Practice Problems & Solutions *(**correct answer highlighted in red**)*

1. Corporate Form

- Which of the following is an example of a conflict that can arise between shareholders and creditors?
  1) The passing up of profitable projects because they are viewed as too risky?
  2) **The undertaking of highly risky projects**.
  3) Taking steps to both defer and minimize taxes payable.
  4) Downplaying negative information and promoting positive news when it is preparing to issue new securities.

- Corporations are legal entities characterized by contractual arrangements between the involved parties. Conflicts arise between the various parties to a corporation because of market imperfections. Which of the following is ***NOT*** source of conflict?
  1) Shareholders versus creditors.
  2) Managers versus shareholders.
  3) Shareholders versus government.
  4) **Managers versus government.**

2. Roles of Man

- Which of the foll for management is that of maximizing share price as opposed to maximizi
  1) Profit must be judged relative to the riskiness of th
  2) Profit must be judged relative to the size of the in
  3) **Profit is a number that can be manipulated by**
  4) The investment is multiperiod.

- Which of the following is ***NOT*** a possible explanation for why management would take environmental and/or social considerations into account when it makes its strategic decisions?
  1) Regulation
  2) Share price
  3) Managerial compensation contracts
  4) **To satisfy bondholders**

- Given that market value and book value are seldom, if ever, the same, which of the following is a reason why analysts and investors are interested in the information provided in the company's Financial Statements?
  1) They are based on GAAP
  2) **They provide insights into the company's operating policies**
  3) They have an historical perspective and can be verified
  4) Analysts and investors are not interested in the company's Financial Statements

3. Market Efficiency

- Which of the following does the concept of market efficiency imply?
  1) All shares have the same price.
  2) Prices reflect all available information.
  3) Stock prices do not fluctuate.
  4) Throwing darts at a page of stocks will yield the same return as a carefully selected portfolio.

- Which of the following statements about the concept of market efficiency is ***TRUE***?
  1) In an efficient market, share price remains constant.
  2) In an efficient market, all shares have the same price.
  3) Technical analysts encourage semi-strong form efficiency.
  4) Fundamental analysts encourage semi-strong efficiency.

- If markets are semi-strong form efficient, which of the following situations is most likely to yield abnormal returns?
  a) Analysing a company's earnings report
  b) Identifying a pattern in a company's stock price
  c) Obtaining insider information
  d) Following the advice of your broker's newsletter

4. The discount r

- Which of the following statements about a stock's
  1) If $\beta_j > 1$, the stock is less volatile than the mar
  2) If $\beta_j = 0$, the stock is the risk-free asset and the
  3) If $\beta_j = 1$, $ER_j = ER_M$.
  4) If $\beta_j < 1$, the stock is more volatile than the market.

- AA Ltd. and ZZ Inc. operate in the same industry and produce the same product. AA and ZZ have, however, adopted quite different production technologies. AA is a totally automated company with virtually all of its costs being fixed in nature. Alternatively, ZZ's costs are largely variable. Which company will have higher operating leverage?
  1) AA Ltd.
  2) ZZ Inc.
  3) The two companies will have the same degree of operating leverage
  4) It isn't possible to determine which company will have the higher operating leverage based on the information provided.

- Maple Ltd. currently has 10 million common shares outstanding. Maple has just paid a dividend of $0.25 per share this year and investment analysts have informed you that the dividends are expected to grow by 7% annually for the foreseeable future. The analysts have also informed you that the shares are expected to be selling at a price of $4.50 in one year's time, the beta on the Maple shares is 1.10, the market price of risk is 6% and the risk-free rate of return is 3%. Based on this information, what is the appropriate discount rate to use in estimating the value of Maple's common shares?
  1) 6.60%
  2) 6.30%
  3) **9.60%**
  4) 9.90%

  r = 0.03 + 1.10(0.06) = 0.096

5. Valuation

- Bundy Inc. paid a dividend of $0.11 per share last year. Investment analysts have indicated that the historical growth rate in dividends of 3% is expected to continue for the foreseeable future. They have also informed you that Bundy's beta is 1.2, the risk-free rate of return is 4% and the market price of risk is 7%. What is the current market price of a share of Bundy Inc.?
  1) **$1.205**
  2) $1.170
  3) $0.914
  4) $1.349

  k = 0.04 + 1.2

  $$P = \frac{x_0(1+g)}{(k-g)} = \frac{0.11(1.03)}{(0.124-0.03)} = \$1.205$$

- Trail Ltd. reported net income of $4 million for its most recent fiscal year (20X0). Analysts expect the earnings to grow at a constant rate of 4% per year for at least the next 10 years. The most recent balance sheet dated 20X0 indicates that the current book value of shareholder's equity is $60 million. Trail has a policy of paying out 30% of earnings as dividends and retaining the balance for reinvestment. Trail does not intend to issue new shares or retire any shares for at least the next 10 years. Based on this information, what are Trail's abnormal earnings for the year 20X3, assuming that the analysts have also indicated that the appropriate discount rate for determining the value of the shares is 8%?
  1) $4,499,456
  2) $ –300,544
  3) **$ –775,782**
  4) $1,349,837

	20X1	20X2	20X3
Begin BV	60,000,000	62,912,000	65,940,480
+ Income	4 (1.04) = 4,160,000	$4(1.04)^2$ = 4,326,400	$4(1.04)^3$ = 4,499,456
– Dividends	=0.3(4.16) = 1,248,000	1,297,920	1,349,837
End BV	62,912,000	65,940,480	69,090,099
Abnormal Earnings	-640,000	-706,560	-775,782

For 20X3, AE = Income – 0.08(begin BV) = 4,499,456 – 0.08(65,940,480) = -775,782

- Based on their forecasts of earnings and dividends, analysts have determined that the abnormal earnings on a per share basis for Nelson Ltd over the next three years should be \$1.20, \$1.40, and \$1.50. The analysts then believe that Nelson's abnormal earnings will grow at an annual rate of 1% after the third year in perpetuity. They have also determined that the appropriate discount rate for use in determining the value of Nelson's common shares is 7.5%. Using the abnormal earnings valuation model, based on these figures, what is the current price of Nelson's common shares assuming that its book value is \$8 per share?
  1) \$22.297
  2) **\$30.297**
  3) \$30.111
  4) \$19.795

$$V_0 = 8 + \frac{1.20}{(1.075)} + \frac{1.40}{(1.075)^2} + \frac{1.50}{(1.075)^3} + \frac{1.50(1.01)}{(0.075-0.01)}\left(\frac{1}{(1.075)^3}\right) = \$30.297$$

- Apex Financial Ltd. is interesting in investing in the shares of Scion Systems Inc. Scion's current dividend is \$0.50 per share and its shares are selling at \$41.22. The required rate of return on the shares is 6%. Based on its extensive investigation, Apex believes that Scion will generate free cash flows of \$1.10 per share next year, \$1.40 per share the following year, \$1.75 per share in three years, following which the flows are projected to grow at an average rate of 2% per year. Based on this information, which of the following statements is correct?
  1) Apex should not invest because the shares are currently overpriced
  2) Apex should invest because the shares are currently underpriced
  3) Apex should no there is no upside potential
  4) **Apex should in of return**

$$V_0 = \frac{1.10}{(1.06)} + \frac{1.40}{(1.06)^2} + \frac{1.75}{(1.06)^3} + \frac{1.75(1.02)}{(0.06-0.02)}\left(\frac{1}{(1.06)^3}\right)$$

6. External Environment

- Which of the following statements about treasury risk management is ***NOT*** true?
  1) Treasury risk management is concerned with protecting a company against unanticipated changes in interest rates
  2) **Treasury risk management is concerned with protecting a company against unanticipated changes in the GDP**
  3) Treasury risk management is concerned with protecting a company against unanticipated changes in commodity prices
  4) The focus of treasury risk management is on fluctuations in the firm's profit, ROE, and/or market value.

- Which of the following factors is ***NOT*** a focus when analysing the way in which a company's prospects are affected by the external environment within which it operates?
  1) social causes
  2) technological change
  3) trade liberalisation
  4) **reputation**

7. Industry Factors

- Which of the following statement is ***TRUE*** about the bargaining power of a company's suppliers?
  1) **If the supplier is more powerful, it will typically charge the company a higher price**
  2) Its bargaining power will be greater if the costs of switching to a new supplier are lower
  3) It bargaining power will be lower if it offers a differentiated product
  4) Its bargaining power will be greater if there are a number of potential suppliers to choose from.

- Which of the following statements is ***TRUE***?
  1) A company's customers are more price sensitive if they have high profit margins
  2) A company's customers are more powerful if there is a large number of large number of potential customers that the company can sell to
  3) **The threat that a new company will enter an industry sector is higher when customer switching costs are low**
  4) A substitute product is less of a threat when the customer's switching costs are low

- Which of the following statements about the degree of rivalry among companies within an industry is ***TRUE***?

  1) **Rivalry is lower when industry growth is high**
  2) Rivalry is higher when exit barriers are low
  3) Rivalry is highe y
  4) Rivalry is lower

- Which of the following statements about a company's strategy is ***NOT*** true?
  1) A cost leadership strategy is most appropriate wh ard
  2) A differentiation strategy typically results in pr

  3) **One source of cost advantage for a cost leadership s rough extensive advertising**
  4) Factors that support a differentiation strategy include investment in R&D and superior customer service.

8. Understanding the Financial Statements

- Which of the following statements is ***NOT*** true about accrual accounting?
  1) Depreciation on fixed assets is an accrual account
  2) Earnings based on accrual accounting provides a better basis for forecasting than cash flow from operations
  3) Accrual accounting simply changes the timing of when items are recognised during the life of the company
  4) **Accrual accounting recognises revenue when it is received and expenses when they are paid.**

- Which of the following statements relating to the Statement of Changes in Equity is ***TRUE***?
  1) The clean surplus relation is always satisfied using Net Profit After Tax
  2) The only items included in the clean surplus relation are the company's earnings and its dividends
  3) **Clean surplus is a requirement for the Financial Statements to articulate**
  4) The only items that appear in the Shareholders' Equity account are contributed capital, retained earnings, and non-controlling interest.

- Which of the following statements about the Revenue Realization and Matching principles is ***NOT*** true?
  1) Revenue is recognised when the earnings process is complete
  2) **Revenue can only be recognised when it occurs in an arms-length transaction**
  3) An expense can only benefit the current period whereas an expenditure can be of benefit across multiple accounting periods
  4) An item of cost (an expenditure) must either be recognised in the Financial Statements as an asset or an expense

- Which of the following statements relating to measurement of the value of an item appearing in the Financial Statements is ***TRUE***?
  1) **The notions of Fair Value, Realisable Value and Present Value are largely viewed as being the same**
  2) The value of property, plant and equipment (pp&e) always appears in the Balance Sheet at historical co
  3) When a compan vestee company but not control, it sh ethod
  4) The amortised v t.

9. Reformulating the Financial Statements

- When reformulating the Balance Sheet and Income Statement, which of the following statements about the classification of items relating to finance leases is ***TRUE***?
  1) **Finance lease assets are classified as operating assets and lease interest is treated as a financial expense**
  2) Finance lease assets are classified as financial assets and lease interest is treated as an operating expense
  3) Finance lease assets are classified as operating assets and lease interest is treated as an operating expense
  4) Finance lease assets are classified as financial assets and lease interest is treated as a financial expense

- In reformulating the Balance Sheet, what is the appropriate classification for dividends payable?
  1) Financial obligation
  2) Operating Liability
  3) **Shareholders' Equity**
  4) Financial Asset

- When a company has recorded a 'Gain' as a result of buying another company in the same industry for less than the fair value of its net assets, how should this item be classified when the Income Statement is reformulated?
  1) Core other operating income
  2) Core operating income from sales
  3) Financial income
  4) **Unusual operating income**

- Which of the following is a levered amount?
  1) **Comprehensive Income**
  2) Cost of Goods Sold
  3) Interest expense
  4) Sales

- Which of the following is ***NOT*** an objective of reformulating the financial statements?
  1) To separately display operating and financing activities
  2) **To separate current and non-current operating assets**
  3) Alter the classification of some items
  4) To separate operating income based on whether it is recurring and driven by sales