Chapter 1

Student: ____

1. The shareholders in a sole proprietorship are represented by:

   A. The owner of the firm.

   B. The general partner of the firm.

   C. The board of directors of the firm.

   D. No one; sole proprietorships have no shareholders.

2. Which of the following would be considered an advantage of the sole proprietorship form of organization?

   A. Wide access to capital markets

   B. Unlimited liability

   C. A pool of expertise

   D. Profits taxed at only one level

3. In a partnership form of organization, income tax liability, if any, is incurred by:

   A. The partnership itself.

   B. The partners individually.

   C. Both the partnership and the partners.

   D. Neither the partnership nor the partners.

4. Which of the following would correctly differentiate general partners from limited partners in a limited partnership?

   A. General partners have more job experience.
   B. General partners have an ownership interest.
   C. General partners are subject to double taxation.
   D. General partners have unlimited personal liability.

5. One common reason for partnerships to convert to a corporate form of organization is that the partnership:

   A. Faces rapidly growing financing requirements.
   B. Wishes to avoid double taxation of profits.
   C. Has issued all of its allotted shares.
   D. Agreement expires after ten years of use.

6. Unlimited liability is faced by the owners of:

   A. Corporations.
   B. Partnerships and corporations.
   C. Sole proprietorships and partnerships.
   D. All forms of business organization.

7. Which of the following statements generally cannot be correct for an investor who faces unlimited liability on an investment?

A. The investor owns stock in the firm.

B. The investor has no partners.

C. The investor is subject to double taxation.

D. The investor is responsible for managing the firm.

8. In the case of a professional corporation, _______ has/have limited liability.

A. Only the professionals

B. Only the business

C. Both the professionals *and* the business

D. Neither the professionals *nor* the business

9. A board of directors is elected as a representative of the corporation's:

A. Top management.

B. Stakeholders.

C. Shareholders.

D. Customers.

10. The legal "life" of a corporation is:

A. Coincident with that of its CEO.

B. Equal to the life of the board of directors.

C. Permanent, as long as shareholders don't change.

D. Permanent, regardless of current ownership.

11. When the management of a business is conducted by individuals other than the owners, the business is more likely to be a:

A. corporation.

B. Sole proprietorship.

C. Partnership.

D. General partner.

12. "Double taxation" refers to:

A. All partners paying equal taxes on profits.

B. Corporations paying taxes on both dividends and retained earnings.

C. Paying taxes on profits at the corporate level and dividends at the personal level.

D. The fact that marginal tax rates are doubled for corporations.

13. A corporation is considered to be closely held when:

A. Only a few shareholders exist.

B. The market value of the shares is stable.

C. It operates in a small geographic area.

D. Management also serves as the board of directors.

14. Corporations are referred to as public companies when their:

A. Shareholders have no tax liability.

B. Shares are held by the federal or state government.

C. Shares are widely traded.

D. Products or services are available to the public.

15. A common problem for closely held corporations is:

A. Lack of access to substantial amounts of capital.

B. That shareholders receive only one vote each.

C. The separation of ownership and management.

D. An abundance of agency problems.

16. Corporate managers are expected to make corporate decisions that are in the best interest of:

A. Top corporate management.

B. The corporation's board of directors.

C. The corporation's shareholders.

D. All corporate employees.

17. Which of the following would not be considered a real asset?

A. A corporate bond

B. A machine

C. A patent

D. A factory

18. Which of the following statements best distinguishes the difference between real and financial assets?

A. Real assets have less value than financial assets.

B. Real assets are tangible; financial assets are not.

C. Financial assets represent claims to income that are generated by real assets.

D. Financial assets appreciate in value; real assets depreciate in value.

19. For small firms, shareholders and management may be one and the same. But for large companies, separation of ownership and management is:

A. A practical necessity.

B. Not a necessity.

C. A liability.

D. A fraudulent move.

20. A corporation is characterized by:

A. A legal entity unto itself (may sue or be sued, engage in contracts, acquire property).

B. Non-profitable.

C. Sufficient funds to fulfill their needs.

D. Simplicity of decision making.

21. Which of the following would be considered a capital budgeting decision?

A. Planning to issue common stock rather than issuing preferred stock

B. A decision to expand into a new line of products, at a cost of $5 million

C. Repurchasing shares of common stock

D. Issuing debt in the form of long-term bonds

22. A financial manager facing a capital budgeting decision must decide whether to:

A. Issue stock or debt securities.

B. Use the money market or capital market.

C. Use primary markets or secondary markets.

D. Buy new machinery or repair the old.

23. The best criterion for success in a capital budgeting decision would be to:

A. Minimize the cost of the investment.

B. Maximize the number of capital budgeting projects.

C. Maximize the difference between cash inflows and cost.

D. Finance all capital budgeting projects with debt.

24. The overall goal of capital budgeting projects should be to:

A. Decrease the firm's reliance upon debt.

B. Increase the firm's sales.

C. Increase the firm's outstanding shares of stock.

D. Increase the wealth of the firm's shareholders.

25. An example of a firm's financing decision would include:

A. Acquisition of a competitive firm.

B. How much to pay for a specific asset.

C. The issuance of ten-year versus twenty-year bonds.

D. Whether or not to increase the price of its products.

26. Long-term financing arrangements occur in the:

A. Money markets.

B. Capital markets.

C. Secondary markets.

D. Primary markets.

27. The term "capital structure" refers to:

A. The manner in which a firm obtains its long-term sources of funding.

B. The length of time needed to repay debt.

C. Whether the firm invests in capital budgeting projects.

D. Which specific assets the firm should invest in.

28. Firms can alter their capital structure by:

A. Not accepting any capital budgeting projects.

B. Investing in non-tangible assets.

C. Issuing stock to repay debt.

D. Becoming a limited liability company.

29. When a corporation decides to issue long-term debt in order to pay for the acquisition of real assets, it has made a:

A. Capital budgeting decision.

B. Financing decision.

C. Money market decision.

D. Secondary market decision.

30. A firm decides to pay for a small investment project through a $1 million increase in short-term bank loans. This is best described as an example of a(n):

A. Financing decision.

B. Investment decision.

C. Capital budgeting decision.

D. Capital market decision.

31. The short-term decisions of financial managers are comprised of:

A. Capital structure decisions.

B. Investment decisions.

C. Financing decisions.

D. Both investment and financing decisions.

32. Which of the following represents a financing decision?

A. A decision to borrow $10 million through a bank loan.

B. A decision to invest in the common stock of another corporation.

C. A decision to buy a new mainframe computer.

D. A decision to pay $1 million of accounts payable.

33. Which of the following is not a financial manager?

A. The treasurer.

B. The controller.

C. The chief financial officer (CFO).

D. The marketing manager.

34. By organizing itself as a corporation, a business may be able to attract:

A. Investors.

B. Partners.

C. Proprietors.

D. Agents.

35. The primary goal of corporate management should be to:

A. Maximize the number of shareholders.

B. Maximize the firm's profit.

C. Minimize the firm's costs.

D. Maximize the shareholders' wealth.

36. Within the realm of ethical decision making, managers should attempt to maximize:

A. The market value of the shareholders' wealth.

B. Their compensation plans.

C. Their firm's market share.

D. The profits of the firm.

37. Which of the following appears to be the most appropriate goal for corporate management?

A. Maximizing market value of the company's shares.

B. Maximizing the company's market share.

C. Maximizing the current profits of the company.

D. Minimizing the company's liabilities.

38. How may a reduction in cash dividends be in the best interests of current shareholders?

A. Dividends are taxed at twice the rate of other gains.

B. The firm will have available cash to increase current investment and future profits.

C. Reduced dividends increase managerial compensation, thus increasing their motivation.

D. A reduction of cash dividends *cannot* be in the best interests of current shareholders.

39. A managerial objective to increase market share is more likely to be successful in the long run if the firm is:

A. Selling shares in the secondary market.

B. The low-cost producer in the industry.

C. Managed by the board of directors.

D. Investing in capital budgeting projects.

40. A manager's compensation plan that offers financial incentives for increases in quarterly profitability may create agency problems in that:

A. The managers are not motivated by personal gain.

B. The board of directors may claim the credit.

C. Short-term, not long-term, profits become the focus.

D. Investors desire stable profits.

41. A first step in determining managerial objectives is to:

A. Develop appropriate compensation policies.

B. Eliminate agency problems.

C. Serve the needs of the customer.

D. Select an appropriate capital structure.

42. Ethical decision making by management has a payoff for shareholders in terms of:

A. Improved capital structure.

B. Enhanced reputation value.

C. Increased managerial benefits.

D. Higher dividend payments.

43. Ethical decision making in business:

A. Reduces the firm's profits.

B. Requires adherence to implied rules as well as written rules.

C. Is not in the best interests of shareholders.

D. is less important than good capital budgeting decisions.

44. In which of the following organizations would the existence of agency problems be *least* likely?

A. A sole proprietorship

B. A partnership

C. A corporation

D. A closely held corporation

45. Sole proprietorships resolve the issue of agency problems by:

A. Avoiding excessive expense accounts.

B. Discharging those who violate the rules.

C. Allowing owners to share the cost of their actions with others.

D. Forcing owners to bear the full cost of their actions.

46. Agency problems can best be characterized as a:

A. Dislike of firm's bondholders by its equity holders.

B. Differing incentives between managers and owners.

C. Spending corporate resources.

D. Friction between the primary and secondary markets.

47. Which of the following is *least* likely to represent an agency problem?

A. Lavish spending on expense accounts.

B. Plush remodeling of the executive suite.

C. Excessive investment in "safe" projects.

D. Executive incentive compensation plans.

48. When managers' compensation plans are tied in a meaningful manner to the profits of the firm, agency problems:

A. Can be reduced.

B. Will be created.

C. Are shifted to other stakeholders.

D. Are eliminated entirely from the firm.

49. The term "corporate stakeholder" typically refers to:

A. A company's customers.

B. Anyone with a financial interest in the firm.

C. The equity holders of the firm.

D. The management and board of directors of the firm.

50. Which of the following groups is least likely to be considered a stakeholder of the firm?

A. Government

B. Bondholders

C. Competitors

D. Employees

51. One continuing problem with managerial incentive-compensation plans is that:

A. The plans increase agency problems.

B. Managers prefer guaranteed salaries.

C. Effectiveness of the plans is difficult to evaluate.

D. The plans do not reward shareholders.

52. Profit-sharing plans may be beneficial when used to:

A. reduce the impact of corporate income taxes.

B. improve managers' incentives for effective decision making.

C. divert financial resources from shareholders.

D. reduce the payment of cash dividends.

53. A corporate board of directors should provide support for the top management team:

A. under all circumstances.

B. in all decisions related to cash dividends.

C. only when the board has confidence in management's actions.

D. if shareholders are pleased with the firm's performance.

54. A corporation's board of directors:

A. Is selected by and can be removed by management.

B. Can be voted out of power by the shareholders.

C. Has a lifetime appointment to the board.

D. Is selected by a vote of all corporate stakeholders.

55. Which of the firm's financial managers is most likely to be involved with obtaining financing for the firm?

A. Treasurer

B. Controller

C. Chief Executive Officer

D. Board of Directors

56. In a large corporation, budget preparation would most likely be conducted by the:

A. treasurer.

B. Controller.

C. Chief financial officer.

D. Financial manager.

57. In a firm having both a treasurer and a controller, which of the following would most likely be handled by the controller?

A. Internal auditing

B. Credit management

C. Banking relationships

D. Insurance

58. A chief financial officer would typically:

A. Report to the treasurer, but supervise the controller.

B. Report to the controller, but supervise the treasurer.

C. Report to both the treasurer and controller.

D. Supervise both the treasurer and controller.

59. One corporate activity that is specifically reserved for the board of directors is the:

A. Declaration of dividends.

B. Custody of records.

C. Preparation of budgets.

D. Day-to-day operation of the firm.

60. Which of the following is *least* likely to be discussed in the articles of incorporation?

A. The maximum number of shares that can be issued.

B. The purpose of the business.

C. The price range of the shares of stock.

D. The number of members of the board of directors.

61. When a corporation fails, the maximum that can be lost by an investor protected by limited liability is:

A. The amount of the initial investment.

B. The amount of the profit on the investment.

C. The amount necessary to pay the corporation's debts.

D. The amount of the investor's personal wealth.

62. Which of the following is *not* an advantage to incorporating a business?

A. Easier access to financial markets.

B. Limited liability.

C. Becoming a permanent legal entity.

D. Profits taxed at the corporate level and the shareholder level.

63. The financial manager has to determine a value to uncertain cash flows. The variables involved in this determination are:

A. Amount

B. Timing

C. Risk

D. All of the above

64. What are the two critical decisions that have to be made by the financial manager?

A. Investment and financing.

B. Short term and long term.

C. Debt and equity.

D. All of the above.

65. Which of the following is correct regarding board membership in a corporation?

A. All corporations have board of directors.

B. In a private corporation, shareholders are also board members.

C. In a public corporation, shareholders are not board members.

D. All of the above

66. The liability of sole proprietors is limited to the amount of their investment in the company.

True False

67. General partners have limited personal liability for business debts in a limited partnership.

True False

68. The corporate form of business organization is often accompanied by separation of ownership and management.

True False

69. A major disadvantage of partnerships is that they have "double taxation" of profits.

True False

70. Capital budgeting decisions are used to determine how to raise the cash necessary for investments.

True False

71. A successful investment is one that increases the value of the firm.

True False

72. The duties of a corporate controller typically include the preparation of financial statements.

True False

73. To obtain the necessary money a company sells financial assets or securities.

True False

74. The primary goal of any company should be to maximize current period profit.

True False

75. Maximizing profits is the same as maximizing the value of the firm.

True False

76. Ethical decision making in business can be viewed as a long-term investment in reputation.

True False

77. Agency problems act as a hindrance to the goal of maximizing firm value.

True False

78. Managers are spurred on by incentive schemes that provide big returns if shareholders gain but are valueless if they do not.

True False

79. If employee compensation plans are not designed properly, they can create incentives for errant behaviour by management.

True False

80. Poorly performing companies are also more likely to be taken over by another firm. After the takeover, the old management team may find itself out on the street.

True False

81. Managers are subject to the scrutiny of specialists. Their actions are monitored by the security analyst who advises investors to buy, hold, or sell the company's shares.

True False

82. The agency problem is mitigated in practice through several devices.

True False

83. As your firm grows, you may decide to form a corporation. You many incorporate your firm federally, under the Canadian Business Corporation Act, or provincially, under the relevant provincial laws.

True False

84. What general factors may influence the decision of whether to organize as a sole proprietorship, a partnership, or a corporation?

85. Discuss why corporations typically exhibit separation of ownership and management, as distinguished from sole proprietorships or partnerships.

86. Why is limited liability such an important aspect to investors?

87. Provide at least three examples each of real and financial assets that might appear on the balance sheet of General Motors.

88. Distinguish between a firm's capital budgeting decision and financing decision.

89. Discuss the interrelationship between a firm's financing and capital structure decisions.

90. Provide examples of managerial goals other than the maximization of market value.

91. Explain why managers should use ethical decision making as a way to increase the profitability of a firm.

92. Describe agency problems in general, and offer at least three examples from corporations.

93. What are the two major decisions made by a financial manager?

94. What does "real asset" mean? What is a "financial asset"?

95. How do corporations ensure that managers' and shareholders' interests coincide?

96. Tabulate and compare the differences among corporations, proprietorships and partnerships.

97. Are all investment decisions made by the financial manager multi-billion dollar investment?

98. Briefly discuss income trusts.

99. What specific arrangements can be used to ensure management is working towards shareholders' goals?

Chapter 1 Key

1. The shareholders in a sole proprietorship are represented by:

A. The owner of the firm.
B. The general partner of the firm.
C. The board of directors of the firm.
D. No one; sole proprietorships have no shareholders.

Brealey - Chapter 01 #1
Difficulty: Easy
Learning Objective: 1.2
Type: Multiple Choice

2. Which of the following would be considered an advantage of the sole proprietorship form of organization?

A. Wide access to capital markets
B. Unlimited liability
C. A pool of expertise
D. Profits taxed at only one level

Brealey - Chapter 01 #2
Difficulty: Easy
Learning Objective: 1.3
Type: Multiple Choice

3. In a partnership form of organization, income tax liability, if any, is incurred by:

A. The partnership itself.

B. The partners individually.

C. Both the partnership and the partners.

D. Neither the partnership nor the partners.

Brealey - Chapter 01 #3
Difficulty: Medium
Learning Objective: 1.3
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4. Which of the following would correctly differentiate general partners from limited partners in a limited partnership?

A. General partners have more job experience.

B. General partners have an ownership interest.

C. General partners are subject to double taxation.

D. General partners have unlimited personal liability.

Brealey - Chapter 01 #4
Difficulty: Medium
Learning Objective: 1.3
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5. One common reason for partnerships to convert to a corporate form of organization is that the partnership:

A. Faces rapidly growing financing requirements.
B. Wishes to avoid double taxation of profits.
C. Has issued all of its allotted shares.
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Brealey - Chapter 01 #5
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Learning Objective: 1.3
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7. Which of the following statements generally cannot be correct for an investor who faces unlimited liability on an investment?

A. The investor owns stock in the firm.

B. The investor has no partners.

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Brealey - Chapter 01 #7
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Learning Objective: 1.3
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A. Only the professionals

B. Only the business

C. Both the professionals *and* the business

D. Neither the professionals *nor* the business

Brealey - Chapter 01 #8
Difficulty: Medium
Learning Objective: 1.3
Type: Multiple Choice

9. A board of directors is elected as a representative of the corporation's:

A. Top management.

B. Stakeholders.

C. Shareholders.

D. Customers.

Brealey - Chapter 01 #9
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Learning Objective: 1.4
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10. The legal "life" of a corporation is:

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Brealey - Chapter 01 #10
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Learning Objective: 1.2
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11. When the management of a business is conducted by individuals other than the owners, the business is more likely to be a:

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B. Sole proprietorship.
C. Partnership.
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Brealey - Chapter 01 #11
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B. The market value of the shares is stable.

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Brealey - Chapter 01 #14
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Learning Objective: 1.2

Type: Multiple Choice

15. A common problem for closely held corporations is:

A. Lack of access to substantial amounts of capital.

B. That shareholders receive only one vote each.

C. The separation of ownership and management.

D. An abundance of agency problems.

Brealey - Chapter 01 #15
Difficulty: Medium
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Type: Multiple Choice

16. Corporate managers are expected to make corporate decisions that are in the best interest of:

A. Top corporate management.

B. The corporation's board of directors.

C. The corporation's shareholders.

D. All corporate employees.

Brealey - Chapter 01 #16
Difficulty: Medium
Learning Objective: 1.2
Type: Multiple Choice

17. Which of the following would not be considered a real asset?

A. A corporate bond

B. A machine

C. A patent

D. A factory

Brealey - Chapter 01 #17

Difficulty: Medium

Learning Objective: 1.1

Type: Multiple Choice

18. Which of the following statements best distinguishes the difference between real and financial assets?

A. Real assets have less value than financial assets.

B. Real assets are tangible; financial assets are not.

C. Financial assets represent claims to income that are generated by real assets.

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Brealey - Chapter 01 #18

Difficulty: Medium

Learning Objective: 1.1

Type: Multiple Choice

19. For small firms, shareholders and management may be one and the same. But for large companies, separation of ownership and management is:

A. A practical necessity.

B. Not a necessity.

C. A liability.

D. A fraudulent move.

Brealey - Chapter 01 #19

Difficulty: Easy

Learning Objective: 1.2

Type: Multiple Choice

20. A corporation is characterized by:

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C. Sufficient funds to fulfill their needs.

D. Simplicity of decision making.

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Difficulty: Medium

Learning Objective: 1.2

Type: Multiple Choice

21. Which of the following would be considered a capital budgeting decision?

A. Planning to issue common stock rather than issuing preferred stock

B. A decision to expand into a new line of products, at a cost of $5 million

C. Repurchasing shares of common stock

D. Issuing debt in the form of long-term bonds

Brealey - Chapter 01 #21

Difficulty: Medium

Learning Objective: 1.1

Type: Multiple Choice

22. A financial manager facing a capital budgeting decision must decide whether to:

A. Issue stock or debt securities.

B. Use the money market or capital market.

C. Use primary markets or secondary markets.

D. Buy new machinery or repair the old.

Brealey - Chapter 01 #22

Difficulty: Medium

Learning Objective: 1.1

Type: Multiple Choice

23. The best criterion for success in a capital budgeting decision would be to:

A. Minimize the cost of the investment.

B. Maximize the number of capital budgeting projects.

C. Maximize the difference between cash inflows and cost.

D. Finance all capital budgeting projects with debt.

Brealey - Chapter 01 #23
Difficulty: Medium
Learning Objective: 1.1
Type: Multiple Choice

24. The overall goal of capital budgeting projects should be to:

A. Decrease the firm's reliance upon debt.

B. Increase the firm's sales.

C. Increase the firm's outstanding shares of stock.

D. Increase the wealth of the firm's shareholders.

Brealey - Chapter 01 #24
Difficulty: Easy
Learning Objective: 1.1
Type: Multiple Choice

25. An example of a firm's financing decision would include:

A. Acquisition of a competitive firm.

B. How much to pay for a specific asset.

C. The issuance of ten-year versus twenty-year bonds.

D. Whether or not to increase the price of its products.

Brealey - Chapter 01 #25

Difficulty: Medium

Learning Objective: 1.1

Type: Multiple Choice

26. Long-term financing arrangements occur in the:

A. Money markets.

B. Capital markets.

C. Secondary markets.

D. Primary markets.

Brealey - Chapter 01 #26

Difficulty: Easy

Learning Objective: 1.1

Type: Multiple Choice

27. The term "capital structure" refers to:

A. The manner in which a firm obtains its long-term sources of funding.

B. The length of time needed to repay debt.

C. Whether the firm invests in capital budgeting projects.

D. Which specific assets the firm should invest in.

Brealey - Chapter 01 #27

Difficulty: Easy

Learning Objective: 1.1

Type: Multiple Choice

28. Firms can alter their capital structure by:

A. Not accepting any capital budgeting projects.

B. Investing in non-tangible assets.

C. Issuing stock to repay debt.

D. Becoming a limited liability company.

Brealey - Chapter 01 #28
Difficulty: Easy
Learning Objective: 1.1
Type: Multiple Choice

29. When a corporation decides to issue long-term debt in order to pay for the acquisition of real assets, it has made a:

A. Capital budgeting decision.

B. Financing decision.

C. Money market decision.

D. Secondary market decision.

Brealey - Chapter 01 #29
Difficulty: Easy
Learning Objective: 1.1
Type: Multiple Choice

30. A firm decides to pay for a small investment project through a $1 million increase in short-term bank loans. This is best described as an example of a(n):

A. Financing decision.

B. Investment decision.

C. Capital budgeting decision.

D. Capital market decision.

Brealey - Chapter 01 #30
Difficulty: Easy
Learning Objective: 1.1
Type: Multiple Choice

31. The short-term decisions of financial managers are comprised of:

A. Capital structure decisions.

B. Investment decisions.

C. Financing decisions.

D. Both investment and financing decisions.

Brealey - Chapter 01 #31
Difficulty: Medium
Learning Objective: 1.1
Type: Multiple Choice

32. Which of the following represents a financing decision?

A. A decision to borrow $10 million through a bank loan.

B. A decision to invest in the common stock of another corporation.

C. A decision to buy a new mainframe computer.

D. A decision to pay $1 million of accounts payable.

Brealey - Chapter 01 #32
Difficulty: Easy

Learning Objective: 1.1
Type: Multiple Choice

33. Which of the following is not a financial manager?

A. The treasurer.
B. The controller.
C. The chief financial officer (CFO).
<u>D.</u> The marketing manager.

Brealey - Chapter 01 #33
Difficulty: Medium
Learning Objective: 1.4
Type: Multiple Choice

34. By organizing itself as a corporation, a business may be able to attract:

<u>A.</u> Investors.
B. Partners.
C. Proprietors.
D. Agents.

Brealey - Chapter 01 #34
Difficulty: Medium
Learning Objective: 1.2
Type: Multiple Choice

35. The primary goal of corporate management should be to:

A. Maximize the number of shareholders.

B. Maximize the firm's profit.

C. Minimize the firm's costs.

D. Maximize the shareholders' wealth.

Brealey - Chapter 01 #35
Difficulty: Medium
Learning Objective: 1.5
Type: Multiple Choice

36. Within the realm of ethical decision making, managers should attempt to maximize:

A. The market value of the shareholders' wealth.

B. Their compensation plans.

C. Their firm's market share.

D. The profits of the firm.

Brealey - Chapter 01 #36
Difficulty: Medium
Learning Objective: 1.5
Type: Multiple Choice

37. Which of the following appears to be the most appropriate goal for corporate management?

A. Maximizing market value of the company's shares.

B. Maximizing the company's market share.

C. Maximizing the current profits of the company.

D. Minimizing the company's liabilities.

Brealey - Chapter 01 #37
Difficulty: Medium
Learning Objective: 1.5

Type: Multiple Choice

38. How may a reduction in cash dividends be in the best interests of current shareholders?

A. Dividends are taxed at twice the rate of other gains.

B. The firm will have available cash to increase current investment and future profits.

C. Reduced dividends increase managerial compensation, thus increasing their motivation.

D. A reduction of cash dividends *cannot* be in the best interests of current shareholders.

Brealey - Chapter 01 #38
Difficulty: Hard
Learning Objective: 1.5
Type: Multiple Choice

39. A managerial objective to increase market share is more likely to be successful in the long run if the firm is:

A. Selling shares in the secondary market.

B. The low-cost producer in the industry.

C. Managed by the board of directors.

D. Investing in capital budgeting projects.

Brealey - Chapter 01 #39
Difficulty: Medium
Learning Objective: 1.5
Type: Multiple Choice

40. A manager's compensation plan that offers financial incentives for increases in quarterly profitability may create agency problems in that:

A. The managers are not motivated by personal gain.

B. The board of directors may claim the credit.

C. Short-term, not long-term, profits become the focus.

D. Investors desire stable profits.

Brealey - Chapter 01 #40
Difficulty: Hard
Learning Objective: 1.7
Type: Multiple Choice

41. A first step in determining managerial objectives is to:

A. Develop appropriate compensation policies.

B. Eliminate agency problems.

C. Serve the needs of the customer.

D. Select an appropriate capital structure.

Brealey - Chapter 01 #41
Difficulty: Medium
Learning Objective: 1.5
Type: Multiple Choice

42. Ethical decision making by management has a payoff for shareholders in terms of:

A. Improved capital structure.

B. Enhanced reputation value.

C. Increased managerial benefits.

D. Higher dividend payments.

Brealey - Chapter 01 #42
Difficulty: Medium

Learning Objective: 1.6
Type: Multiple Choice

43. Ethical decision making in business:

A. Reduces the firm's profits.

B. Requires adherence to implied rules as well as written rules.

C. Is not in the best interests of shareholders.

D. is less important than good capital budgeting decisions.

Brealey - Chapter 01 #43
Difficulty: Hard
Learning Objective: 1.6
Type: Multiple Choice

44. In which of the following organizations would the existence of agency problems be *least* likely?

A. A sole proprietorship

B. A partnership

C. A corporation

D. A closely held corporation

Brealey - Chapter 01 #44
Difficulty: Easy
Learning Objective: 1.7
Type: Multiple Choice

45. Sole proprietorships resolve the issue of agency problems by:

A. Avoiding excessive expense accounts.

B. Discharging those who violate the rules.

C. Allowing owners to share the cost of their actions with others.

D. Forcing owners to bear the full cost of their actions.

Brealey - Chapter 01 #45
Difficulty: Medium
Learning Objective: 1.7
Type: Multiple Choice

46. Agency problems can best be characterized as a:

A. Dislike of firm's bondholders by its equity holders.

B. Differing incentives between managers and owners.

C. Spending corporate resources.

D. Friction between the primary and secondary markets.

Brealey - Chapter 01 #46
Difficulty: Medium
Learning Objective: 1.7
Type: Multiple Choice

47. Which of the following is *least* likely to represent an agency problem?

A. Lavish spending on expense accounts.

B. Plush remodeling of the executive suite.

C. Excessive investment in "safe" projects.

D. Executive incentive compensation plans.

Brealey - Chapter 01 #47
Difficulty: Hard
Learning Objective: 1.7

Type: Multiple Choice

48. When managers' compensation plans are tied in a meaningful manner to the profits of the firm, agency problems:

A. Can be reduced.

B. Will be created.

C. Are shifted to other stakeholders.

D. Are eliminated entirely from the firm.

Brealey - Chapter 01 #48
Difficulty: Medium
Learning Objective: 1.5
Type: Multiple Choice

49. The term "corporate stakeholder" typically refers to:

A. A company's customers.

B. Anyone with a financial interest in the firm.

C. The equity holders of the firm.

D. The management and board of directors of the firm.

Brealey - Chapter 01 #49
Difficulty: Medium
Learning Objective: 1.5
Type: Multiple Choice

50. Which of the following groups is least likely to be considered a stakeholder of the firm?

A. Government

B. Bondholders

<u>C.</u> Competitors

D. Employees

Brealey - Chapter 01 #50

Difficulty: Easy

Learning Objective: 1.5

Type: Multiple Choice

51. One continuing problem with managerial incentive-compensation plans is that:

A. The plans increase agency problems.

B. Managers prefer guaranteed salaries.

<u>C.</u> Effectiveness of the plans is difficult to evaluate.

D. The plans do not reward shareholders.

Brealey - Chapter 01 #51

Difficulty: Medium

Learning Objective: 1.7

Type: Multiple Choice

52. Profit-sharing plans may be beneficial when used to:

A. reduce the impact of corporate income taxes.

<u>B.</u> improve managers' incentives for effective decision making.

C. divert financial resources from shareholders.

D. reduce the payment of cash dividends.

Brealey - Chapter 01 #52

Difficulty: Medium

Learning Objective: 1.7

Type: Multiple Choice

53. A corporate board of directors should provide support for the top management team:

A. under all circumstances.

B. in all decisions related to cash dividends.

C. only when the board has confidence in management's actions.

D. if shareholders are pleased with the firm's performance.

Brealey - Chapter 01 #53
Difficulty: Medium
Learning Objective: 1.2
Type: Multiple Choice

54. A corporation's board of directors:

A. Is selected by and can be removed by management.

B. Can be voted out of power by the shareholders.

C. Has a lifetime appointment to the board.

D. Is selected by a vote of all corporate stakeholders.

Brealey - Chapter 01 #54
Difficulty: Medium
Learning Objective: 1.2
Type: Multiple Choice

55. Which of the firm's financial managers is most likely to be involved with obtaining financing for the firm?

A. Treasurer

B. Controller

C. Chief Executive Officer

D. Board of Directors

Brealey - Chapter 01 #55

Difficulty: Easy

Learning Objective: 1.4

Type: Multiple Choice

56. In a large corporation, budget preparation would most likely be conducted by the:

A. treasurer.

B. Controller.

C. Chief financial officer.

D. Financial manager.

Brealey - Chapter 01 #56

Difficulty: Easy

Learning Objective: 1.4

Type: Multiple Choice

57. In a firm having both a treasurer and a controller, which of the following would most likely be handled by the controller?

A. Internal auditing
B. Credit management
C. Banking relationships
D. Insurance

Brealey - Chapter 01 #57
Difficulty: Medium
Learning Objective: 1.4
Type: Multiple Choice

58. A chief financial officer would typically:

A. Report to the treasurer, but supervise the controller.
B. Report to the controller, but supervise the treasurer.
C. Report to both the treasurer and controller.
D. Supervise both the treasurer and controller.

Brealey - Chapter 01 #58
Difficulty: Easy
Learning Objective: 1.4
Type: Multiple Choice

59. One corporate activity that is specifically reserved for the board of directors is the:

A. Declaration of dividends.
B. Custody of records.
C. Preparation of budgets.
D. Day-to-day operation of the firm.

Brealey - Chapter 01 #59
Difficulty: Easy

Learning Objective: 1.2

Type: Multiple Choice

60. Which of the following is *least* likely to be discussed in the articles of incorporation?

A. The maximum number of shares that can be issued.

B. The purpose of the business.

C. The price range of the shares of stock.

D. The number of members of the board of directors.

Brealey - Chapter 01 #60

Difficulty: Easy

Learning Objective: 1.2

Type: Multiple Choice

61. When a corporation fails, the maximum that can be lost by an investor protected by limited liability is:

A. The amount of the initial investment.

B. The amount of the profit on the investment.

C. The amount necessary to pay the corporation's debts.

D. The amount of the investor's personal wealth.

Brealey - Chapter 01 #61

Difficulty: Easy

Learning Objective: 1.2

Type: Multiple Choice

62. Which of the following is *not* an advantage to incorporating a business?

A. Easier access to financial markets.

B. Limited liability.

C. Becoming a permanent legal entity.

D. Profits taxed at the corporate level and the shareholder level.

Brealey - Chapter 01 #62
Difficulty: Easy
Learning Objective: 1.2
Type: Multiple Choice

63. The financial manager has to determine a value to uncertain cash flows. The variables involved in this determination are:

A. Amount

B. Timing

C. Risk

D. All of the above

Brealey - Chapter 01 #63
Difficulty: Medium
Learning Objective: 1.1
Type: Multiple Choice

64. What are the two critical decisions that have to be made by the financial manager?

A. Investment and financing.

B. Short term and long term.

C. Debt and equity.

D. All of the above.

Brealey - Chapter 01 #64
Difficulty: Medium

Learning Objective: 1.1

Type: Multiple Choice

65. Which of the following is correct regarding board membership in a corporation?

<u>A.</u> All corporations have board of directors.

B. In a private corporation, shareholders are also board members.

C. In a public corporation, shareholders are not board members.

D. All of the above

Brealey - Chapter 01 #65

Difficulty: Medium

Learning Objective: 1.2

Type: Multiple Choice

66. The liability of sole proprietors is limited to the amount of their investment in the company.

<u>FALSE</u>

Brealey - Chapter 01 #66

Difficulty: Easy

Learning Objective: 1.3

Type: True False

67. General partners have limited personal liability for business debts in a limited partnership.

<u>FALSE</u>

Brealey - Chapter 01 #67

Difficulty: Medium

Learning Objective: 1.3

Type: True False

68. The corporate form of business organization is often accompanied by separation of ownership and management.

TRUE

Brealey - Chapter 01 #68
Difficulty: Easy
Learning Objective: 1.3
Type: True False

69. A major disadvantage of partnerships is that they have "double taxation" of profits.

FALSE

Brealey - Chapter 01 #69
Difficulty: Easy
Learning Objective: 1.3
Type: True False

70. Capital budgeting decisions are used to determine how to raise the cash necessary for investments.

FALSE

Brealey - Chapter 01 #70
Difficulty: Medium
Learning Objective: 1.1
Type: True False

71. A successful investment is one that increases the value of the firm.

TRUE

Brealey - Chapter 01 #71
Difficulty: Easy
Learning Objective: 1.5
Type: True False

72. The duties of a corporate controller typically include the preparation of financial statements.

TRUE

Brealey - Chapter 01 #72
Difficulty: Medium
Learning Objective: 1.4
Type: True False

73. To obtain the necessary money a company sells financial assets or securities.

TRUE

Brealey - Chapter 01 #73
Difficulty: Easy
Learning Objective: 1.1
Type: True False

74. The primary goal of any company should be to maximize current period profit.

FALSE

Brealey - Chapter 01 #74
Difficulty: Medium
Learning Objective: 1.5
Type: True False

75. Maximizing profits is the same as maximizing the value of the firm.

FALSE

Brealey - Chapter 01 #75
Difficulty: Medium
Learning Objective: 1.5
Type: True False

76. Ethical decision making in business can be viewed as a long-term investment in reputation.

TRUE

Brealey - Chapter 01 #76
Difficulty: Easy
Learning Objective: 1.5
Type: True False

77. Agency problems act as a hindrance to the goal of maximizing firm value.

TRUE

Brealey - Chapter 01 #77
Difficulty: Medium
Learning Objective: 1.7
Type: True False

78. Managers are spurred on by incentive schemes that provide big returns if shareholders gain but are valueless if they do not.

TRUE

Brealey - Chapter 01 #78
Difficulty: Medium
Learning Objective: 1.5
Type: True False

79. If employee compensation plans are not designed properly, they can create incentives for errant behaviour by management.

TRUE

Brealey - Chapter 01 #79
Difficulty: Medium
Learning Objective: 1.6
Type: True False

80. Poorly performing companies are also more likely to be taken over by another firm. After the takeover, the old management team may find itself out on the street.

<u>TRUE</u>

Brealey - Chapter 01 #80
Difficulty: Medium
Learning Objective: 1.7
Type: True False

81. Managers are subject to the scrutiny of specialists. Their actions are monitored by the security analyst who advises investors to buy, hold, or sell the company's shares.

<u>TRUE</u>

Brealey - Chapter 01 #81
Difficulty: Medium
Learning Objective: 1.7
Type: True False

82. The agency problem is mitigated in practice through several devices.

<u>TRUE</u>

Brealey - Chapter 01 #82
Difficulty: Easy
Learning Objective: 1.7
Type: True False

83. As your firm grows, you may decide to form a corporation. You many incorporate your firm federally, under the Canadian Business Corporation Act, or provincially, under the relevant provincial laws.

<u>TRUE</u>

Brealey - Chapter 01 #83
Difficulty: Medium
Learning Objective: 1.2
Type: True False

84. What general factors may influence the decision of whether to organize as a sole proprietorship, a partnership, or a corporation?

Factors that may influence the decision concerning organizational form would include: amount of capital needed in relation to amount of capital that can be raised, estimated sales volume, the extent of managerial expertise, the willingness to share profits, the importance of limited liability, a desire for the permanence of the organization, the issue of double taxation.

Brealey - Chapter 01 #84
Difficulty: Easy
Learning Objective: 1.2
Learning Objective: 1.3
Type: Short Answer

85. Discuss why corporations typically exhibit separation of ownership and management, as distinguished from sole proprietorships or partnerships.

One reason corporations typically exhibit a separation of ownership and management is that ownership often includes a diverse amount of relatively small investors. Thus, it would be nearly impossible to coordinate these owners into decision makers. Also, many small investors are pleased in being relieved of management responsibilities. Therefore, the quality of management is likely to be better if those managers have been hired specifically for that function. Finally, the separation minimizes managerial disruptions that would occur with changing or deceased investors. Most sole proprietorships and partnerships are smaller firms that do not need, may not be able to afford, and may not desire even if they could afford, the existence of a separate management.

Brealey - Chapter 01 #85
Difficulty: Easy
Learning Objective: 1.2

Learning Objective: 1.3
Type: Short Answer

86. Why is limited liability such an important aspect to investors?

Many investors would not be willing to commit their investment funds into projects if it were known they were risking more than those specific funds. Specifically in the case of separated ownership and management, shareholders may be unwilling to remain liable for decisions they did not have a hand in making. With the aversion to risk that is witnessed in general for many investors, it is questionable whether investors would direct their funds into financial assets that did not offer limited liability. Thus, the existence of limited liability may greatly affect the demand for corporate shares.

Brealey - Chapter 01 #86
Difficulty: Medium
Learning Objective: 1.2
Type: Short Answer

87. Provide at least three examples each of real and financial assets that might appear on the balance sheet of General Motors.

Examples of real assets for General Motors: cash, raw materials inventory, production facilities, tools and machines, finished inventory of automobiles. Examples of financial assets that could have been issued by General Motors: common stock (different classes), preferred stock, corporate bonds, bank loans, et cetera. Of course, GM could show financial assets on the left side of their balance sheet also, such as: short-term investments in government securities, contracts receivable from the financing of their automobiles, or possibly residential mortgages (GM, through its subsidiaries, is a large originator of residential mortgages, although most would eventually be sold in the secondary market).

Brealey - Chapter 01 #87

Difficulty: Medium
Learning Objective: 1.1
Type: Short Answer

88. Distinguish between a firm's capital budgeting decision and financing decision.

Examples of the capital budgeting decision for a firm could include: a decision to replace all of the firm's personal computers, a decision to expand the size of the production facility, a decision to buy a corporate jet, a decision to expand production into two new product lines, et cetera. Examples of the financing decision for a firm could include: a decision to issue corporate bonds rather than expand a bank loan, a decision to float a new issue of common stock, a decision to denominate a loan in Japanese yen rather than Canadian dollars, a decision to roll over short-term financing rather than borrow for a longer term, et cetera.

Brealey - Chapter 01 #88
Difficulty: Hard
Learning Objective: 1.1
Type: Short Answer

89. Discuss the interrelationship between a firm's financing and capital structure decisions.

Although the capital budgeting decision considers what to invest in and specifically how much to invest, this decision is importantly related to how the necessary funds should be raised. For example, if many other firms of similar risk have recently issued bonds, the supply of loanable funds may be low, which could affect the interest rate on such funds. Or, the current market value of common stock may be so low that management would prefer not to issue additional shares at this time. Alternatively, the existence of loan or bond covenants could restrict certain forms of borrowing. Finally, although certain forms of financing may appear attractive, they may not represent the targeted capital structure. Thus, elements of the financing decision need to be considered simultaneously with the capital budgeting decision.

Brealey - Chapter 01 #89
Difficulty: Hard
Learning Objective: 1.1
Type: Short Answer

90. Provide examples of managerial goals other than the maximization of market value.

Managers may attempt to maximize profits, or to maximize market share, or even to maximize their own benefits! Problems with maximizing profits can include the method of maximizing (i.e., is it in the long-run or short-run best interests of the firm?), the maintenance of product quality, ethical decision making, customer satisfaction, et cetera. Problems with market share can include economies of scale (i.e., low average cost of production), maintained profitability, increased liabilities, et cetera. Agency problems that relate to managerial compensation or perquisites that are not in the long-run interest of shareholders are another example of misguided goals.

Brealey - Chapter 01 #90
Difficulty: Medium

Learning Objective: 1.4
Type: Short Answer

91. Explain why managers should use ethical decision making as a way to increase the profitability of a firm.

Ethical decision making can have an important impact on employee attitudes, investor actions, and customer retention. Further, all of these factors can have a large impact on the bottom line. The list of potential benefits for a firm that has developed a reputation for ethical operations can be long—easier employee recruitment, lower employee turnover, easier issue of primary securities, repeat business, good word of mouth, et cetera. In other words, the actions of all stakeholders can be positively affected when they perceive the firm to be ethical in its decisions.

Brealey - Chapter 01 #91
Difficulty: Medium
Learning Objective: 1.6
Type: Short Answer

92. Describe agency problems in general, and offer at least three examples from corporations.

Whenever the firm's managers are different from the firm's owners, the potential exists for agency problems. Management may be taking advantage of the fact that corporate ownership is often quite diverse, such that none of the owners appears to be "minding the store." In those cases, it may be easy for top management to vote itself an excessive raise, or to redecorate the corporate suite, or to be lax on the justification of expense reports, or even to invest in projects that are "too safe." Why might managers choose safe projects? For example, the executive may have one year remaining on an employment contract and be more concerned with stable profits than with rising profits.

Brealey - Chapter 01 #92

Difficulty: Easy
Learning Objective: 1.6
Type: Short Answer

93. What are the two major decisions made by a financial manager?

Financial management can be broken down into (1) the investment, or capital budgeting decision, and (2) the financing decision. The firm has to decide on how much to invest and which real assets to invest in, and secondly, how to raise the necessary cash.

Brealey - Chapter 01 #93
Difficulty: Easy
Learning Objective: 1.4
Type: Short Answer

94. What does "real asset" mean? What is a "financial asset"?

Real assets include all assets used in the production or sale of the firm's products or services. Real assets can be tangible or intangible. Financial assets are securities such as shares, sold by the firm to raise money, and represent claims on the firm's real assets and the cash generated by those assets.

Brealey - Chapter 01 #94
Difficulty: Medium
Learning Objective: 1.1
Type: Short Answer

95. How do corporations ensure that managers' and shareholders' interests coincide?

Conflicts of interest between managers and shareholders can lead to agency problems. These problems are kept in check by compensation plans that link the well-being of employees to that of the firm; by monitoring of management by the board of directors, security holders, and creditors; and by the threat of takeover.

Brealey - Chapter 01 #95
Difficulty: Hard
Learning Objective: 1.7
Type: Short Answer

96. Tabulate and compare the differences among corporations, proprietorships and partnerships.

	Sole Proprietorship	**Partnership**	**Corporation**
Who owns the Business?	The manager	Partners	Shareholders
Are managers and owner(s) separate?	No	No	Usually
What is the owner's liability?	Unlimited	Unlimited	Limited
Are the owner and business taxed separately?	No	No	Yes

Brealey - Chapter 01 #96
Difficulty: Medium
Learning Objective: 1.5
Type: Short Answer

97. Are all investment decisions made by the financial manager multi-billion dollar investment?

No. Most investment decisions are smaller and simpler, such as purchase of trucks, machine tools or computer systems. But the objective is to add value to the firm.

Brealey - Chapter 01 #97
Difficulty: Medium
Learning Objective: 1.1
Type: Short Answer

98. Briefly discuss income trusts.

An income trust is an investment fund, legally known as a mutual fund trust. Mutual fund trusts sell units to investors to raise money to purchase shares and debt of operating businesses. Mutual fund trusts are not operating companies but flow-through entities, in which the earnings on the investments are not taxed at the fund level, but rather are taxed in the hands of the unit holders. Unlike typical investment funds, which invest in many different companies, an income trust invests in only one company, making a unit similar to a share. Clever lawyers and financial experts were able to structure income trusts to dramatically reduce the taxes paid by the underlying business enterprise. One way this was accomplished was by having the income trust own both the debt and the equity of the underlying corporation. This allowed the corporation to be financed with a lot of debt, reducing its taxes. Income trusts became very popular, with some corporations converting to the trust structures and other business going public as trusts. On October 31, 2006, the Canadian federal government, fearing significant loss of tax revenue, changed the rules for the taxation of income trusts, taking away their tax advantage, and the income trust boom came to a sudden end.

Brealey - Chapter 01 #98
Difficulty: Medium
Learning Objective: 1.3
Type: Short Answer

99. What specific arrangements can be used to ensure management is working towards shareholders' goals?

Compensation Plans, board of directors, takeover threats, specialist monitoring, legal and regulatory requirements.

Brealey - Chapter 01 #99

Difficulty: Medium

Learning Objective: 1.7

Type: Short Answer

Chapter 1 Summary

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