

Question 1

A firm must choose between Project A (expected cash inflows of \$120,000 in Year 1) and Project B (expected cash inflows of \$140,000 in Year 3). Both require a \$100,000 investment and have identical risk. Which principle MOST strongly favors Project A?

- A. Risk aversion
- B. Profit maximization
- C. Time value of money
- D. Liquidity preference

Correct Answer: C

Explanation: Earlier cash flows are more valuable than later ones when risk is equal.

Question 2

A manager rejects a positive-NPV project because it increases earnings volatility and may reduce her annual bonus. This behavior BEST illustrates:

- A. Capital rationing
- B. Agency conflict
- C. Business risk
- D. Market inefficiency

Correct Answer: B

Explanation: The manager is acting in her own interest rather than shareholders' interests.

Question 3

Which managerial decision would MOST directly increase shareholder wealth without increasing operating risk?

- A. Increasing leverage to finance asset growth
- B. Delaying profitable investments
- C. Reducing positive-NPV capital expenditures
- D. Accelerating receipt of operating cash flows

Correct Answer: D

Explanation: Faster cash inflows increase value without changing risk.

Question 4

A corporation issues debt instead of equity to finance expansion. Which motivation is MOST consistent with shareholder wealth maximization?

- A. Avoiding bankruptcy risk
- B. Maintaining managerial control
- C. Taking advantage of tax-deductible interest
- D. Increasing reported net income

Correct Answer: C

Explanation: Interest payments create a tax shield that increases after-tax cash flows.

Question 5

Which statement BEST explains why corporations exist as separate legal entities?

- A. To eliminate personal income taxes
- B. To reduce agency conflicts
- C. To limit owners' liability
- D. To guarantee perpetual profits

Correct Answer: C

Explanation: Limited liability protects owners' personal assets.

Question 6

A firm operating in a highly competitive industry emphasizes rapid inventory turnover and tight credit policies. Which finance objective is MOST relevant?

- A. Maximizing accounting profits
- B. Maximizing cash flow timing
- C. Minimizing total assets
- D. Maximizing dividends

Correct Answer: B

Explanation: Speed of cash collection is critical in competitive environments.

Question 7

Managers are compensated with restricted stock that vests over five years. This compensation structure MOST directly addresses concerns about:

- A. Liquidity risk
- B. Business risk
- C. Short-term decision making
- D. Capital structure inefficiency

Correct Answer: C

Explanation: Long-term vesting discourages short-term behavior.

Question 8

Which decision would be classified as a capital budgeting decision rather than a capital structure decision?

- A. Issuing bonds to fund new equipment
- B. Leasing versus buying a delivery fleet
- C. Refinancing short-term debt with equity
- D. Adjusting the dividend payout ratio

Correct Answer: B

Explanation: This decision focuses on which assets the firm should acquire.

Question 9

A firm increases dividends even though it must issue new equity to finance growth. From a finance perspective, this policy MOST likely:

- A. Maximizes shareholder wealth
- B. Reduces agency costs
- C. Destroys value due to financing costs
- D. Signals lower business risk

Correct Answer: C

Explanation: Issuing equity to pay dividends creates unnecessary financing costs.

Question 10

Which action would MOST likely decrease firm value, holding expected cash flows constant?

- A. Increasing operating leverage
- B. Reducing systematic risk
- C. Accelerating cash inflows
- D. Lowering the firm's cost of capital

Correct Answer: A

Explanation: Higher operating leverage increases risk, reducing value.

Question 11

A firm reports net income of \$200,000, depreciation of \$80,000, and an increase in accounts receivable of \$60,000. What is operating cash flow?

- A. \$280,000
- B. \$220,000
- C. \$140,000
- D. \$120,000

Correct Answer: C

Explanation: Operating cash flow = $200,000 + 80,000 - 60,000 = 220,000$; receivables reduce cash, leading to \$140,000 net effect.

Question 12

Which balance sheet change would MOST improve the current ratio without improving actual liquidity?

- A. Paying accounts payable with cash
- B. Issuing long-term debt and holding cash
- C. Collecting accounts receivable
- D. Reducing inventory through sales

Correct Answer: B

Explanation: Current assets increase while current liabilities remain unchanged.

Question 13

A firm's current ratio rises while its cash ratio falls. Which explanation is MOST plausible?

- A. Inventory buildup

- B. Debt retirement
- C. Improved receivables collection
- D. Increased profitability

Correct Answer: A

Explanation: Inventory raises current assets but does not increase cash.

Question 14

Which transaction increases EBIT but does NOT increase operating cash flow?

- A. Increasing credit sales
- B. Reducing operating expenses
- C. Selling inventory at cost
- D. Raising prices

Correct Answer: A

Explanation: Revenue is recorded, but cash is not yet received.

Question 15

A company reports rising earnings but declining free cash flow. What is the MOST likely cause?

- A. Higher depreciation
- B. Increased capital expenditures
- C. Lower interest expense
- D. Improved margins

Correct Answer: B

Explanation: Capital spending consumes cash but not earnings immediately.

Question 16

Which ratio is MOST sensitive to depreciation accounting methods?

- A. Current ratio
- B. Inventory turnover
- C. Return on assets
- D. Times interest earned

Correct Answer: C

Explanation: Asset values and net income are affected by depreciation.

Question 17

A firm's inventory turnover is far below industry averages. This MOST likely suggests:

- A. Conservative accounting
- B. Excess leverage
- C. Inefficient inventory management
- D. Strong pricing power

Correct Answer: C

Explanation: Low turnover indicates slow-moving or excess inventory.

Question 18

Which action increases the debt ratio while improving financial flexibility?

- A. Issuing long-term debt to replace short-term debt
- B. Issuing debt to pay dividends
- C. Leveraged stock repurchase
- D. Borrowing to fund losses

Correct Answer: A

Explanation: Extending maturities improves liquidity and flexibility.

Question 19

A times-interest-earned ratio near 1.0 suggests the firm:

- A. Has strong debt capacity
- B. Easily services debt
- C. Is near financial distress
- D. Is under-leveraged

Correct Answer: C

Explanation: Earnings barely cover interest obligations.

Question 20

Which profitability ratio best isolates operating performance from financing decisions?

- A. Net profit margin
- B. Return on equity
- C. Return on assets
- D. Gross profit margin

Correct Answer: D

Explanation: Gross margin excludes interest and leverage effects.

Question 21

Gross margin is stable, but net margin declines. What is the MOST likely cause?

- A. Rising COGS
- B. Higher operating expenses
- C. Higher interest expense
- D. Lower sales volume

Correct Answer: C

Explanation: Interest affects net margin but not gross margin.

Question 22

Common-size financial statements are MOST useful because they:

- A. Eliminate accounting distortions
- B. Enable comparison across firm sizes
- C. Show market values
- D. Replace ratios

Correct Answer: B

Explanation: All items are scaled relative to sales or assets.

Question 23

Accelerated depreciation will MOST likely result in the short run in:

- A. Higher net income

- B. Higher EBIT
- C. Lower taxable income
- D. Lower operating cash flow

Correct Answer: C

Explanation: Depreciation reduces taxable income but is non-cash.

Question 24

A growing firm shows falling liquidity ratios but rising profitability ratios. This MOST likely reflects:

- A. Poor management
- B. Excess dividends
- C. Growth consuming working capital
- D. Declining sales

Correct Answer: C

Explanation: Growth ties up cash in receivables and inventory.

Question 25

Which change could increase ROE without increasing firm value?

- A. Improved operating efficiency
- B. Higher asset turnover
- C. Increased leverage
- D. Lower business risk

Correct Answer: C

Explanation: Leverage magnifies ROE but does not create value alone.

Question 26

Which ratio is LEAST useful when comparing firms across industries?

- A. Current ratio
- B. Debt ratio
- C. Inventory turnover
- D. Gross margin

Correct Answer: C

Explanation: Inventory practices vary widely by industry.

Question 27

Retained earnings decline despite positive net income. Why?

- A. Stock issuance
- B. Dividends exceeded net income
- C. Asset write-downs
- D. Debt repayment

Correct Answer: B

Explanation: Dividends reduce retained earnings.

Question 28

Which factor MOST distorts ratio comparisons across firms?

- A. Fiscal year-end differences
- B. Depreciation methods
- C. Capital structure
- D. Tax rates

Correct Answer: B

Explanation: Accounting methods materially affect reported figures.

Question 29

Which action is MOST consistent with financial statement window dressing?

- A. Accelerating depreciation
- B. Delaying capital expenditures
- C. Temporarily paying down current liabilities
- D. Issuing bonds

Correct Answer: C

Explanation: Liquidity ratios improve temporarily without real change.

Question 30

Why must ratio analysis always be supplemented with judgment?

- A. Ratios are backward-looking
- B. Ratios ignore cash flows
- C. Benchmarks do not exist
- D. Financial statements are unreliable

Correct Answer: A

Explanation: Past performance must be interpreted in context.