expenditure projects over 10 years B) A primary tool in short-term financial planning that forecasts cash inflows and outflows C) A pro forma income statement adjusted for inflation D) A schedule of depreciation tax shields under MACRS
2. Which type of unsecured bank loan involves a formal agreement with the bank that includes a commitment fee? A) Non-committed line of credit B) Committed line of credit C) Commercial paper D) Blanket inventory lien
3. What is accounts receivable factoring? A) Assigning receivables as collateral while the borrower retains default risk B) Discounting and selling accounts receivable to a lender (factor) who bears the risk of default C) Storing inventory in a warehouse managed by an independent control agent D) Issuing short-term unsecured promissory notes to the public
4. Short-term unsecured promissory notes issued directly by large, highly rated corporations are known as: A) Bankers' Acceptances B) Commercial Paper C) Trust Receipts D) Trade Acceptances

Answer Key

1. B — A cash budget is the primary short-term planning tool used to forecast expected cash receipts and disbursements over a planning horizon.
2. B — A committed line of credit is a formal legal arrangement with a bank that involves a commitment fee paid by the borrowing firm.
3. B — Factoring involves selling accounts receivable to a financial institution (factor) at a discount, transferring default risk to the factor.
4. B — Commercial paper consists of short-term, unsecured promissory notes issued by large, financially strong firms.

Lesson 43: Float and Cash Management

1. How is net float defined? A) The sum of total cash collections and cash disbursements B) The difference between a firm's available bank balance and its book cash balance C) The ratio of current assets to current liabilities D) The total interest earned on short-term marketable securities
2. What type of float is created when a firm writes a cheque to pay a vendor? A) Collection Float B) Disbursement Float C) Availability Delay D) Processing Float
3. What is the primary motive for holding cash to satisfy normal payment and collection activities of daily operations? A) Speculative Motive B) Precautionary Motive C) Transaction Motive D) Arbitrage Motive
4. What cash management system utilizes a master account to transfer funds into disbursement accounts only as cheques are presented for payment? A) Concentration Bank System B) Zero-Balance Account (ZBA) System C) Lockbox Processing System D) Preauthorized Payment System

Answer Key

1. B — Net float is the difference between a firm's available bank balance and its internal book cash balance.
2. B — Writing a cheque generates disbursement float, causing book cash to immediately decrease while available bank balance remains higher until the cheque clears.
3. C — The transaction motive refers to holding cash to handle day-to-day operational collections and disbursements.
4. B — A zero-balance account maintains a zero balance, automatically receiving cash transfers from a master account only when cheques are presented.

Lesson 44: Credits and Receivables

1. Under credit terms quoted as "2/10, net 30", what choice is offered to the buyer? A) Take a 10% discount if paid in 2 days, or pay in full in 30 days B) Take a 2% discount if paid within 10 days, otherwise pay the full invoice amount within 30 days C) Pay 2% of the invoice each month for 10 months D) Take a 30% discount if paid within 2 to 10 days
2. Which factor would generally lead a firm to offer a SHORTER credit period to its buyers? A) Selling slow-moving, unestablished products B) Selling highly perishable goods with rapid turnover and low collateral value C) Operating in a highly competitive market D) Dealing with low-risk buyers in large account sizes
3. What are the three components that make up the carrying costs of granting credit? A) Order costs, setup costs, and stock-out penalties B) Required return on receivables, bad debt losses, and credit department management costs C) Mailing delay, processing delay, and clearing delay D) Flotation costs, interest tax shields, and commitment fees
4. What collection monitoring schedule classifies outstanding accounts receivable based on the number of days they have been unpaid? A) Amortization Schedule B) Aging Schedule C) Pro Forma Budget D) Cash Flow Matrix

Answer Key

1. B — Terms of 2/10, net 30 mean the customer receives a 2% discount for paying within 10 days; otherwise, full payment is due in 30 days.
2. B — Perishable items feature rapid turnover and poor collateral value, causing sellers to enforce shorter credit periods.
3. B — Carrying costs of credit consist of required return on receivables, losses from bad debts, and credit management expenses.
4. B — An aging schedule categorizes accounts receivable by age brackets (e.g., 0–10 days, 11–60 days) to track past-due balances.

Lesson 45: Inventory Management

1. In the ABC approach to inventory management, Category A items typically represent: A) A large percentage of total inventory items but a small percentage of total inventory value B) A small percentage of total inventory items but a relatively large percentage of total dollar inventory value C) Low-value bulk raw materials requiring minimal control D) Work-in-progress items with dependent demand

2. In the Economic Order Quantity (EOQ) model, what two opposing costs are balanced to find the optimal order size (Q^*)? A) Flotation costs and dividend payout costs B) Carrying costs and restocking (order) costs C) Direct bankruptcy costs and indirect financial distress costs D) Interest expenses and corporate taxes
3. What is the mathematical formula for the Economic Order Quantity (EOQ)? A) $Q^* = \sqrt{(2 \times T \times F / CC)}$ B) $Q^* = T \times F \times CC$ C) $Q^* = (T/F) \times CC$ D) $Q^* = (T \times F / (2 \times CC))^{(1/2)}$
4. What is safety stock? A) The maximum inventory capacity a warehouse can physically store B) A minimum level of inventory held on hand to protect against stock-outs and delivery delays C) Inventory that has become obsolete and written off D) The average level of inventory calculated as $Q/2$

Answer Key

1. B — The ABC approach groups high-value items into Category A, which account for a small fraction of item count but a large share of total monetary value.
2. B — The EOQ model minimizes total inventory holding costs by balancing carrying costs against restocking (ordering) costs.
3. A — The optimal order quantity is calculated as $Q^* = \sqrt{(2 \times T \times F / CC)}$, where T is total unit sales, F is fixed cost per order, and CC is carrying cost per unit per year.
4. B — Safety stock is the buffer level of inventory retained to prevent stock-outs during lead time before a reorder arrives.

End of Quiz

ACC501 — 180 solved MCQs
Prepared by VU Learning HUB
vulearninghub.xyz