***Managerial Economics, 7e* (Keat)**
Chapter 2 The Firm and Its Goals

Multiple-Choice Questions

1) Transaction costs include
A) costs of negotiating contracts with other firms.
B) cost of enforcing contracts.
C) the existence of asset-specificity.
D) All of the above
Answer: D
Diff: 1

2) A company will strive to minimize
A) transaction costs.
B) costs of internal operations.
C) total costs of transactions and internal operations combined.
D) variable costs.
Answer: C
Diff: 1

3) The best example of an economic goal of a firm is
A) providing good products/services to its customers.
B) improving its public image.
C) increasing employee morale.
D) increasing shareholder wealth.
Answer: D
Diff: 1

4) A large corporation's profit objective may not be profit or wealth maximization, because
A) stockholders have little power in corporate decision making.
B) management is more interested in maximizing its own income.
C) managers are overly concerned with their own survival and may not take all prudent risks.
D) All of the above
Answer: D
Diff: 2

5) One of the weaknesses in pursuing the objective of profit maximization is that it ignores
A) the timing of cash flows.
B) the time-value of money concept.
C) the riskiness of cash flows.
D) All of the above
Answer: D
Diff: 1

6) Goals which are concerned with creating and maintaining employee and customer satisfaction and social responsibility are referred to as ________ objectives.
A) social
B) noneconomic
C) welfare
D) public relations
Answer: B
Diff: 1

7) Financial risk occurs due to variations in returns which
A) is induced by leverage.
B) is due to the ups and downs of the economy.
C) is due to changes in government regulations.
D) is a result of changes in exchange rates.
Answer: A
Diff: 2

8) Financial risk is associated with changes in
A) the demand for a firm's products.
B) a firm's debt.
C) a firm's labor costs.
D) government regulations of a firm's activities.
Answer: B
Diff: 2

9) ________ risk involves variation in returns due to the ups and downs of the economy, the industry and the firm.
A) Structural
B) Fluctuational
C) Business
D) Financial
Answer: C
Diff: 1

10) Unlike an accountant, an economist measures costs on a(n) ________ basis.
A) explicit
B) replacement
C) historical
D) conservative
Answer: B
Diff: 1

11) ________ maximization is achieved when a company manages its business in such a way that its cash flows over time, discounted at the appropriate discount rate, will cause the value of the company's common stock to be at a maximum.
A) Profit
B) Stockholder wealth
C) Asset
D) None of the above
Answer: B
Diff: 1

12) The calculation of stockholder wealth involves
A) the time-value of money concept.
B) the cash flow stream.
C) business and financial risk.
D) All of the above
Answer: D
Diff: 1

13) Another name for stockholder wealth maximization is
A) profit maximization.
B) maximization of earnings per share.
C) maximization of the value of the common stock.
D) maximization of cash flows.
Answer: C
Diff: 1

14) Accounting costs
A) are historical costs.
B) are replacements costs.
C) usually include implicit costs.
D) usually include normal profits.
Answer: A
Diff: 1

15) A firm earns a normal profit when its total revenues just offset both the ________ cost and ________ cost.
A) accounting; opportunity
B) accounting; replacement
C) historical; replacement
D) explicit; accounting
Answer: A
Diff: 2

16) A firm's "normal profit" is best characterized by the
A) average of a firm's profits over the past five years.
B) amount of profit necessary to keep the price of a firm's stock from changing.
C) amount of profit a firm could earn in its next best alternative activity.
D) the average amount of profit earned in the firm's industry.
Answer: C
Diff: 3

17) MVA (Market Value Added)
A) will always be a positive number.
B) may be a negative number.
C) measures the market value of the firm.
D) None of the above
Answer: B
Diff: 2

18) Opportunistic behavior is best described as a firm
A) gathering as much information as possible before dealing with another entity.
B) attempting to make a profit from its dealings with another entity.
C) firm trying to take advantage of another entity in its dealings with it.
D) selecting another entity to deal with.
Answer: C
Diff: 2

19) Firms are organized to keep their costs as low as possible by
A) comparing external transactions costs with internal operating cost.
B) analyzing supply and demand conditions.
C) minimizing their use of borrowed funds.
D) utilizing the latest technology.
Answer: A
Diff: 2

Analytical Questions

1) a. If a stock is expected to pay an annual dividend of $20 forever, what is the approximate present value of the stock, given that the discount rate is 5%?
b. If a stock is expected to pay an annual dividend of $20 forever, what is the approximate present value of the stock, given that the discount rate is 8%?
c. If a stock is expected to pay an annual dividend of $20 this year, what is the approximate present value of the stock, given that the discount rate is 8% and dividends are expected to grow at a rate of 2% per year?
Answer:
a. P = D/k = 20/.05 = $400
b. P = 20/.08 = $250
c. P = D1/(k - g) = 20/(.08 - .02) = $333.33

2) If a stock is expected to pay a dividend of $40 for the current year, what is the approximate present value of this stock, given at discount rate of 5% and a dividend growth rate of 3%?
Answer: P = $40/(0.05 - 0.03) = $40/0.02 = $2,000

3) Describe the difference between the Economic Value Added (EVA) and the Market Value Added (MVA) approach to determining stockholder wealth.
Answer: EVA is the difference between a firm's return on total capital and its cost of capital, while MVA is the difference between the market value (equity plus debt) of a firm and the amount of capital investors have paid into the company.