Part 1 The Financial Environment

CHAPTER 2

BUSINESS (CORPORATE) FINANCE

CHAPTER LEARNING OBJECTIVES

2.1 ***List the four forms of business organizations and describe the advantages and disadvantages of each.***

- Sole proprietorship: a business owned and operated by one person
  Advantages: it is easy to set up
  Disadvantages: the business is inseparable from the owner; there is unlimited legal liability; net income is taxed at personal marginal tax rate; financing is limited to the resources of the single owner

- Partnership: a business owned and operated by two or more people.
  Advantages: it combines the financial resources and talents of its partners; liability is spread across the partners
  Disadvantages: income is taxed at the individual's marginal tax rate; there is unlimited legal liability

- Trust: a legal organization in which assets are owned by one party and managed or controlled by a different party
  Advantages: there is no taxation of funds flowing through the trust; ownership and control are separated
  Disadvantage: there are no funds left for investment because all cash is passed to unitholders

- Corporation: a business organized as a separate legal entity under corporate law, with ownership divided into transferable shares
  Advantages: ownership and control are separated; it has the potential to attract great amounts of financing by expanding the base of shareholders; it has the potential to attract and use the expertise of its board of directors; it has the potential to hire professional managers to build value
  Disadvantages: formality and structure may slow the speed of response of the organization; there is double taxation of corporate income tax and personal dividend tax

2.2 ***Describe the goals of the firm and the pressures exerted on corporations by various stakeholders.*** Corporations are owned by the shareholders but managed by the executives. The link between the groups is the board of directors (BOD). The BOD has a fiduciary responsibility to represent the best interests of shareholders when dealing with the executives. The BOD hires and fires the senior executives. Other stakeholder groups, such as employees and the general public, may have an interest in the company's activities but do not have any legal sway over corporate decisions.

2.*3* ***Explain what agency costs are and how they affect the interests of management and shareholders.*** Agency costs are the costs associated with the agency problem. There are two major types of agency costs: (1) direct costs, which arise because suboptimal decisions are made by management when it acts in a manner that is not in the best interests of shareholders, and (2) indirect costs, which are incurred in an attempt to avoid direct agency costs. Indirect costs include those that arise from any restrictions placed on the actions of management, those associated with monitoring the actions of management, and those associated with management compensation schemes that provide managers with incentives to act in the shareholders ' best interests.

2.4 ***Explain the importance of aligning the interests of management with the interests of shareholders in a corporation.*** Management's personal interest and compensation may determine how hard it works to serve the best interests of the shareholders. This is the classic agency problem associated with the separation of ownership and management. Shareholders and management may disagree about performance appraisal, investment analysis, financing priorities, and risk consideration, which may result in management behaviour that reduces shareholders' value. Thus, it is important to align the interests of management with the interests of shareholders in order to maximize shareholders' value.

2.5 ***Identify the main corporate finance decisions involving the financial management of a firm's assets and its liabilities (corporate financing).*** Financial managers in corporations make both short-term working capital decisions and long-term capital budgeting decisions. Both short- and long-term decisions have implications for the capital needs of the company.

2.6 ***List some finance jobs available with financial and non-financial companies.***

- Finance jobs in corporations include chief financial officer, treasurer, and controller.
- Jobs in the investment industry include portfolio managers, brokers, traders, and analysts.
- Jobs on the buy side of the investment industry include buyers of securities.
- Jobs on the sell side of the investment industry include sellers of securities, such as investment dealers.
- Investment banking (corporate finance) jobs involve advising firms on their interactions with the capital markets. Investment bankers are involved with such events as new issues of securities and mergers.

MULTIPLE CHOICE QUESTIONS

1. What is an advantage of forming a general partnership instead of a corporation?
a) It is easier for partnerships to access the debt and equity markets.
b) Partners have limited liability, where corporate shareholders do not.
c) Partnerships are easier to set up than corporations.
d) The partnership lives on, even when all partners have died.

Answer: c

Type: Definition
Difficulty: Easy
Learning Objective: List the four forms of business organizations and describe the advantages and disadvantages of each.
Section Reference: Types of Business Organizations

2. Which of the situations listed below would be an example of a limited liability partnership?
a) Harun and Ahmed mow lawns together, sharing equipment and expenses. They share the work equally.
b) Xi and Fung operate a delivery business. Xi handles the pickups and deliveries only, while Fung handles only the financial and accounting tasks.
c) Jordan and Chris have a landscaping business, with unequal involvement. Jordan works in the business full-time while Chris is involved half-time.
d) Sara, Morgan, and Sabina started an accounting practice. Sara and Morgan work actively as accountants. Sabina’s involvement is as an investor in the firm only.

Answer: d

Type: Concept
Difficulty: Medium
Learning Objective: List the four forms of business organizations and describe the advantages and disadvantages of each.
Section Reference: Types of Business Organizations

3. Which of the following is NOT a reason for incorporating a business?
a) There is limited liability.
b) Ownership is relatively easy to transfer.
c) It is easier to form than a proprietorship.
d) Corporate tax laws may allow tax deferral or avoidance.

Answer: c

Type: Concept
Difficulty: Easy
Learning Objective: List the four forms of business organizations and describe the advantages and disadvantages of each.
Section Reference: Types of Business Organizations

4. Which of the following is NOT a form of business organization?
a) corporation
b) sole partnership
c) general partnership
d) sole proprietorship

Answer: b

Type: Definition
Difficulty: Easy
Learning Objective: List the four forms of business organizations and describe the advantages and disadvantages of each.
Section Reference: Types of Business Organizations

5. If you are in a business that is faced with enormous risks of failure, what type of ownership would you avoid?
a) corporation
b) sole partnership
c) general partnership
d) sole proprietorship

Answer: d

Type: Concept
Difficulty: Easy
Learning Objective: List the four forms of business organizations and describe the advantages and disadvantages of each.
Section Reference: Types of Business Organizations

6. Which of the following is an advantage of a corporation over a sole proprietorship?
a) A corporation is easy to set up.
b) Corporate tax laws are often less attractive than personal tax laws.
c) Shareholders' liability is limited to their investment in the corporation.
d) In a sole proprietorship, it is easier to transfer ownership.

Answer: c

Type: Concept
Difficulty: Easy
Learning Objective: List the four forms of business organizations and describe the advantages and disadvantages of each.
Section Reference: Types of Business Organizations

7. What was the reason for the increase in the number of income trusts in Canada?
a) limited liability
b) unlimited liability
c) tax advantage

d) transfer of ownership

Answer: c

Type: Concept
Difficulty: Easy
Learning Objective: List the four forms of business organizations and describe the advantages and disadvantages of each.
Section Reference: Types of Business Organizations

8. Which of the following is the most correct? ______ know their exposure is limited to the amount of capital they invest in the company.
a) Employees
b) Sole proprietors
c) General partners
d) Limited partners and shareholders

Answer: d

Type: Concept
Difficulty: Medium
Learning Objective: List the four forms of business organizations and describe the advantages and disadvantages of each.
Section Reference: Types of Business Organizations

9. Which of the following is (are) true about a general partnership?
I. Some of the partners have limited liability.
II. Some of the partners may not be involved in the day-to-day operations.
III. Some partners may receive a different percentage of the profits.
a) III only
b) I and III
c) II and III
d) I and II

Answer: c

Type: Concept
Difficulty: Medium
Learning Objective: List the four forms of business organizations and describe the advantages and disadvantages of each.
Section Reference: Types of Business Organizations

10. Beginning in 2013, in Canada, what would be the most appropriate type of organization for a business with large assets and revenue?
a) trust
b) corporation
c) general partnership
d) sole proprietorship

Answer: b

Type: Concept
Difficulty: Medium
Learning Objective: List the four forms of business organizations and describe the advantages and disadvantages of each.
Section Reference: Types of Business Organizations

11. Which of the following businesses is most likely to be operated as a corporation?
a) a law firm
b) a mining company
c) an accounting firm
d) All of these are likely to be operated as a corporation.

Answer: b

Type: Concept
Difficulty: Easy
Learning Objective: List the four forms of business organizations and describe the advantages and disadvantages of each.
Section Reference: Types of Business Organizations

12. The main purpose of creating a trust is to
I. separate ownership from control.
II. avoid legal liability.
III. avoid taxes.
IV. improve a firm's reputation.
a) I, II, and III
b) I and IV
c) I and III
d) III and IV

Answer: c

Type: Concept
Difficulty: Easy
Learning Objective: List the four forms of business organizations and describe the advantages and disadvantages of each.
Section Reference: Types of Business Organizations

13. Which of the following is NOT an example of a trust?
a) a mutual fund
b) an estate
c) a royalty trust
d) a bank

Answer: d

Type: Concept
Difficulty: Easy
Learning Objective: List the four forms of business organizations and describe the advantages and disadvantages of each.
Section Reference: Types of Business Organizations

14. After 20 years of being the sole proprietor of Montere Lawn Care, Denis Seville is considering making a change. His business has grown substantially over the years and he now has approximately 100 extremely loyal clients. Denis wants to retire and move to Florida. Unfortunately, Denis has no children to carry on his business and thus he is thinking of selling it to someone else. What is the main consideration Denis should have about selling his lawn care business?
a) He will face some difficulty in selling because all the client relationships are personal and belong to him; he will have to explain the new situation to each client.
b) Lawn care is seasonal and not many people would want to purchase his business.
c) It is difficult to learn lawn care skills for potential buyers.
d) The new owner may not retain the same business name.

Answer: a

Type: Concept
Difficulty: Medium
Learning Objective: List the four forms of business organizations and describe the advantages and disadvantages of each.
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15. Lucy Vale and Bob Fama, both accountants, have opened an accounting firm in Calgary together and business has been steadily increasing. Since they each have the same number of clients, Lucy and Bob decided to simply split any income equally between them. However, Lucy has recently made a grievous error in the financial statements of one of her clients, and that client is now considering suing Lucy and the firm. If Lucy and Bob had never created a formal partnership agreement since the inception of their firm, should Bob be at all concerned about the potential lawsuit? Choose the best answer from the following:
a) No. Since there was no formal partnership agreement made, Bob cannot be held responsible for Lucy’s error.
b) Yes. A legal agreement is not always required for someone to be considered a partner of a partnership. Thus, Bob may be held partially responsible for Lucy’s error in the event the client sues the firm.
c) No. It was Lucy’s client and she made the error. Bob was not involved.
d) Yes. Bob has just incurred substantial debt by purchasing a new home which was partially financed by his share of the firm’s earnings.

Answer: b

Type: Concept
Difficulty: Medium
Learning Objective: List the four forms of business organizations and describe the advantages and disadvantages of each.

Section Reference: Types of Business Organizations

16. A corporation's board of directors should first and foremost be accountable to which group?
a) politicians (law makers)
b) senior managers
c) shareholders
d) suppliers

Answer: c

Type: Concept
Difficulty: Medium
Learning Objective: Describe the goals of the firm and the pressures exerted on corporations by various stakeholders.
Section Reference: The Goals of the Corporation

17. Which of the following should be the primary goal of a CEO in a publicly traded company?
a) Maximize the profit margin.
b) Avoid bankruptcy.
c) Increase market share.
d) Maximize the company's share price.

Answer: d

Type: Concept
Difficulty: Easy
Learning Objective: Describe the goals of the firm and the pressures exerted on corporations by various stakeholders.
Section Reference: The Goals of the Corporation

18. How is wealth different from profits?
a) Wealth is a personal issue, while profits are related to a business.
b) Profits include a deduction for expenses, and expenses are not relevant for wealth calculations.
c) Wealth reflects the value of all profits, both short- and long-term, while profits refer to economic profits only.
d) all of the above

Answer: c

Type: Concept
Difficulty: Medium
Learning Objective: Describe the goals of the firm and the pressures exerted on corporations by various stakeholders.
Section Reference: The Goals of the Corporation

19. What are externalities?
a) valuable resources to a company that the firm does not pay or charge for

b) issues in the surrounding business environment of a firm that have no impact on the firm's operations or policies
c) members of the board of directors who are not employed by the firm
d) none of the above

Answer: a

Type: Definition
Difficulty: Easy
Learning Objective: Describe the goals of the firm and the pressures exerted on corporations by various stakeholders.
Section Reference: The Goals of the Corporation

20. Why are externalities a necessary consideration when conducting business, especially for large corporations?
a) Externalities always cost money, and those costs hurt a firm's bottom line.
b) Forgetting to account for externalities is against tax laws in Canada.
c) The actions a large firm makes can have a significant impact on other firms, and those actions may not necessarily be in Canada's best interests.
d) all of the above

Answer: c

Type: Concept
Difficulty: Medium
Learning Objective: Describe the goals of the firm and the pressures exerted on corporations by various stakeholders.
Section Reference: The Goals of the Corporation

21. Which of the following is/are considered a stakeholder in the Toronto Stock Exchange?
a) shareholders
b) listing companies
c) provincial government
d) all of the above

Answer: d

Type: Concept
Difficulty: Easy
Learning Objective: Describe the goals of the firm and the pressures exerted on corporations by various stakeholders.
Section Reference: The Goals of the Corporation

22. Which one of the following is NOT part of externalities?
a) union pension costs and regulations
b) high borrowing rate
c) labour regulations
d) cost of carbon emissions

Answer: b

Type: Concept
Difficulty: Medium
Learning Objective: Describe the goals of the firm and the pressures exerted on corporations by various stakeholders.
Section Reference: The Goals of the Corporation

23. Who, of the following, does NOT have a contractual claim on a company?
a) employees
b) shareholders
c) local community
d) customers

Answer: c

Type: Concept
Difficulty: Medium
Learning Objective: Describe the goals of the firm and the pressures exerted on corporations by various stakeholders.
Section Reference: The Goals of the Corporation

24. What is the risk-return trade-off?
a) A firm will only have returns when it takes on risk.
b) A firm can either have risk, or it can have returns, but not both.
c) The balancing of gain with risk.
d) A risky return is always preferred to a risk-free return.

Answer: c

Type: Definition
Difficulty: Easy
Learning Objective: Describe the goals of the firm and the pressures exerted on corporations by various stakeholders.
Section Reference: The Goals of the Corporation

25. Which one of the following is NOT true about the board of directors?
a) It represents shareholders' interests.
b) It cannot ignore its stakeholders.
c) It is involved with guiding the management of the company.
d) Board of directors may include members of the company's management team.

Answer: b

Type: Concept
Difficulty: Medium
Learning Objective: Describe the goals of the firm and the pressures exerted on corporations by

various stakeholders.
Section Reference: The Goals of the Corporation

26. What is the main implication of the 1994 Dey Report?
a) Firms should pay attention to special interests or other stakeholders, not just shareholders.
b) Boards of directors are responsible only for ensuring management is maximizing revenue.
c) Boards of directors can ignore stakeholders and focus solely on shareholders while maintaining their contractual responsibilities.
d) Considerations for social welfare should be of utmost importance to firms.

Answer: c

Type: Concept
Difficulty: Medium
Learning Objective: Describe the goals of the firm and the pressures exerted on corporations by various stakeholders.
Section Reference: The Goals of the Corporation

27. Which one of the following is NOT an example of the agency problem?
a) management refusing a merger because of the possibility of major changes in management
b) taking a high-risk project to increase the value of the stock options held by management
c) increasing the level of debt of the company to increase the return on equity value
d) distributing a low level of dividends to have enough cash for bonuses

Answer: c

Type: Concept
Difficulty: Hard
Learning Objective: Explain what agency costs are and how they affect the interests of management and shareholders.
Section Reference: The Role of Management and Agency Issues

28. Which of the following illustrates an agency problem?
a) The advertising agency that a company uses produces top quality materials and charges a high price for its work.
b) A not-for-profit environmental agency stages a protest. This results in negative attention to a company’s manufacturing methods.
c) A company’s board, in wanting to protect board member compensation, agrees with everything company management suggests.
d) A hiring agency screens out potential applicants to a company’s job posting.

Answer: c

Type: Definition
Difficulty: Medium
Learning Objective: Explain what agency costs are and how they affect the interests of management and shareholders.
Section Reference: The Role of Management and Agency Issues

29. You are asked to watch over your brother and sister in exchange for a fee. You invited your friends over and you watched TV all night without paying attention to your siblings. What type of agency problem is this?
a) indirect
b) direct
c) moral hazard
d) none of the above

Answer: c

Type: Concept
Difficulty: Medium
Learning Objective: Explain what agency costs are and how they affect the interests of management and shareholders.
Section Reference: The Role of Management and Agency Issues

30. Which of the following is true?
a) Management buying another business at a premium may be an example of an agency cost.
b) Corporations are not vulnerable to agency costs.
c) Stock options are an example of an agency cost.
d) Agency costs do not include expenses of monitoring and controlling the actions of management.

Answer: c

Type: Concept
Difficulty: Hard
Learning Objective: Explain what agency costs are and how they affect the interests of management and shareholders.
Section Reference: The Role of Management and Agency Issues

31. Of the following list, which represents a potential implication for agency issues when shareholders are dispersed?
a) More shareholders have a controlling say in what happens in the firm.
b) The likelihood of management pleasing all shareholders is greatly improved.
c) A firm's chief executive officer (CEO) is better able to choose his or her friends to sit on the board of directors.
d) none of the above

Answer: c

Type: Concept
Difficulty: Medium
Learning Objective: Explain what agency costs are and how they affect the interests of management and shareholders.
Section Reference: The Role of Management and Agency Issues

32. Johan, a corporate manager, often takes significant business and financial risks because of the company's compensation structure, which provides him with a comfortable base salary and large bonuses when the business does well. Johan does not suffer in any way when the company performs poorly, even if the performance is a result of his decisions. What is the term that describes this situation?
a) moral hazard
b) agency monitoring problem
c) asymmetric risk structure
d) stakeholder snubbing

Answer: a

Type: Definition
Difficulty: Easy
Learning Objective: Explain what agency costs are and how they affect the interests of management and shareholders.
Section Reference: The Role of Management and Agency Issues

33. Which of the following is true?
a) Managers can ignore the objective of shareholder wealth in the short run in favour of other stakeholders' interests, but not in the long run.
b) In 2000, BCE spun off its ownership in Nortel, making this an example of a firm's agency costs diminishing shareholder value.
c) A 1997 Canadian survey of Shareholder Value Measurement showed that a minority of companies with listed shares state maximizing firm value is a key corporate objective.
d) Without adequate financial performance, a firm can survive in a competitive environment.

Answer: a

Type: Concept
Difficulty: Medium
Learning Objective: Explain what agency costs are and how they affect the interests of management and shareholders.
Section Reference: The Role of Management and Agency Issues

34. A merger between Bank of Montreal and TD Bank would be a potential
a) agency problem.
b) too-big-to-fail problem.
c) moral hazard.
d) none of the above

Answer: b

Type: Concept
Difficulty: Easy
Learning Objective: Explain what agency costs are and how they affect the interests of management and shareholders.
Section Reference: The Role of Management and Agency Issues

35. Which one of the following is true?
a) Managers have the mandate to increase the market value of the company.
b) Managers always look after shareholders' interests.
c) The board of directors is legally responsible for all the company's decisions.
d) all of the above

Answer: a

Type: Concept
Difficulty: Medium
Learning Objective: Explain the importance of aligning the interests of management with the interests of shareholders in a corporation.
Section Reference: Aligning Managers and Owners Interest

36. Which of the following is NOT a reason why the market for corporate control is the most effective mechanism to give managers the incentive to act like shareholders?
a) The government imposes significant lawsuits and penalties for managers not acting in the best interests of shareholders.
b) The threat of acquisition keeps managers focused on achieving good performance and a high stock price.
c) A low stock price makes a firm a good target for acquisition.
d) It allows the best managers the chance to manage assets.

Answer: a

Type: Concept
Difficulty: Medium
Learning Objective: Explain the importance of aligning the interests of management with the interests of shareholders in a corporation.
Section Reference: Aligning Managers and Owners Interest

37. If shareholders are not happy with a company's management, a proxy fight is one method that can be used to attempt to remove managers. Which of the following is true, with regard to a proxy fight?
a) A proxy fight is an inexpensive method for a shareholder with a small holding to have an impact.
b) If a large shareholder is unhappy they are more likely to launch a proxy fight than to sell shares.
c) Most proxy fights are successful.
d) Proxy fights can be very expensive and time consuming.

Answer: d

Type: Definition
Difficulty: Medium
Learning Objective: Explain the importance of aligning the interests of management with the interests of shareholders in a corporation.
Section Reference: Aligning Managers and Owners Interest

38. Which of the following is an example of an indirect agency cost?
a) A company buys the latest computer equipment for its employees.
b) Senior management use company money to pay their children's education.
c) Managers can use the company float plane to fly to their cottages on weekends.
d) Managers may take risky projects when the company is not doing well.

Answer: d

Type: Concept
Difficulty: Easy
Learning Objective: Explain the importance of aligning the interests of management with the interests of shareholders in a corporation.
Section Reference: Aligning Managers and Owners Interest

39. Agency problems are best defined as
a) difficulties arising in dealings with real estate agencies.
b) problems arising due to potential misalignment between the interests of owners, creditors, and managers.
c) problems arising due to the complete alignment of the interests of owners, creditors, and managers.
d) issues surrounding whether or not to outsource production to an external agency.

Answer: b

Type: Definition
Difficulty: Easy
Learning Objective: Explain the importance of aligning the interests of management with the interests of shareholders in a corporation.
Section Reference: Aligning Managers and Owners Interest

40. Which of the following will help shareholders mitigate agency problems? Shareholders can
I. elect directors.
II. challenge management through proxy fights.
III. tender their shares to outsiders in a hostile takeover.
IV. sell their shares on the stock market.
a) I, II, and IV
b) II, III, and IV
c) I, II, and III
d) I, II, III, and IV

Answer: d

Type: Concept
Difficulty: Medium
Learning Objective: Explain the importance of aligning the interests of management with the interests of shareholders in a corporation.
Section Reference: Aligning Managers and Owners Interest

41. Which of the following illustrates a situation that would encourage a manager to work in the interests of a company's shareholders?
a) The manager's salary depends largely on increasing quarterly accounting profits.
b) The manager's salary depends largely on his/her ability to keep costs low.
c) The manager's total compensation depends on maximizing the share price.
d) The manager has access to many perks, which improves his/her personal work environment.

Answer: c

Type: Definition
Difficulty: Easy
Learning Objective: Explain the importance of aligning the interests of management with the interests of shareholders in a corporation.
Section Reference: Aligning Managers and Owners Interest

42. Which one of the following is NOT a criterion that managers prefer to be judged upon?
a) return on assets
b) return on equity
c) share price
d) market share

Answer: c

Type: Concept
Difficulty: Easy
Learning Objective: Explain the importance of aligning the interests of management with the interests of shareholders in a corporation.
Section Reference: Aligning Managers and Owners Interest

43. Why do shareholders have a greater preference for risk than do managers?
a) Shareholders are always richer than managers, and can afford to take more risk.
b) Shareholders can diversify risk by holding many securities, while a manager's career is tied up with the firm.
c) Because they are investing in the stock market, shareholders must naturally prefer taking more risk than managers.
d) Managers do not like risk because it hurts the value of the company.

Answer: b

Type: Concept
Difficulty: Medium
Learning Objective: Explain the importance of aligning the interests of management with the interests of shareholders in a corporation.
Section Reference: Aligning Managers and Owners Interest

44. What is the main purpose behind share incentive plans?
a) The plans encourage managers to invest in the stock market.

b) The plans are meant to align the interests of management and shareholders.
c) The plans encourage managers to give shares as incentives for employees.
d) all of the above

Answer: b

Type: Concept
Difficulty: Easy
Learning Objective: Explain the importance of aligning the interests of management with the interests of shareholders in a corporation.
Section Reference: Aligning Managers and Owners Interest

45. Share incentive plans may NOT produce the desired results. Why?
a) the retooling of option grants and share incentive schemes
b) Compensation schemes are generally designed to reward management, not to provide incentives.
c) fraud
d) all of the above

Answer: d

Type: Concept
Difficulty: Medium
Learning Objective: Explain the importance of aligning the interests of management with the interests of shareholders in a corporation.
Section Reference: Aligning Managers and Owners Interest

46. Which one of the following is NOT a way to improve the efficiency in Canadian wealth management?
a) Encourage takeovers.
b) Expand management's defence mechanisms with regards to takeovers.
c) Hold managers personally accountable.
d) Increase measures of corporate governance.

Answer: b

Type: Concept
Difficulty: Medium
Learning Objective: Explain the importance of aligning the interests of management with the interests of shareholders in a corporation.
Section Reference: Aligning Managers and Owners Interest

47. Ten years ago a company spent $10 million on a large machine. It is expected that the machine will be useful for two more years. What should the company's financial managers do?
a) They should consider the value of the machine today and in two years, and the potential cost and benefit to extend the machine's life.
b) They should scrap the machine on schedule – the plan was made, so stick to the plan.
c) They should sell the machine now. It always makes more sense to upgrade to new

technology than to keep older technology running.
d) They should hand this decision off to the company’s accountants. This is an accounting decision, not a finance decision.

Answer: a

Type: Concept
Difficulty: Medium
Learning Objective: Identify the main corporate finance decisions involving the financial management of a firm’s assets and its liabilities (corporate financing).
Section Reference: Corporate Finance

48. When a company faces uncertainty it is common for managers to attempt to build up cash reserves. Which of the following is an important advantage of having large cash balances on hand?
a) Cash balances pay significant interest, enabling a company to receive additional revenue.
b) Having large cash balances enables a company to pay its bills even when sales are dropping.
c) A cash account will increase in value when equity markets go up in value.
d) Corporate shareholders generally approve of large corporate cash balances, believing that corporate managers are acting prudently.

Answer: b

Type: Concept
Difficulty: Easy
Learning Objective: Identify the main corporate finance decisions involving the financial management of a firm’s assets and its liabilities (corporate financing).
Section Reference: Corporate Finance

49. Which of the following is an example of a capital structure decision?
a) issuing new shares
b) buying a new factory
c) reducing inventory levels
d) increasing purchases on credit

Answer: a

Type: Definition
Difficulty: Easy
Learning Objective: Identify the main corporate finance decisions involving the financial management of a firm’s assets and its liabilities (corporate financing).
Section Reference: Corporate Finance

50. The framework for analyzing investment or asset decisions is known as
a) income management analysis.
b) capital budgeting analysis.
c) capital aligning analysis.

d) asset allocation analysis.

Answer: b

Type: Definition
Difficulty: Easy
Learning Objective: Identify the main corporate finance decisions involving the financial management of a firm’s assets and its liabilities (corporate financing).
Section Reference: Corporate Finance

51. Capital budgeting refers to
a) the decision to raise capital from the market.
b) the decision to invest.
c) the decision to budget the administrative expenses of the firm.
d) the decision to budget compensation within the firm.

Answer: b

Type: Definition
Difficulty: Medium
Learning Objective: Identify the main corporate finance decisions involving the financial management of a firm’s assets and its liabilities (corporate financing).
Section Reference: Corporate Finance

52. What does it mean to “go public”?
a) to sell goods and services to the public
b) to raise money from the stock market
c) to borrow money from the debt market
d) to do business with governmental firms

Answer: b

Type: Definition
Difficulty: Medium
Learning Objective: Identify the main corporate finance decisions involving the financial management of a firm’s assets and its liabilities (corporate financing).
Section Reference: Corporate Finance

53. If a controller is responsible for liquidity management, which of the following accounts is she NOT interested in?
a) Long-term Debt
b) Cash
c) Accounts Payable
d) Inventory

Answer: a

Type: Concept

Difficulty: Medium
Learning Objective: Identify the main corporate finance decisions involving the financial management of a firm’s assets and its liabilities (corporate financing).
Section Reference: Corporate Finance

54. Another term for the “paper” market is
a) debt market.
b) equity market.
c) money market.
d) options market.

Answer: c

Type: Definition
Difficulty: Easy
Learning Objective: Identify the main corporate finance decisions involving the financial management of a firm’s assets and its liabilities (corporate financing).
Section Reference: Corporate Finance

55. Which of the following statements is NOT true?
a) Cash and cash equivalents are defined as deposits in banks plus short-term investments.
b) A firm’s accounts receivable is debt owed to them by other firms.
c) Another term for accounts receivable is trade credit.
d) A firm’s mortgages would appear on the asset side of its balance sheet.

Answer: d

Type: Definition
Difficulty: Easy
Learning Objective: Identify the main corporate finance decisions involving the financial management of a firm’s assets and its liabilities (corporate financing).
Section Reference: Corporate Finance

56. Which one of the following is NOT part of financial management?
a) deciding on sources of capital financing
b) deciding on debt versus equity
c) deciding on buying property
d) deciding on changing company image

Answer: d

Type: Concept
Difficulty: Easy
Learning Objective: Identify the main corporate finance decisions involving the financial management of a firm’s assets and its liabilities (corporate financing).
Section Reference: Corporate Finance

57. Which of the following is NOT a source of corporate financing?
a) equity
b) retained earnings
c) bonds
d) increase in inventory

Answer: d

Type: Definition
Difficulty: Medium
Learning Objective: Identify the main corporate finance decisions involving the financial management of a firm’s assets and its liabilities (corporate financing).
Section Reference: Corporate Finance

58. Typical duties of the financial manager include
I. raising funds.
II. product line evaluation.
III. controlling the disbursement of funds.
IV. dividend policy.
V. auditing financial statements.
VI. shareholder relations.
VII. setting personnel policy.
VIII. pricing of the company’s products.
a) I, III, IV, V, and VI
b) I, III, IV, and VI
c) III, IV, VI, and VII
d) II, III, VI, and VIII

Answer: b

Type: Concept
Difficulty: Hard
Learning Objective: List some finance jobs available with financial and non-financial companies.
Section Reference: Finance Careers and the Organization of the Finance Function

59. If your job requires you to monitor the valuations of the companies you follow and make recommendations to buy or sell a company’s shares, you are most likely a(n)
a) banker to retail clients.
b) investment dealer security analyst.
c) valuation insurance agent.
d) mutual fund private client sales representative.

Answer: b

Type: Definition
Difficulty: Medium
Learning Objective: List some finance jobs available with financial and non-financial companies.
Section Reference: Finance Careers and the Organization of the Finance Function

60. What is the primary responsibility of a portfolio manager?
a) to oversee the financial investments within a portfolio
b) to take care of the financial needs of a portfolio of clients, as a personal representative
c) to make forecasts for a portfolio of economic and financial variables
d) to buy and sell bonds

Answer: a

Type: Definition
Difficulty: Easy
Learning Objective: List some finance jobs available with financial and non-financial companies.
Section Reference: Finance Careers and the Organization of the Finance Function

61. Which of the following is the least important of the financial manager's responsibilities?
a) Keep an up-to-date record on past operations.
b) Contain costs and foster productivity improvements.
c) Raise funds to support the ongoing operations and planned investments.
d) Control the disbursement of funds to ensure efficiency and adequate returns.

Answer: a

Type: Concept
Difficulty: Medium
Learning Objective: List some finance jobs available with financial and non-financial companies.
Section Reference: Finance Careers and the Organization of the Finance Function

62. All of the following are the responsibility of the controller EXCEPT
a) financial planning.
b) liquidity management.
c) mergers and acquisitions.
d) dividend policy.

Answer: d

Type: Definition
Difficulty: Medium
Learning Objective: List some finance jobs available with financial and non-financial companies.
Section Reference: Finance Careers and the Organization of the Finance Function

63. The primary objective of the financial manager is to
a) maximize earnings.
b) maximize dividend payments.
c) maximize shareholder wealth.
d) minimize expenses.

Answer: c

Type: Concept
Difficulty: Easy
Learning Objective: List some finance jobs available with financial and non-financial companies.
Section Reference: Finance Careers and the Organization of the Finance Function

64. If you are working for a company and your job description includes accounting, budgeting, internal audit, systems management/MIS, and tax management, you are most likely a(n)
a) treasurer.
b) tax accountant.
c) auditor.
d) controller.

Answer: d

Type: Concept
Difficulty: Easy
Learning Objective: List some finance jobs available with financial and non-financial companies.
Section Reference: Finance Careers and the Organization of the Finance Function

65. In major financial institutions, people generally start out their careers as
a) consultants.
b) analysts.
c) account managers.
d) banking associates.

Answer: b

Type: Definition
Difficulty: Medium
Learning Objective: List some finance jobs available with financial and non-financial companies.
Section Reference: Finance Careers and the Organization of the Finance Function

PRACTICE PROBLEMS

66. Give three potential advantages that explain why corporations represent a small percentage of the total number of businesses in Canada, but dominate in terms of assets and dollar volumes of sales.

Answer:
a) Limited liability: investors know that their exposure to loss is limited.
b) Transfer of ownership is relatively easy; investors can cash out at any time if they need cash or are unhappy with the direction in which the company is headed.
c) Corporate tax laws may be more attractive in some circumstances, allowing tax deferral or avoidance.
In principle, the separation of ownership from control allows corporations to obtain the best available management team.

Type: Concept
Difficulty: Medium
Learning Objective: List the four forms of business organizations and describe the advantages and disadvantages of each.
Section Reference: Types of Business Organizations

67. Which is a better economic objective for financial managers: maximizing profit or maximizing share price? Why? Give three reasons.

Answer: Maximizing share price is a better economic objective for financial managers because simple profit maximization does not address the following three issues:
Profits versus Return on Capital – Profits have to be viewed in relation to the amount of capital invested. The wealth position of shareholders can suffer even when total profits increase.
Timing of cash flows – The time value of money has to be considered when comparing profits across different time periods. Identical dollar amounts received at two different points in time do not have the same economic value.
Risk – Any stream of anticipated profits is subject to risk. Given the same potential return, investors will prefer less risk, as they are risk adverse. Investors will demand a higher return, or a risk premium, in order to invest in risky securities.
The objective of share price maximization overcomes the shortcomings of profit maximization.

Type: Concept
Difficulty: Medium
Learning Objective: Describe the goals of the firm and the pressures exerted on corporations by various stakeholders.
Section Reference: The Goals of the Corporation

68. Explain the concept of “too-big-to-fail” and how it relates to the latest financial crisis.

Answer: The “too-big-to-fail” argument relates to firms that employ a high number of people or are involved in a vital sector of the economy. The argument refers to the inability of society to lose firms that are so important, and society must do whatever is in its power to protect these large businesses. However, the issue becomes: how can we control the management of businesses that are important in the economy? The saving of AIG and other financial institutions during the latest crisis shows the cost that society pays as a result.

Type: Concept
Difficulty: Medium
Learning Objective: Explain what agency costs are and how they affect the interests of management and shareholders.
Section Reference: The Role of Management and Agency Issues

69. Describe what is meant by agency relationships, and outline the potential conflicts of interest that may arise.

Answer: One type of agency relationship arises when there is a separation of management from ownership, which results in management being hired to act as an agent on behalf of the owner. Potential conflicts of interest arise when actions that are in the best interests of shareholders do not coincide with those that are in management's best interests.
Another type of agency relationship arises when a corporation finances its activities with both equity and debt. At times, shareholders (who control the decisions of the firm) have an incentive to invest in projects that are detrimental to bondholders. To eliminate the potential for such actions, bondholders put restrictive covenants in the debt contracts restricting the actions of management. These covenants may impair management's ability to make value-maximizing decisions.

Type: Definition
Difficulty: Medium
Learning Objective: Explain what agency costs are and how they affect the interests of management and shareholders.
Section Reference: The Role of Management and Agency Issues

70. Do agency costs only occur in a corporation, or can you have agency costs in a sole proprietorship?

Answer: Agency costs primarily occur in corporations, but can also occur in other forms of business. Whenever an owner of a business hires another person to act on their behalf, there exists an agency relationship. Whenever there exists an agency relationship, there is a potential for conflicts of interest to arise, and therefore agency costs may be incurred.

Type: Concept
Difficulty: Hard
Learning Objective: Explain what agency costs are and how they affect the interests of management and shareholders.
Section Reference: The Role of Management and Agency Issues

71. The management of Prairie Resources Limited (PRL) has just recommended to the board that the company should purchase an expensive corporate jet in order to improve management's ability to oversee the company's operations. PRL's operations are geographically remote. Are company jets always a waste of shareholder wealth? How should the board decide if the purchase is appropriate?

Answer: This is an open-ended question intended to build class discussion. Students should consider that, because members of the company's management team likely have access to considerably more spending power through the corporation than individually it might be tempting to buy assets that have a lot of personal benefit, without proper business and financial analysis. If this happens, an agency problem exists and the corporation's shareholders may be forced to bear significant direct and indirect agency costs. It is important however to look at any asset purchase, be it a raw material or a corporate jet, through a financial analysis lens. With remote operations, it is very possible that distance could make effective management very difficult, particularly if the company has operations that are scattered across Canada's North. Commercial air travel might not be efficient, or even plausible, for remote resource developments. The instructor could ask students if it makes sense to require a high-level executive to spend major portions of his or her day driving to remote sites when a corporate aircraft could reduce the travel time to fractions of an hour. Discussion may vary.

Type: Discussion
Difficulty: Medium
Learning Objective: Explain the importance of aligning the interests of management with the interests of shareholders in a corporation.
Section Reference: Aligning Managers and Owners Interest

72. Frank Wood, the owner of Cozy Corner Cabinets (CCC), has just hired Joe Boss to manage his company. Instead of using a flat salary, the two men have agreed that Joe will be paid 15 percent of the profits at the end of each year. CCC currently has three project opportunities to choose from, and can only choose one of them. Project A will generate profits of $75,000 per year, and will increase the value of CCC by $145,000. Project B will generate profits of $63,000 per year, and will increase the value of CCC by $153,000. Project C will generate profits of $68,000 per year, and will increase the value of CCC by $138,000. Which project is Joe Boss likely to choose and why? As the owner of CCC, which project would Frank prefer?

Answer: Under Project A, Joe would receive 0.15 * $75,000 = $11,250 per year. Under Project B, Joe would receive 0.15 * $63,000 = $9,450. Under Project C, Joe would receive 0.15 * $68,000 = $10,200. Thus, since $11,250 > $10,200 > $9,450, Joe would choose Project A to maximize his income.
However, Frank would prefer that Project B be chosen as it results in the greatest increase in firm value for CCC ($153,000 > $145,000 > $138,000).

Type: Calculation
Difficulty: Hard
Learning Objective: Identify the main corporate finance decisions involving the financial management of a firm's assets and its liabilities (corporate financing).
Section Reference: Corporate Finance

73. Define the term finance. What are the three broad functional categories associated with finance?

Answer: Finance is the study of the management of funds. The three broad functional categories associated with finance are:
a) making long-term investment decisions, also called capital budgeting decisions.

b) making long-term financing decisions, also called capital structure decisions.
c) managing day-to-day activities, also called working capital (or liquidity) management.

Type: Definition
Difficulty: Easy
Learning Objective: Identify the main corporate finance decisions involving the financial management of a firm's assets and its liabilities (corporate financing).
Section Reference: Corporate Finance

74. Give two reasons for the importance and scope of finance.

Answer: First, the scale of operations of business firms has expanded greatly in recent years. The growing significance of large corporations and the increasing size of investments highlight the importance of long-range financial planning.
Second, the widespread diversification of products and the global nature of today's business environment have increased the complexity of managing a business. We now have multiproduct, multidivisional, and multinational corporations.

Type: Concept
Difficulty: Medium
Learning Objective: Identify the main corporate finance decisions involving the financial management of a firm's assets and its liabilities (corporate financing).
Section Reference: Corporate Finance

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