CHAPTER 4

Cost of Capital

MULTIPLE CHOICE QUESTIONS

1. Which of the following is not an assumption of the capital asset pricing model (CAPM)?
(*a*) The capital market is efficient
(*b*) Investors lend or borrow at a risk-free rate of return
(*c*) Investors do not have the same expectations about the risk and return
(*d*) Investor's decisions are based on a single-time period

2. Given: risk-free rate of return = 5%; market return = 10%; cost of equity = 15%; value of bet (β) is:
(*a*) 1.9 (*b*) 1.8 (*c*) 2.0 (*d*) 2.2

3. ____________ may be defined as the cost of raising an additional rupee of capital:
(*a*) Marginal cost of capital (*b*) Weighted average cost of capital
(*c*) simple average cost of capital (*d*) Liquid cost of capital

4. Which of the following cost of capital requires to adjust taxes?
(*a*) Cost of equity share (*b*) Cost of preference shares
(*c*) Cost of debentures (*d*) Cost of retained earnings

5. Marginal cost of capital is the cost of:
(*a*) Additional revenue (*b*) Additional funds
(*c*) Additional interests (*d*) None of the above

6. In order to calculate Weighted Average Cost of capital, weights may be based on:
(*a*) Market values (*b*) Target values
(*c*) Book values (*d*) Anyone of the above

7. Firm's cost of capital is the average cost of:
(*a*) All sources of finance (*b*) All borrowings
(*c*) All share capital (*d*) All bonds and debentures

8. A company has a financial structure where equity is 70% of its total debt plus equity. Its cost of equity is 10% and gross loan interest is 5%. Corporation tax is paid at 30%. What is the company's weighted average cost of capital (WACC)?

(*a*) 7.55% (*b*) 7.80%

(*c*) 8.70% (*d*) 8.05%

9. The cost of equity capital is all of the following except:

(*a*) The minimum rate that a firm should earn on the equity-financed part of an investment

(*b*) A return on the equity-financed portion of an investment that, at worst, leaves the market price of the stock unchanged

(*c*) By far, the most difficulty component cost to estimate

(*d*) Generally, lower than the before-tax cost of debt

10. What is the overall (weighted average) cost of capital when the firm has ₹20 crores in long-term debt, ₹4 crores in preferred stock, and ₹16 crores in equity shares? The before-tax cost for debt, preferred stock, and equity capital are 8%, 9% and 15%, respectively. Assume a 50% tax rate.

(*a*) 7.60% (*b*) 6.90%

(*c*) 7.30% (*d*) 8.90%

11. If the required rate of return of a particular bond is less than coupon rate, it is known as

(*a*) Discount Bond (*b*) Premium Bond

(*c*) Par Bond (*d*) Junk Bond

12. If a coupon bond is selling at discount, then which of the following is true?

(*a*) Po < Par and YTM < coupon (*b*) Po < Par and YTM > coupon

(*c*) Po > Par and YTM < coupon (*d*) Po > Par and YTM > coupon

13. Which of the following is a feature of zero-coupon bonds?

(*a*) Sold at Par (*b*) Sold at premium

(*c*) Pays no Interest (*d*) Not Redeemable

14. In a 3 years Bond purchased and held till maturity, the rate earned is called

(*a*) Coupon Rate (*b*) Yield to Maturity

(*c*) Current Yield (*d*) Holding Period Return

15. An investor should buy a bond if

(*a*) Intrinsic Value < Market Value (*b*) Intrinsic Value > Market Value

(*c*) Market Value < Redemption Value (*d*) Market Value = Redemption Value

16. What's the worth to you of a ₹1,000 face-value bond with an 8% coupon rate when your required rate of return is 15 percent?

(*a*) More than its face value (*b*) Less than its face value

(*c*) ₹1,000 (*d*) None of the above

17. Bonds that can be converted into shares of common stock are classified as

(*a*) convertible bonds
(*b*) stock bonds
(*c*) shared bonds
(*d*) common bonds

18. Which of the following sources of funds has an Implicit Cost of Capital?

(*a*) Equity Share Capital
(*b*) Preference Share Capital
(*c*) Debentures
(*d*) Retained earnings.

19. Marginal cost of capital is the cost of:

(*a*) Additional Sales
(*b*) Additional Funds
(*c*) Additional Interests
(*d*) None of the above

20. Which of the following is true?

(*a*) Retained earnings are cost free
(*b*) External Equity is cheaper than Internal Equity
(*c*) Retained Earnings are cheaper than External Equity
(*d*) Retained Earnings are costlier than External Equity

21. The constant growth model of equity valuation assumes that ______________

(*a*) the dividends paid by the company remain constant
(*b*) the dividends paid by the company grow at a constant rate of growth
(*c*) the cost of equity may be less than or equal to the growth rate
(*d*) the growth rate is less than the cost of equity.

22. CAPM describe the _____ between risk and return for securities.

(*a*) Linear Relationship
(*b*) Hypothetical Relationship
(*c*) No Relationship
(*d*) Diagonal Relationship

23. An increase in market value of preference share will ______________ the cost of preference share.

(*a*) increase
(*b*) not affect
(*c*) either increase or decrease
(*d*) decrease

24. Beta of Market is _____.

(*a*) 1
(*b*) less than 1
(*c*) more than 1
(*d*) not defined

25. If Beta of security is more than 1, than such investment are known as ______________ investment.

(*a*) defensive
(*b*) moderate
(*c*) aggressive
(*d*) polite

26. If beta of security is less than 1, than its CAPM return will be ______________ than market rate of return.

(*a*) more
(*b*) less
(*c*) equal
(*d*) one

27. If beta of security is equal to 1, than its CAPM return will be ______________ than market rate of return.

(*a*) more (*b*) less

(*c*) equal (*d*) one

28. R Ltd. has disbursed a dividend of ₹75 on each equity share of ₹25. The market price of share is ₹200. Corporate tax rate is 40%. Its cost of equity is -

(*a*) 30.0% (*b*) 37.5%

(*c*) 35.7% (*d*) 33.5%

29. SK Ltd. Beta is 1.8025. Dividend paid by the company last year was ₹9 per share on face value of ₹30. The risk free rate is .061275. Risk premium is 0.0825. Calculate cost of equity capital.

(*a*) 21% (*b*) 6.28%

(*c*) 14.77% (*d*) 12%

Answer Key

1. (*c*)	**2.** (*c*)	**3.** (*a*)	**4.** (*c*)	**5.** (*b*)	**6.** (*d*)	**7.** (*a*)	**8.** (*d*)	**9.** (*d*)	**10.** (*d*)
11. (*b*)	**12.** (*b*)	**13.** (*c*)	**14.** (*b*)	**15.** (*b*)	**16.** (*b*)	**17.** (*a*)	**18.** (*d*)	**19.** (*b*)	**20.** (*c*)
21. (*b*)	**22.** (*a*)	**23.** (*d*)	**24.** (*a*)	**25.** (*c*)	**26.** (*b*)	**27.** (*c*)	**28.** (*b*)	**29.** (*a*)	