FIN 3414
Conceptual Review Questions for Exam 1

For the exam (and your future), it is important to not only understand the math but also the underlying theory or concepts. Remember, these skills will help you be more successful in business and decision making regardless of what field you choose. To help you build your critical thinking skills and prepare for the conceptual questions on the exam, please answer the following questions. Your response should be written as if speaking to your coworker who has only a basic understanding of finance. I will award you up to 2 bonus points on your exam for answering all the questions in a meaningful way.

1. The goal of the firm is to maximize shareholder wealth. Explain what this really means. Also, why is maximizing earnings per share not the goal of the firm?
2. In the context of corporations, what is meant by “agency relationship”? Be sure to identify the principal and agent. If you are a shareholder, why should you care about agency relationships?
3. Critique the statement: The firm’s debt level increased substantially last year. This is clearly a sign of financial weakness.
4. Discuss the problems with and benefits of financial ratios.
5. Your company just applied for a short-term loan at the bank. Which ratios do you think the bank manager will review and why?
6. Explain the difference between the coupon rate and yield to maturity.
7. Suppose that interest rates increase. Explain what should happen to bond prices. Which types of bonds will be the most affected (e.g., long or short coupon, long or short maturity) and why?
8. Suppose that interest rates increase. Applying the dividend growth model, explain what should happen to stock prices and why.
9. Applying the basic economic theory of pricing any financial asset, explain why the price of a stock depends on the dividend.
10. The dividend growth model is not used much in the real world. What weaknesses do you see with the model that prevent its wide spread use?

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Conceptual Review Questions for Exam 2

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1. Explain the cases in which IRR may either not work or might lead to the wrong decision.
2. When should you use incremental IRR?
3. Payback period is often used by small businesses. Explain why the payback is useful (i.e., what it does tell you). Also, explain why the payback analysis should not be used to accept or reject a project.
4. Why does the NPV always work?
5. Net working capital is included in project cash flows. Explain what it measures and why it is included.
6. Explain why interest expense is not explicitly included in project cash flows.
7. What are the differences between sensitivity, scenario, and breakeven analysis?
8. You are buying a plot of land to build a restaurant. You decide also to buy the lot next store in case you want to add a larger parking lot and/or a larger deck. What type of real option is this? Also, briefly describe the other types of real options we discussed in class.
9. Explain how business risk (cyclicality of revenues, operating leverage) and financial risk (financial leverage) affect beta.
10. Your boss thinks that you should just always use a 10% discount rate to evaluate projects regardless of their risk. Explain why this is not correct.
11. Your boss thinks 10% is the right discount rate for all companies. Explain why you should calculate and use the WACC instead.

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Conceptual Review Questions for Exam 3

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1. Explain Propositions 1 and 2 from Modigliani and Miller's theory of capital structure when there are no taxes. How do these change when corporate taxes are added?
2. Financial distress costs are significant and can lead to shareholders engaging in selfish behaviors. Explain the three selfish strategies that we discussed in class.
3. Explain how trade off theory differs from Modigliani and Miller's model. Be sure to explain what is being "traded off" in the model.
4. Pecking order is a signaling model based on the idea that managers have better information than shareholders. Describe the specific order of financing that is implied by pecking order theory. Also, explain what is meant by financial slack and why this is important.
5. When using the WACC as the discount rate to evaluate a project, what assumptions are being made?
6. When debt levels increase, what will happen to Rs? In the WACC equation, which term captures financial distress?
7. Why is the free cash flow model better than the dividend growth model at estimating firm value?
8. Explain the factors that encourage firms to use both a 1) high dividend and a 2) low dividend payout.
9. A firm whose primary shareholders are individuals in the highest tax bracket is deciding between paying a special cash dividend and a repurchase. Which would you recommend and why?
10. When personal taxes are factorrd in, why is acceptance to issue debt to pay for a dividend but not equity?