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CHAPTER

The Cost of Capital

Multiple Choice Questions

1. Constructing zero-beta portfolios, though simple, is costly:
(a) True (b) False

2. In valuing a company using the CAPM, the rate on a treasury bill is often used as a proxy for the risk-free rate:
(a) True (b) False

3. It is a common practice to use a value-weighted equity index as a proxy for the market portfolio in the CAPM:
(a) True (b) False

4. The advocates of arithmetic mean argue that it is more consistent with the mean-variance framework:
(a) True (b) False

5. For knowing the central tendency of a series of returns it is preferable to use the geometric mean than the arithmetic mean:
(a) True (b) False

6. Most analysts regard a five year period to be reasonable for setting up the regression equation for estimating beta using market returns:
(a) True (b) False

7. It is generally observed that high cost of debt leads to a high cost of equity:
(a) True (b) False

8. There is no adjustment for risk in the dividend discount model for estimating the cost of equity:
(a) True (b) False

9. Earnings-price ratio approach is a good tool to estimate the cost of equity when retained earnings are expected to earn a rate of return equal to the rate of return required by equity investors:
(a) True (b) False

10. Financial leverage is a key determinant of the asset beta of a company:
(a) True (b) False

11. A bond's expected YTM cannot be more than the YTM stated at the time of its issue:
(a) True (b) False

12. Debt ratios based on book values are more conservative than debt ratios based on market values:
(a) True (b) False

13. The correct cost of debt to be used in calculation of the average cost of capital is the:
(a) Marginal cost of debt
(b) Yield to maturity
(c) Average cost of debt
(d) Either a or b
(e) None of the above

14. Cost of retained earning is
(a) Nil
(b) Nearly equal to cost of depreciation
(c) Nearly equal to cost of equity
(d) Nearly equal to average cost of debt
(e) None of the above

15. In determining cost of capital using 'Bond yield plus risk premium approach' the risk premium is set at
(a) 2 % of the bond yield
(b) 4 % of the bond yield
(c) 1% of the bond yield if the latter is more than 12 %
(d) Both (a) and (c)
(e) None of the above

16. The chief merit of using book value proportions to calculate WACC is that
(a) It is unbiased
(b) It is simple
(c) It is more realistic
(d) It is based on audited figures
(e) None of the above

17. Which of the following is not considered in the calculation of the weighted average cost of capital?
(a) Trade creditors
(b) Deposits from the public
(c) Unsecured loan from the promoters
(d) Redeemable preference capital
(e) None of the above

18. While calculating the weighted average cost of capital, we should not leave out the cost of short-term debt like working capital:
(a) True (b) False

19. Conceptually, the cost of a debt instrument is its:
(a) Coupon rate
(b) Yield to maturity
(c) Current yield
(d) Interest rate
(e) None of the above

20. A firm raised a bank loan at 10 percent a year ago. Exactly six months back the bank raised the interest rate by 2 percent. For calculation of the cost of capital, the cost of bank loan has to be taken at:

(a) 12 percent
(b) 10 percent
(c) 11 percent
(d) Time weighted interest rate charged by the bank
(e) None of the above

21. Which of the following is not relevant in the calculation of the average cost of capital?
(a) Cost of new loans
(b) Cost of short term debt
(c) Coupon rate
(d) Proportion of debt
(e) None of the above

22. Cost of which of the following is not necessarily equal to its yield?
(a) Long term debt
(b) Short term debt
(c) Equity capital
(d) Preference capital
(e) None of the above

23. Cost of retained earnings is equal to the cost of depreciation funds:
(a) True (b) False

24. Which of the following is not required to calculate CAPM?
(a) Beta
(b) Risk- free rate
(c) Cost of capital
(d) Market risk premium
(e) None of the above