Financial Management
Chapter 11 Quiz

1) The final step in the capital budgeting process is
A) implementation.
*B) follow-up monitoring.
C) re-evaluation.
D) education.

2) A $60,000 outlay for a new machine with a usable life of 15 years is called
*A) capital expenditure.
B) operating expenditure.
C) replacement expenditure.
D) none of the above.

3) A conventional cash flow pattern associated with capital investment projects consists of an initial
A) outflow followed by a broken cash series.
B) inflow followed by a broken series.
*C) outflow followed by a series of inflows.
D) inflow followed by a series of outflows.

4) Projects that compete with one another, so that the acceptance of one eliminates the others from further consideration are called
A) independent projects.
*B) mutually exclusive projects.
C) replacement projects.
D) none of the above.

5) When evaluating a capital budgeting project, the change in net working capital must be considered as part of
A) the operating cash inflows.
*B) the initial investment.
C) the incremental operating cash inflows.
D) the operating cash outflows.

6) A corporation is considering expanding operations to meet growing demand. With the capital expansion, the current accounts are expected to change. Management expects cash to increase by $20,000, accounts receivable by $40,000, and inventories by $60,000. At the same time accounts payable will increase by $50,000, accruals by $10,000, and long-term debt by $100,000. The change in net working capital is __________.
A) an increase of $120,000
B) a decrease of $40,000
C) a decrease of $120,000
*D) an increase of $60,000

7) The tax treatment regarding the sale of existing assets which are sold for more than the book value but less than the original purchase price results in

A) an ordinary tax benefit.
B) a capital gain tax liability.
*C) recaptured depreciation taxed as ordinary income.
D) a capital gain tax liability and recaptured depreciation taxed as ordinary income.

8) A corporation is selling an existing asset for $1,700. The asset, when purchased, cost $10,000, was being depreciated under MACRS using a five-year recovery period, and has been depreciated for four full years. If the assumed tax rate is 40 percent on ordinary income and capital gains, the tax effect of this transaction is

*A) $0 tax liability.
B) $840 tax liability.
C) $3,160 tax liability.
D) $3,160 tax benefit.

9) A corporation has decided to replace an existing asset with a newer model. Two years ago, the existing asset originally cost $30,000 and was being depreciated under MACRS using a five-year recovery period. The existing asset can be sold for $25,000.The new asset will cost $75,000 and will also be depreciated under MACRS using a five-year recovery period. If the assumed tax rate is 40 percent on ordinary income and capital gains, the initial investment is __________.

A) $42,000
B) $52,440
*C) $54,240
D) $50,000

10) One basic technique used to evaluate after-tax operating cash flows is to

*A) add noncash charges to net income.
B) subtract depreciation from operating revenues.
C) add cash expenses to net income.
D) subtract cash expenses from noncash charges.

Answers:

1) B
2) A
3) C
4) B
5) B
6) D
7) C
8) A
9) C
10) A

Financial Management
Chapter 13 Quiz

1) The firm's __________ is the level of sales necessary to cover all operating costs, i.e., the point at which EBIT = $0.
A) cash break-even point
B) financial break-even point
*C) operating break-even point
D) total break-even point

2) Which of the following is NOT a variable cost?
A) materials used
*B) rent
C) delivery costs
D) direct labor

3) If a firm's fixed operating costs decrease, the firm's operating break-even point will
*A) decrease.
B) increase.
C) remain unchanged.
D) change in an undetermined direction.

4) A firm has fixed operating costs of $150,000, total sales of $1,500,000, and total variable costs of $1,275,000. The firm's operating break-even point in dollars is ___________.
A) $150,000
B) $176,471
*C) $1,000,000
D) $1,425,000

5) The three basic types of leverage are:
A) operating, production, and financial.
B) operating, production, and total.
C) production, financial, and total.
*D) operating, financial, and total.

6) The higher financial leverage causes __________ to increase more for a given increase in

__________.
A) EBIT, sales
B) EPS, sales
*C) EPS, EBIT
D) EBIT, EPS

7) Generally, __________ in leverage result in __________ return and __________ risk.
A) increases, decreased, increased
B) increases, decreased, decreased
*C) increases, increased, increased
D) decreases, increased, decreased

8) The firm's __________ is the mix of long-term debt and equity utilized by the firm, which may significantly affect its value by affecting return and risk.
A) dividend policy
B) capital budget
*C) capital structure
D) working capital

9) __________ risk is the risk of being unable to cover operating costs.
*A) Business
B) Financial
C) Leverage
D) Total

10) According to the traditional approach to capital structure, the value of the firm will be maximized when
A) the financial leverage is maximized.
B) the cost of debt is minimized.
*C) the weighted average cost of capital is minimized.
D) the dividend payout is maximized.

Answers:

1) C
2) B
3) A
4) C
5) D
6) C
7) C
8) C
9) A
10) C

Financial Management
Chapter 11 Practice Quiz

1) __________ projects have the same function; the acceptance of one __________ the others from consideration.
A) Capital; eliminates
B) Independent; does not eliminate
C) Mutually exclusive; eliminates
D) Replacement; does not eliminate

2) The cash flows of any project having a conventional pattern include all of the basic components except
A) initial investment.
B) operating cash outflows.
C) operating cash inflows.
D) terminal cash flow.

3) The final step in the capital budgeting process is
A) implementation.
B) follow-up monitoring.
C) re-evaluation.
D) education.

4) A loss on the sale of an asset which is depreciable and used in business is __________; a loss on the sale of a non-depreciable asset is __________.
A) deductible from capital gains income; deductible from ordinary income
B) deductible from ordinary income; deductible only against capital gains
C) a credit against the tax liability; not deductible
D) not deductible; deductible only against capital gains

5) A non-conventional cash flow pattern associated with capital investment projects consists of an initial
A) outflow followed by a series of cash inflows and outflows.
B) inflow followed by a series of cash inflows and outflows.
C) outflow followed by a series of inflows.
D) inflow followed by a series of outflows.

6) The tax treatment regarding the sale of existing assets which are sold for more than the book value and more than the original purchase price results in
A) an ordinary tax benefit.
B) no tax benefit or liability.
C) recaptured depreciation taxed as ordinary income.
D) a capital gain tax liability and recaptured depreciation taxed as ordinary income.

7) A firm with limited dollars available for capital expenditures is subject to
A) capital dependency.
B) mutually exclusive projects.
C) working capital constraints.
D) capital rationing.

8) A corporation is evaluating the relevant cash flows for a capital budgeting decision and must estimate the terminal cash flow. The proposed machine will be disposed of at the end of its usable life of five years at an estimated sale price of $2,000. The machine has an original purchase price of $80,000, installation cost of $20,000, and will be depreciated under the five-year MACRS. Net working capital is expected to decline by $5,000. The firm has a 40 percent tax rate on ordinary income and long-term capital gain. The terminal cash flow is __________.
A) $5,800
B) $7,800
C) $8,200
D) $6,200

9) Projects that compete with one another, so that the acceptance of one eliminates the others from further consideration are called
A) independent projects.
B) mutually exclusive projects.
C) replacement projects.
D) none of the above.

FIGURE 11.4

Cuda Marine Engines, Inc. must develop the relevant cash flows for a replacement capital investment proposal. The proposed asset costs $50,000 and has installation costs of $3,000. The asset will be depreciated using a five-year recovery schedule. The existing equipment, which originally cost $25,000 and will be sold for $10,000, has been depreciated using an MACRS five-year recovery schedule and three years of depreciation has already been taken. The new equipment is expected to result in incremental before-tax net profits of $15,000 per year. The firm has a 40 percent tax rate.

10) The incremental depreciation expense for year 5 is __________. (See Figure 11.4.)
A) $2,250
B) $5,110
C) $7,950
D) $6,360

11) A corporation has decided to replace an existing asset with a newer model. Two years ago, the existing asset originally cost $70,000 and was being depreciated under MACRS using a five-year recovery period. The existing asset can be sold for $30,000. The new asset will cost $80,000

and will also be depreciated under MACRS using a five-year recovery period. If the assumed tax rate is 40 percent on ordinary income and capital gains, the initial investment is __________.
A) $48,560
B) $44,360
C) $49,240
D) $27,600

12) The tax treatment regarding the sale of existing assets which are sold for their book value results in
A) an ordinary tax benefit.
B) no tax benefit or liability.
C) recaptured depreciation taxed as ordinary income.
D) a capital gain tax liability and recaptured depreciation taxed as ordinary income.

FIGURE 11.3

Computer Disk Duplicators, Inc. has been considering several capital investment proposals for the year beginning in 2004. For each investment proposal, the relevant cash flows and other relevant financial data are summarized in the table below. In the case of a replacement decision, the total installed cost of the equipment will be partially offset by the sale of existing equipment. The firm is subject to a 40 percent tax rate on ordinary income and on long-term capital gains. The firm's cost of capital is 15 percent.

		Proposal	
Type of Capital Budgeting Decision	1 Expansion	2 Replacement	3 Replacement
Type of Project	Independent	Mutually exclusive with 3	Mutually exclusive with 2
Cost of new asset	$1,500,000	$200,000	$300,000
Installation costs	$ 0	$ 0	$ 15,000
MACRS (new asset)	10 years	5 years	5 years
Original cost of old asset	N/A*	$ 80,000	$100,00
Purchase date (old asset)	N/A	1/1/97	1/1/2000
Sale proceeds (old asset)	N/A	$ 50,000	$120,000
MACRS (old asset)	N/A	5 years	5 years
Annual net profits before depreciation & taxes (old)	N/A	$ 30,000	$ 25,000
Annual net profits before depreciation & taxes (new)	$ 250,000	$100,000	$175,000

*Not applicable

13) For Proposal 1, the initial outlay equals __________. (See Figure 11.3.)
A) $1,380,000
B) $1,440,000
C) $1,500,000
D) $1,620,000

14) An important cash inflow in the analysis of initial cash flows for a replacement project is
A) taxes.
B) the cost of the new asset.

C) installation cost.
D) the sale value of the old asset.

15) The most common motive for adding fixed assets to the firm is
A) expansion.
B) replacement.
C) renewal.
D) transformation.

16) In evaluating the initial investment for a capital budgeting project,
A) an increase in net working capital is considered a cash inflow.
B) a decrease in net working capital is considered a cash outflow.
C) an increase in net working capital is considered a cash outflow.
D) net working capital does not have to be considered.

FIGURE 11.3

Computer Disk Duplicators, Inc. has been considering several capital investment proposals for the year beginning in 2004. For each investment proposal, the relevant cash flows and other relevant financial data are summarized in the table below. In the case of a replacement decision, the total installed cost of the equipment will be partially offset by the sale of existing equipment. The firm is subject to a 40 percent tax rate on ordinary income and on long-term capital gains. The firm's cost of capital is 15 percent.

		Proposal	
Type of Capital Budgeting Decision	1 Expansion	2 Replacement	3 Replacement
Type of Project	Independent	Mutually exclusive with 3	Mutually exclusive with 2
Cost of new asset	$1,500,000	$200,000	$300,000
Installation costs	$ 0	$ 0	$ 15,000
MACRS (new asset)	10 years	5 years	5 years
Original cost of old asset	N/A*	$ 80,000	$100,000
Purchase date (old asset)	N/A	1/1/97	1/1/2000
Sale proceeds (old asset)	N/A	$ 50,000	$120,000
MACRS (old asset)	N/A	5 years	5 years
Annual net profits before depreciation & taxes (old)	N/A	$ 30,000	$ 25,000
Annual net profits before depreciation & taxes (new)	$ 250,000	$100,000	$175,000

*Not applicable

17) For Proposal 3, the annual incremental after-tax cash flow from operations for year 3 is __________. (See Figure 11.3.)
A) $45,000
B) $75,150
C) $90,150
D) $113,940

18) When evaluating a capital budgeting project, the change in net working capital must be considered as part of

A) the operating cash inflows.
B) the initial investment.
C) the incremental operating cash inflows.
D) the operating cash outflows.

FIGURE 11.4

Cuda Marine Engines, Inc. must develop the relevant cash flows for a replacement capital investment proposal. The proposed asset costs $50,000 and has installation costs of $3,000. The asset will be depreciated using a five-year recovery schedule. The existing equipment, which originally cost $25,000 and will be sold for $10,000, has been depreciated using an MACRS five-year recovery schedule and three years of depreciation has already been taken. The new equipment is expected to result in incremental before-tax net profits of $15,000 per year. The firm has a 40 percent tax rate.

19) The initial outlay equals __________. (See Figure 11.4.)
A) $41,100
B) $44,100
C) $38,800
D) $38,960

20) Relevant cash flows for a project are best described as
A) incidental cash flows.
B) incremental cash flows.
C) sunk cash flows.
D) accounting cash flows.

FIGURE 11.3

Computer Disk Duplicators, Inc. has been considering several capital investment proposals for the year beginning in 2004. For each investment proposal, the relevant cash flows and other relevant financial data are summarized in the table below. In the case of a replacement decision, the total installed cost of the equipment will be partially offset by the sale of existing equipment. The firm is subject to a 40 percent tax rate on ordinary income and on long-term capital gains. The firm's cost of capital is 15 percent.

		Proposal	
Type of Capital Budgeting Decision	1 Expansion	2 Replacement	3 Replacement
Type of Project	Independent	Mutually exclusive with 3	Mutually exclusive with 2
Cost of new asset	$1,500,000	$200,000	$300,000
Installation costs	$ 0	$ 0	$ 15,000
MACRS (new asset)	10 years	5 years	5 years
Original cost of old asset	N/A*	$ 80,000	$100,00
Purchase date (old asset)	N/A	1/1/97	1/1/2000
Sale proceeds (old asset)	N/A	$ 50,000	$120,000
MACRS (old asset)	N/A	5 years	5 years
Annual net profits before depreciation & taxes (old)	N/A	$ 30,000	$ 25,000

Annual net profits before depreciation & taxes (new)	$ 250,000	$100,000	$175,000

*Not applicable

21) For Proposal 1, the annual incremental after-tax cash flow from operations for year 1 is __________. (See Figure 11.3.)
A) $60,000
B) $255,000
C) $300,000
D) $210,000

22) One basic technique used to evaluate after-tax operating cash flows is to
A) add noncash charges to net income.
B) subtract depreciation from operating revenues.
C) add cash expenses to net income.
D) subtract cash expenses from noncash charges.

23) The basic variables that must be considered in determining the initial investment associated with a capital expenditure are all of the following EXCEPT
A) incremental annual savings produced by the new asset.
B) cost of the new asset.
C) proceeds from the sale of the existing asset.
D) taxes on the sale of an existing asset.

24) Fixed assets that provide the basis for the firm's profit and value are often called
A) tangible assets.
B) non-current assets.
C) earning assets.
D) book assets.

FIGURE 11.3

Computer Disk Duplicators, Inc. has been considering several capital investment proposals for the year beginning in 2004. For each investment proposal, the relevant cash flows and other relevant financial data are summarized in the table below. In the case of a replacement decision, the total installed cost of the equipment will be partially offset by the sale of existing equipment. The firm is subject to a 40 percent tax rate on ordinary income and on long-term capital gains. The firm's cost of capital is 15 percent.

		Proposal	
Type of Capital	1	2	3
Budgeting Decision	Expansion	Replacement	Replacement
Type of Project	Independent	Mutually exclusive with 3	Mutually exclusive with 2
Cost of new asset	$1,500,000	$200,000	$300,000
Installation costs	$ 0	$ 0	$ 15,000
MACRS (new asset)	10 years	5 years	5 years
Original cost of old asset	N/A*	$ 80,000	$100,000
Purchase date (old asset)	N/A	1/1/97	1/1/2000

Sale proceeds (old asset)	N/A	$ 50,000	$120,000
MACRS (old asset)	N/A	5 years	5 years
Annual net profits before depreciation & taxes (old)	N/A	$ 30,000	$ 25,000
Annual net profits before depreciation & taxes (new)	$ 250,000	$100,000	$175,000

*Not applicable

25) For Proposal 2, the cash flow pattern for the replacement project is (See Figure 11.3.)
A) a mixed stream and conventional.
B) a mixed stream and non-conventional.
C) an annuity and conventional.
D) an annuity and non-conventional.

Answers:

1) C
2) B
3) B
4) B
5) A
6) D
7) D
8) C
9) B
10) D
11) A
12) B
13) C
14) D
15) A
16) C
17) D
18) B
19) B
20) B
21) D
22) A
23) A
24) C
25) A

Financial Management
Chapter 13 Practice Quiz

1) The lower risk nature of long-term debt in a firm's capital structure is due to the fact that
A) the equity holders are the true owners of the firm.
B) equity capital has a fixed return.
C) creditors have a higher position in the priority of claims.
D) dividend payments are tax-deductible.

2) __________ leverage is concerned with the relationship between sales revenue and earnings per share.
A) Financial
B) Operating
C) Variable
D) Total

3) According to the traditional approach to capital structure, the value of the firm will be maximized when
A) the financial leverage is maximized.
B) the cost of debt is minimized.
C) the weighted average cost of capital is minimized.
D) the dividend payout is maximized.

4) The __________ approach to capital structure proposes that an optimal capital structure be selected which __________.
A) M and M; maximizes the weighted average cost of capital

B) traditional; minimizes the cost of debt
C) EBIT-EPS; maximizes the EPS
D) residual theory; minimizes dividends

5) The conflict resulting from a manager's desire to increase the firm's risk without increasing current borrowing costs and a lenders' desire to limit lending is one effect of the __________ problem.
A) agency
B) leverage
C) capital
D) variable cost

6) The optimal capital structure is the one that balances
A) return and risk factors in order to maximize profits.
B) return and risk factors in order to maximize earnings per share.
C) return and risk factors in order to maximize market value.
D) return and risk factors in order to maximize dividends.

7) The cost of debt financing results from
A) the increased profitability of bankruptcy caused by debt obligations.
B) the agency costs of the lender's monitoring and controlling the firm's actions.
C) the costs associated with managers having more information about the firm's prospects than do investors.
D) all of the above.

8) Which one of the following is (are) considered as a limitation of break-even analysis?
A) It assumes that the firm faces linear or nonvarying sales revenue and total operating cost functions.
B) It is difficult to break semivariable costs into fixed and variable components.
C) It has a short-term time horizon.
D) All of the above.

9) In order to enhance the wealth of stockholders and to send positive signals to the market, corporations generally raise funds using the following order:
A) retained earnings, equity, debt.
B) retained earnings, debt, equity.
C) debt, retained earnings, equity.
D) equity, retained earnings, debt.

10) __________ risk is the risk of being unable to cover operating costs.
A) Business
B) Financial
C) Leverage
D) Total

11) A firm is analyzing two possible capital structures-30 and 50 percent debt ratios. The firm has total assets of $5,000,000 and common stock valued at $50 per share. The firm has a marginal tax rate of 40 percent on ordinary income. The number of common shares outstanding for each of the capital structures would be
A) 30 percent debt ratio: 30,000 shares and 50 percent debt ratio: 50,000 shares.
B) 30 percent debt ratio: 50,000 shares and 50 percent debt ratio: 70,000 shares.
C) 30 percent debt ratio: 70,000 shares and 50 percent debt ratio: 100,000 shares.
D) 30 percent debt ratio: 70,000 shares and 50 percent debt ratio: 50,000 shares.

12) At the operating break-even point, __________ equals zero.

A) sales revenue
B) fixed operating costs
C) variable operating costs
D) earnings before interest and taxes

13) A firm has a current capital structure consisting of $400,000 of 12 percent annual interest debt and 50,000 shares of common stock. The firm's tax rate is 40 percent on ordinary income. If the EBIT is expected to be $200,000, the firm's earnings per share will be __________.
A) $2.40
B) $3.04
C) $7.04
D) $1.82

14) As debt is substituted for equity in the capital structure and the debt ratio increases, all of the following statements about the component costs of capital are true EXCEPT
A) the cost of equity continually increases.
B) the cost of debt continually increases.
C) the overall cost of capital first declines, reaches a minimum, and then rises again.
D) the overall cost of capital continually increases.

15) Operating and financial constraints placed on a corporation by loan provisions are
A) agency costs to the lender.
B) agency costs to the firm.
C) interest rate costs to the firm.
D) necessary to control the risk of the firm.

16) __________ results from the use of fixed-cost assets or funds to magnify returns to the firm's owners.
A) Long-term debt
B) Equity
C) Leverage
D) Capital structure

17) A decrease in fixed financial costs will result in __________ in financial risk.
A) an increase
B) a decrease
C) no change
D) an undetermined change

18) A firm has fixed operating costs of $25,000, a per unit sales price of $5, and a variable cost per unit of $3. What is its operating break-even point if it desires net operating income of $10,000, not $0 (zero)?
A) 12,500 units
B) 15,000 units
C) 17,500 units
D) 25,000 units

19) The preferred approach to break-even analysis for the multiproduct firm is the
A) break-even point expressed in units.
B) break-even point expressed in dollars.
C) cash break-even point.
D) overall break-even point.

20) A firm has EBIT of $375,000, interest expense of $75,000, preferred dividends of $6,000 and a tax rate of 40 percent. The firm's degree of financial leverage at a base EBIT level of $375,000 is __________.
A) 0.97

B) 1.29
C) 1.27
D) 1.09

21) Poor capital structure decisions can result in __________ the cost of capital, resulting in __________ acceptable investments. Effective capital structure decisions can __________ the cost of capital, resulting in __________ acceptable investments.
A) increasing; fewer; lower; more
B) decreasing; more; higher; fewer
C) increasing; more; lower, fewer
D) decreasing; fewer; higher; more

22) __________ risk is the risk of being unable to cover financial costs.
A) Business
B) Financial
C) Total
D) Leverage

23) As fixed operating costs increase and all other factors are held constant, the degree of operating leverage will
A) increase.
B) decrease.
C) remain unchanged.
D) change in an undetermined direction.

24) __________ costs are a function of time, not sales, and are typically contractual.
A) Fixed
B) Semi-variable
C) Variable
D) Operating

25) Because the degree of total leverage is multiplicative and not additive, when a firm has very high operating leverage it can moderate its total risk by
A) increasing sales.
B) using more financial leverage.
C) increasing EBIT.
D) using a lower level of financial leverage.

Answers:

1) C
2) D
3) C
4) C
5) A
6) C
7) D
8) D
9) B
10) A
11) D
12) D
13) D
14) D
15) B
16) C
17) B
18) C
19) B
20) B
21) A
22) B
23) A
24) A
25) D