


Question #1 of 12

Question ID: 1646481

Compared to public companies, private companies:

- A) have shares that are easier to transfer.
- B) are subject to stricter disclosure requirements.
- C) may provide greater returns over long investment horizons.** 


Explanation

Particularly for owners who invest early in a private company's life, returns may be greater on average than returns on investments in public companies. Public company shares are easier to transfer because they trade on exchanges. Public companies are subject to stricter disclosure requirements than private companies. (Module 20.1, LOS 20.c)

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With respect to a corporation's mechanisms to manage stakeholder relationships, special resolutions are *most* accurately described as a:

- A) creditor mechanism.
- B) shareholder mechanism.** 
- C) board of directors mechanism.

Explanation

Resolutions refer to matters that require approval by a voting majority of shareholders. Special resolutions are those that amend a corporation's bylaws or address issues such as mergers or takeovers, and may require a supermajority of shareholder votes. (Module 22.1, LOS 22.b)

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Which of the following changes in a firm's working capital management is *most likely* to result in a shorter operating cycle?

- A) Reducing stock-outs by carrying greater quantities of inventory.**

B) Stretching its payables by paying on the last permitted date.

C) **Changing its credit terms for customers from 2/10, net 60 to 2/10, net 30.**



Explanation

The operating cycle is average days of receivables plus average days of inventory. Changing its credit terms for customers from "net 60" to "net 30" would likely decrease the firm's average days of receivables and shorten its operating cycle. Increasing inventory quantities would increase average days of inventory and lengthen the operating cycle. Stretching payables by waiting until their due date to pay would increase the firm's average days of payables. This would shorten the firm's cash conversion cycle (days of receivables + days of inventory – days of payables) but would not affect its operating cycle. (Module 23.1, LOS 23.a)

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The use of secondary sources of liquidity would *most likely* be considered:

A) a normal part of daily business for a company.

B) **a signal that a company's financial position is deteriorating.**

C) a lower-cost source of short-term financing compared to primary sources of liquidity.

Explanation

Secondary sources of liquidity include renegotiating debt contracts, liquidating assets, and filing for bankruptcy protection and reorganization. The use of these sources of funds is typically a signal that a company's financial position is deteriorating. The liquidity provided by these sources usually comes at a substantially higher cost than liquidity provided by primary sources. (Module 23.1, LOS 23.b)

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Companies that use significant short-term funding in their capital structure should:

A) **use multiple sources for a specific type of lending.**

B) deal primarily with a single source to achieve the lowest cost.

- C) not maintain sources of funding beyond their current needs because that increases their funding cost.


Explanation

Companies that use significant short-term funding should maintain multiple sources of funding because market conditions and lender circumstances can change over time. Companies should maintain sources of excess funding to take advantage of profitable that may arise, even if doing so raises their overall funding costs. (Module 23.1, LOS 23.c)

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With regard to the internal rate of return (IRR), which of the following statements is *most accurate*?

- A) The IRR is the discount rate that maximizes a project's net present value.
A proper decision rule is to accept the project if IRR is less than the required rate of return.
- B) **IRR is the discount rate at which the present value of expected future after-tax cash flows is equal to the investment outlay.** 
- C)

Explanation


The IRR is the discount rate that equates a project's initial cost with the present value of its future expected cash flows (i.e., for which a project's net present value equals zero). The correct IRR decision rule is to accept the project if IRR is greater than the required rate of return, and to reject the project if IRR is less than the required rate of return. (Module 24.1, LOS 24.b)

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The manufacturer of Pow Detergent has developed New Improved Pow with Dirteaters and is considering adding it to its product line. New Improved Pow would sell at a premium price compared to Pow. In order to manufacture New Improved Pow, the firm will need to build a new facility and purchase new equipment. Which of the following is *least likely* included when calculating the appropriate cash flows for analysis of whether to add New Improved Pow to its product line?

A) Expected depreciation on the new facility and equipment for tax purposes.

B) **Costs of a marketing survey performed last month to decide whether to introduce New Improved Pow.** 

C) Reduced sales of Pow that result from the introduction of New Improved Pow.

Explanation

Costs that are incurred prior to the decision of whether or not to pursue a project are sunk costs and should not be used in the NPV calculation. Only cash flows that result from the decision to actually do the project should be considered in the analysis. Taxes must be deducted so the project's cash flows can be analyzed on an after-tax basis. Because depreciation is tax deductible, expected depreciation will affect annual taxes and after-tax cash flows. Cannibalization of sales of an existing product is an externality that should be included in the estimation of incremental project cash flows. (Module 24.2, LOS 24.c)

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Other things equal, a company is likely able to support a higher proportion of debt in its capital structure if it:

A) operates in a cyclical industry.

B) is early in its company life cycle.

C) **has a subscription-based revenue model.** 

Explanation

Compared to a pay-per-use revenue model, a subscription-based revenue model can support a higher proportion of debt financing. Mature companies and noncyclical companies are also better able to support high proportions of debt, compared to early-stage or cyclical companies. (Module 25.1, LOS 25.b)

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The idea that firm management and shareholders have asymmetric information regarding firm prospects is a key assumption of:

A) **pecking order theory.** 

B) static trade-off theory.

C) optimal debt level theory.


Explanation

Pecking order theory is based on the idea that management's choice of a financing alternative signals investors about a firm's prospects because management and shareholders have asymmetric information. (Module 25.1, LOS 25.b)

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One of the results of Modigliani and Miller's model of capital structure for a firm with a zero tax rate is that:

- A) the cost of debt decreases as more debt is used in its capital structure.
- B) the required return on equity increases as more debt is used in its capital structure.** 
- C) the weighted average cost of capital for the firm decreases as more debt is used in its financial structure.


Explanation

In MM without taxes, a firm's cost of equity increases with more debt in its capital structure, while the cost of debt financing remains constant. (Module 25.2, LOS 25.c)

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The Modigliani and Miller model of capital structure with a positive corporate tax rate concludes that a company's weighted average cost of capital will be:

- A) minimized with 100% debt financing.** 
- B) constant at various levels of financial leverage.
- C) minimized with an optimal level of debt financing between 0% and 100%.

Explanation

MM with taxes concludes that the weighted average cost of capital will be minimized with 100% debt financing. (Module 25.2, LOS 25.c)

An analyst observes that Fuchsia Company is using a bundling strategy and Turquoise Company is using a razors-and-blades strategy. Which feature of the two companies' business models is the analyst comparing?

- A) Pricing models.** 
- B) Channel strategies.**
- C) Value propositions.**

Explanation

Bundling and razors-and-blades are examples of pricing models for multiple products. (Module 26.1, LOS 26.b)