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28 USES OF CAPITAL

1. A large, creditworthy manufacturing firm would most likely get short-term financing by:
   (A) issuing commercial paper.
   (B) factoring its receivables.
   (C) entering into an agreement for a committed line of credit.

2. The quick ratio is considered a more conservative measure of liquidity than the current ratio because the quick ratio excludes:
   (A) marketable securities.
   (B) accounts receivable.
   (C) inventories.

3. The condition that occurs when a company disburses cash too quickly, stretching the company's cash reserves, is best described as a:
   (A) pull on liquidity.
   (B) drag on liquidity.
   (C) liquidity premium.

4. In reviewing the effectiveness of a company's liquidity, an analyst has calculated operating cycle and cash conversion cycle measures for the past three years.

	20X6	20X7	20X8
Operating cycle (number of days)	55	60	62
Cash conversion cycle (number of days)	27	30	32

   The trends in the operating cycle and cash conversion cycle most likely indicate:
   (A) slower collections of receivables.
   (B) improving liquidity.
   (C) stretching of payables.

5. Which of the following sources of credit would an analyst most likely associate with a borrower of the lowest credit quality?
   (A) Revolving line of credit.
   (B) Uncommitted line of credit.
   (C) Committed line of credit.

6. An analyst computes the following ratios for Iridescent Carpeting Inc. and compares the results to the industry averages:

Financial Ratio	Iridescent Carpeting	Industry Average
Current Ratio	2.3	1.8
Net Profit Margin	22%	24%
Return on Equity	17%	20%
Total Debt / Total Capital	35%	56%
Interest Coverage Ratio	4.7	4.1

Based on the above data, which of the following can the analyst conclude? Compared to its competitors, Iridescent Carpeting is more:

(A) profitable.

(B) leveraged.

(C) liquid.

7. Liquidating short-term assets and renegotiating debt agreements are best described as a firm's:

(A) primary sources of liquidity.

(B) pulls and drags on liquidity.

(C) secondary sources of liquidity.

8. Which of the following most accurately represents the cash conversion cycle?

(A) average days of payables + average days of inventory - average days of receivables.

(B) average days of receivables + average days of inventory + average days of payables.

(C) average days of receivables + average days of inventory - average days of payables.

9. Alton Industries will have better liquidity than its peer group of companies if its:

(A) quick ratio is lower.

(B) average trade payables are lower.

(C) receivables turnover is higher.

10. A high cash conversion cycle suggests that a company's investment in working capital is:

(A) appropriate.

(B) too high.

(C) too low.

11. A company is most likely to have a longer operating cycle than its peers if it:
    (A) has a higher payables turnover ratio than its peers.
    (B) has a higher inventory turnover ratio than its peers.
    (C) grants more lenient credit terms to its customers than its peers.

12. An example of a secondary source of liquidity is:
    (A) negotiating debt contracts.
    (B) cash flow management.
    (C) trade credit and bank lines of credit.

13. Quixote Co. and Sisyphus Co., two similar-sized competitors, have had stable operating cycles of 180 days and cash conversion cycles of 140 days over the past several years. Sisyphus' operating and cash conversion cycles remained at these levels in the most recent year, but Quixote's cash conversion cycle contracted to 120 days while its operating cycle remained at 180 days. Relative to Sisyphus, Quixote has most likely begun:
    (A) offering easier credit terms to its customers.
    (B) operating with less inventory on hand.
    (C) taking more time to pay its suppliers.

14. Pierce Motor Company has an operating cycle of 150 days and a cash conversion cycle of 120 days, while Dunhill Motor, Inc. has an operating cycle of 140 days and a cash conversion cycle of 125 days. Based on these figures it is most likely that:
    (A) average days of payables for Dunhill is less than for Pierce.
    (B) average days of inventory for Dunhill is less than for Pierce.
    (C) average days of receivables for Dunhill is less than for Pierce.

15. Which of the following is NOT a limitation to financial ratio analysis?
    (A) The need to use judgment.
    (B) A firm that operates in only one industry.
    (C) Differences in international accounting practices.

16. An example of a primary source of liquidity is:
    (A) renegotiating debt agreements.
    (B) using trade credit from vendors.
    (C) filing for bankruptcy.

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17. An analyst who is evaluating a firm's liquidity position would be least likely to be concerned if the firm's:
    (A) number of days of inventory is higher than that of its peers.
    (B) operating cycle is shorter than that of its peers.
    (C) total asset turnover is lower than its industry average.

18. The average number of days that it takes to turn raw materials into cash proceeds is a firm's:
    (A) inventory turnover cycle.
    (B) receivables cycle.
    (C) operating cycle.

19. A firm has average days of receivables outstanding of 22 compared to an industry average of 29 days. An analyst would most likely conclude that the firm:
    (A) has better credit controls than its peer companies.
    (B) has a lower cash conversion cycle than its peer companies.
    (C) may have credit policies that are too strict.

20. Which of the following is least likely an indicator of a firm's liquidity?
    (A) Inventory turnover.
    (B) Amount of credit sales.
    (C) Cash as a percentage of sales.

21. Which of the following factors is most likely to cause a firm to need short-term financing?
    (A) Operating cash inflows that fluctuate seasonally.
    (B) Return of principal from maturing investments.
    (C) Shorter cash conversion cycle than the industry average.

22. Which of the following sources of short-term liquidity is considered reliable enough that it can be listed in the footnotes to a firm's financial statements as a source of liquidity?
    (A) Revolving line of credit.
    (B) Factoring agreement.
    (C) Uncommitted line of credit.

23. An analyst has calculated the following statistics for Company X and Company Y.

	Company X		Company Y	
	Year 1	Year 2	Year 1	Year 2
Number of days of inventory	18	22	33	24
Number of days of receivables	14	16	14	12
Number of days of payables	19	20	18	20

The net operating cycle for:

(A) Company X was 18 days in year 2, an improvement in liquidity compared to year 1.

(B) Company Y was 36 days in year 2, a decline in liquidity compared to year 1.

(C) Company Y was 16 days in year 2, an improvement in liquidity compared to year 1.

24. Which of the following sources of liquidity is the most reliable?

(A) Revolving line of credit.

(B) Uncommitted line of credit.

(C) Committed line of credit.

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25. The greatest amount of detailed capital budgeting analysis is typically required when deciding whether to:

(A) introduce a new product or develop a new market.

(B) replace a functioning machine with a newer model to reduce costs.

(C) expand production capacity.

26. Which of the following is least relevant in determining project cash flow for a capital investment?

(A) Tax impacts.

(B) Opportunity costs.

(C) Sunk costs.

27. An investment is purchased at a cost of $775,000 and returns $300,000 at the end of years 2 and 3. At the end of year 4 the investment receives a final payment of $400,000. The IRR of this investment is closest to:

(A) 8.65%.

(B) 9.45%.

(C) 13.20%.

28. A firm is reviewing an investment opportunity that requires an initial cash outlay of $336,875 and promises to return the following irregular payments:

Year 1: $100,000

Year 2: $82,000

Year 3: $76,000

Year 4: $111,000

Year 5: $142,000

If the required rate of return for the firm is 8%, what is the net present value of the investment?

(A) $64,582.

(B) $99,860.

(C) $86,133.

29. An analyst has gathered the following data about a company with a 12% cost of capital:

	Project P	Project Q
Cost	$15,000	$25,000
Life	5 years	5 years
Cash inflows	$5,000/year	$7,500/year

If the projects are independent, what should the company do?

(A) Accept both Project P and Project Q.

(B) Accept Project P and reject Project Q.

(C) Reject both Project P and Project Q.

30. The CFO of Axis Manufacturing is evaluating the introduction of a new product. The costs of a recently completed marketing study for the new product and the possible increase in the sales of a related product made by Axis are best described (respectively) as:

(A) sunk cost; externality.

(B) externality; cannibalization.

(C) opportunity cost; externality.

31. Jack Smith, CFA, is analyzing independent investment projects X and Y. Smith has calculated the net present value (NPV) and internal rate of return (IRR) for each project:

Project X: NPV = $250; IRR = 15%

Project Y: NPV = $5,000; IRR = 8%

Smith should make which of the following recommendations concerning the two projects?

(A) Accept Project Y only.

(B) Accept both projects.

(C) Accept Project X only.

32. The estimated annual after-tax cash flows of a proposed investment are shown below:

Year1: $10,000

Year 2: $15,000

Year 3: $18,000

After-tax cash flow from sale of investment at the end of year 3 is $120,000

The initial cost of the investment is $100,000, and the required rate of return is 12%. The net present value (NPV) of the project is closest to:

(A) $19,113.

(B) $63,000.

(C) -$66,301.

33. An analyst has gathered the following data about a company with a 12% cost of capital:

	Project P	Project Q
Cost	$15,000	$25,000
Life	5 years	5 years
Cash inflows	$5,000/year	$7,500/year

If Projects P and Q are mutually exclusive, what should the company do?

(A) Accept Project P and reject Project Q.

(B) Accept Project Q and reject Project P.

(C) Reject both Project P and Project Q.

34. If two projects are mutually exclusive, a company:

(A) can accept either project, but not both projects.

(B) must accept both projects or reject both projects.

(C) can accept one of the projects, both projects, or neither project.

35. Which of the following steps is least likely to be an administrative step in the capital budgeting process?

(A) Arranging financing for capital projects.

(B) Conducting a post-audit to identify errors in the forecasting process.

(C) Forecasting cash flows and analyzing project profitability.

36. Financing costs for a capital project are:

(A) subtracted from estimates of a project's future cash flows.

(B) subtracted from the net present value of a project.

(C) captured in the project's required rate of return.

37. The effect of a company announcement that they have begun a project with a current cost of $10 million that will generate future cash flows with a present value of $20 million is most likely to:
    (A) increase value of the firm's common shares by $10 million.
    (B) increase the value of the firm's common shares by $20 million.
    (C) only affect value of the firm's common shares if the project was unexpected.

38. As the director of capital budgeting for Denver Corporation, an analyst is evaluating two mutually exclusive projects with the following net cash flows:

Year	Project X	Project Z
0	-$100,000	-$100,000
1	$50,000	$10,000
2	$40,000	$30,000
3	$30,000	$40,000
4	$10,000	$60,000

If Denver's cost of capital is 15%, which project should be chosen?
    (A) Project X, since it has the higher IRR.
    (B) Project X, since it has the higher net present value (NPV).
    (C) Neither project.

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39. Which of the following statements about NPV and IRR is least accurate?
    (A) The IRR can be positive even if the NPV is negative.
    (B) The NPV will be positive if the IRR is less than the cost of capital.
    (C) When the IRR is equal to the cost of capital, the NPV equals zero.

40. Which of the following types of capital budgeting projects are most likely to generate little to no revenue?
    (A) Regulatory projects.
    (B) New product or market development.
    (C) Replacement projects to maintain the business.

41. If the calculated net present value (NPV) is negative, which of the following must be correct. The discount rate used is:
    (A) greater than the internal rate of return (IRR).
    (B) less than the internal rate of return (IRR).
    (C) equal to the internal rate of return (IRR).

42. Should a company accept a project that has an IRR of 14% and an NPV of $2.8 million if the cost of capital is 12%?
    (A) No, based on the NPV and the IRR.
    (B) Yes, based only on the NPV.
    (C) Yes, based on the NPV and the IRR.

43. Fisher, Inc., is evaluating the benefits of investing in a new industrial printer. The printer will cost $28,000 and increase after-tax cash flows by $7,000 during each of the next four years and $6,000 in each of the two years after that. The internal rate of return (IRR) of the printer project is closest to:
    (A) 11.8%.
    (B) 11.6%.
    (C) 12.0%.

44. Johnson's Jar Lids is deciding whether to begin producing jars. Johnson's pays a consultant $50,000 for market research that concludes Johnson's sales of jar lids will increase by 5% if it also produces jars. In choosing the cash flows to include when evaluating a project to begin producing jars, Johnson's should:
    (A) include the cost of the market research and exclude the effect on the sales of jar lids.
    (B) include both the cost of the market research and the effect on the sales of jar lids.
    (C) exclude the cost of the market research and include the effect on the sales of jar lids.

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45 Garner Corporation is investing $30 million in new capital equipment. The present value of future after-tax cash flows generated by the equipment is estimated to be $50 million. Currently, Garner has a stock price of $28.00 per share with 8 million shares outstanding. Assuming that this project represents new information and is independent of other expectations about the company, what should the effect of the project be on the firm's stock price?
    (A) The stock price will increase to $30.50.
    (B) The stock price will increase to $34.25.
    (C) The stock price will remain unchanged.

46. A company is considering a $10,000 project that will last 5 years.
    - Annual after tax cash flows are expected to be $3,000
    - Cost of capital = 9.7%

    What is the project's net present value (NPV)?
    (A) +$1,460.
    (B) -$1,460.
    (C) +$11,460.

47. Lincoln Coal is planning a new coal mine, which will cost $430,000 to build. The mine will bring cash inflows of $200,000 annually over the next seven years. It will then cost $170,000 to close down the mine in the following year. Assume all cash flows occur at the end of the year. Alternatively, Lincoln Coal may choose to sell the site today. If Lincoln has a 16% required rate of return, the minimum price they should accept for the property is closest to:
    (A) $318,000.
    (B) $310,000.
    (C) $326,000.

48. The effects that the acceptance of a project may have on other firm cash flows are best described as:
    (A) pure plays.
    (B) externalities.
    (C) opportunity costs.

49. The financial manager at Genesis Company is looking into the purchase of an apartment complex for $550,000. Net after-tax cash flows are expected to be $65,000 for each of the next five years, then drop to $50,000 for four years. Genesis' required rate of return is 9% on projects of this nature. After nine years, Genesis Company expects to sell the property for after-tax proceeds of $300,000. What is the respective internal rate of return on this project?
    (A) 7.01%.
    (B) 13.99%.
    (C) 6.66%.

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50. One of the basic principles of capital budgeting is that:
    (A) projects should be analyzed on a pre-tax basis.
    (B) decisions are based on cash flows.
    (C) opportunity costs should be excluded from the analysis of a project.

51. Polington Aircraft Co. just announced a sale of 30 aircraft to Cuba, a project with a net present value of $10 million. Investors did not anticipate the sale because government approval to sell to Cuba had never before been granted. The share price of Polington should:
    (A) not necessarily change because new contract announcements are made all the time.
    (B) increase by the project NPV divided by the number of common shares outstanding.
    (C) increase by the NPV x (1 - corporate tax rate) divided by the number of common shares outstanding.

52. An analyst with Laytech Corp. is evaluating two machines as possible replacements for an existing stamping machine. He estimates that machine 1 has a cost of $5 million and that purchasing it would produce a profitability index of 1.20. He estimates that machine 2 has a cost of $6 million and that purchasing it would produce a profitability index of 1.17. Based on these estimates he should conclude that:

(A) machine 1 should be chosen.

(B) machine 2 should be chosen.

(C) neither project is preferred to the other.