

Exam

Name _____

MULTIPLE CHOICE. Choose the one alternative that best completes the statement or answers the question.

- 1) Which of the following statements is *true*? 1) _____
- A) Valuation is not an exact science.
 - B) The relative value of any asset is, at best, a lucky guess.
 - C) The true value of an asset is unaffected by externalities such as interest rate levels, the state of the economy, etc.
 - D) In finance, it is important to determine an asset's absolute value.

Answer: A

- 2) The law of one price stipulates that 2) _____
- A) the price of an asset is independent of the market in which the asset is being offered for sale.
 - B) identical goods must be sold to all buyers at the same price; otherwise price discrimination occurs.
 - C) assets that are identical in all respects should sell for the same price.
 - D) the absolute value of an asset will always equal its relative value.

Answer: C

- 3) Which of the following statements about the law of one price is *true*? 3) _____
- A) It is most useful in assessing the true value of identical assets that are trading in more than one country.
 - B) It is a useful tool in determining the absolute value of an asset.
 - C) Empirical evidence suggests that it will provide the true value of an asset, except in those rare cases in which no comparable asset exists.
 - D) Although it rarely will provide an exact value for an asset, it will often provide a close approximation.

Answer: D

- 4) Which of the following assets would be the *most* difficult to value? 4) _____
- A) a 1968 red Mustang convertible
 - B) World War II memorabilia
 - C) a Caribbean vacation
 - D) an uninhabited, privately-owned island

Answer: D

- 5) Which of the following would best reflect the current value of a dark green 2005 Subaru Outback, rated in good condition with 75,000 miles on it, located in Denver, Colorado? 5) _____
- A) the price of a dark green 2005 Toyota RAV4 rated in good condition with 100,000 miles on it, located in Denver, Colorado
 - B) the price of a dark green 2005 Subaru Outback, rated in good condition with 65,000 miles on it and located in Fairbanks, Alaska
 - C) the price of a dark green 2005 Subaru Legacy sedan rated in good condition with 70,000 miles on it, located in Golden, Colorado
 - D) the price of a red 2005 Subaru Outback rated in good condition with 83,000 miles on it, located in Fort Collins, Colorado

Answer: D

SHORT ANSWER. Write the word or phrase that best completes each statement or answers the question.

6) What does the term "opportunity cost" mean?

6) _____

Answer: An opportunity cost refers to what is given up when choosing one option over another. For example, when you choose to buy a home rather than rent, one opportunity cost is what you might have earned on the money that you used for the down payment on the home had you instead invested it in your next best alternative.

MULTIPLE CHOICE. Choose the one alternative that best completes the statement or answers the question.

7) Kiley is considering opening a restaurant and is trying to identify the appropriate cash flows to use in evaluating this project. Which of the following should *not* be included?

7) _____

- A) the cost of a liability insurance policy to protect her should a customer sue the business
- B) Kiley's dislike of having to work weekends
- C) the lease expense for the building that would house her restaurant
- D) All of the above should be included when determining the cash flows associated with the project.

Answer: D

8) Which of the following statements about project cash flows is *false*?

8) _____

- A) Opportunity costs--e.g., cash flows that would be generated by an alternative project--should be included in your cash flow analysis.
- B) Although most projects involve both financial and non-financial costs and benefits, the non-financial items are typically minor and can be ignored when estimating a project's value.
- C) In order to accurately evaluate a project's effect on value, it is necessary to quantify any non-financial costs and benefits.
- D) Both B and C are false statements.

Answer: B

9) David owns the building out of which he operates a small graphic arts business. He has extra space available and is considering converting the extra space into a gourmet coffee shop that he would also run. A local businesswoman has offered to rent the extra space from him for her own needs. She has suggested she would be willing to pay \$1,000 a month in rent. In estimating the cash flows associated with the gourmet coffee shop, David should

9) _____

- A) ignore the \$1,000 rent since it is a non-issue if David decides to undertake the coffee shop project.
- B) include the \$1,000 rent as a cash inflow.
- C) include the \$1,000 rent as a cash outflow.
- D) consider the \$1,000 as an added benefit.

Answer: C

10) You own a firm if

10) _____

- A) you own all the outstanding stock and all the outstanding liabilities, both financial and non-financial.
- B) you own all the outstanding stock.
- C) you own all the outstanding bonds.
- D) you own all the outstanding stock and bonds.

Answer: A

- 11) The value of a firm is equal to _____
- A) the market value of its outstanding stock.
 - B) the value of all its projects' net cash flows.
 - C) the market value of its outstanding stock plus the market value of its outstanding bonds.
 - D) the value of all its projects' cash inflows.

Answer: B

SHORT ANSWER. Write the word or phrase that best completes each statement or answers the question.

- 12) Melissa is a massage therapist at a well-known spa. As such, Melissa must provide her own oils and lotions, hot stones, and music. Melissa purchased the hot stones and music she required when she first began her career, about a year ago. The oils and lotions run her about \$300 a month. She generates revenues of about \$3,000 a month, but the spa takes 50% of the fees she collects in return for providing the facility, massage table, linen service, and support (e.g., receptionist and scheduler.) Melissa is considering opening her own business now that she has built up a sufficient clientele. She has found a place she can rent for \$1,000 a month. This includes utilities. She has estimated that a massage table would cost her \$600. Linens will cost another \$1,000, but she figures she'll launder them herself and, thus, avoid the cost of a linen service. She'll also handle her own bookings. Calculate the amount by which Melissa's net monthly financial cash flows would increase or decrease if she sets up her own shop. What other information would you require to estimate the costs and benefits of her decision more accurately? _____

Answer: Her net monthly cash flow is currently the \$1,500 she keeps in revenues minus the \$300 she pays to replenish her supply of oils, for a net cash inflow of \$1,200. Assuming she'll generate the same amount in revenues (at least initially), her net monthly cash flow will be $\$3,000 - \$1,000 \text{ (rent)} - \$300 \text{ (oils)} = \$1,700$. So, her net monthly cash flow will increase by \$500, based on the numbers provided. (For simplicity, we are assuming that the table and linens are a one-time charge at the outset of the project and are not considered part of the monthly cash flow. To be more accurate, we may want to consider the fact that the linens will undoubtedly wear out and need replaced--maybe semiannually or annually--and that the table may break and need replaced in a few years.. Moreover, we should figure in the net effect on Melissa's tax liability, but we don't have the necessary information to do so.)

We do need to have information about how much it will cost Melissa to do her own linens--both in terms of detergent, higher utility bills, etc., and in terms of the cost of her time and her satisfaction or dissatisfaction with this part of the job. Similarly, we need to estimate the cost of the time it will take her to perform the receptionist scheduling function as well as the cost of materials (e.g. appointment book) needed. The pride she might derive from owning her own business as well as other benefits, such as a more flexible schedule, should be valued positively. In addition, we need to consider the fact that if Melissa's business grows, so will her incremental net benefits since some of her costs are fixed (lease expense.) On the other hand, if the business does poorly, and she loses clientele, she will still have to pay this fixed cost while she has no fixed costs in her current position.

MULTIPLE CHOICE. Choose the one alternative that best completes the statement or answers the question.

- 13) The main objective of corporate management is to 13) _____
A) behave in a socially responsible manner.
B) minimize the value of all outstanding liabilities.
C) maximize the value of the firm.
D) Both A and B are true since minimizing outstanding liabilities maximizes firm value.

Answer: C

- 14) Which of the following statements is *true*? 14) _____
A) In a well-run, publicly-held company, management relies on the shareholder input to decide what policies will, in fact, maximize the value of their firm.
B) Because it is difficult for management to determine what will maximize firm value in the imperfect world of reality, it is critical for the government to pass laws that will result in value-maximizing decisions in all firms.
C) Although it should be clear to corporate managers what steps are necessary to maximize firm value, managers choose to look out for their own best interests instead.
D) None of the above is a true statement.

Answer: D

SHORT ANSWER. Write the word or phrase that best completes each statement or answers the question.

- 15) True, False, or Uncertain: A project's value may vary, depending on the firm 15) _____
evaluating it.

Answer: True. In an imperfect world, you need to consider the aspects of your specific firm in determining the value of a project. For example, the value of acquiring a small pharmaceutical company will undoubtedly be different if the acquiring firm is another pharmaceutical company than if it is an airline.