

CHAPTER 1

AN OVERVIEW OF FINANCIAL MANAGEMENT

(Difficulty: E = Easy, M = Medium, and T = Tough)

Multiple Choice: Conceptual

Easy:

Firm organization

Answer: c Diff: E

1. Which of the following statements is true?
- a. One of the benefits of incorporating your business is that you become entitled to receive unlimited liability.
 - b. Sole proprietorships are subject to more regulations than corporations.
 - c. Sole proprietorships do not have to pay corporate tax.
 - d. All of the statements above are correct.
 - e. None of the statements above is correct.

Firm organization

Answer: c Diff: E

2. Which of the following statements is most correct?
- a. One of the advantages of the corporate form of organization is that there is no double taxation.
 - b. The partnership form of organization has easy transferability of ownership.
 - c. One of the disadvantages of the sole proprietorship form of organization is that there is unlimited liability.
 - d. Statements b and c are correct.
 - e. None of the statements above is correct.

Firm organization

Answer: a Diff: E

3. Which of the following statements is most correct?
- a. One advantage of forming a corporation is that you have limited liability.
 - b. Corporations face fewer regulations than sole proprietorships.
 - c. One disadvantage of being a sole proprietor is that you have to pay corporate taxes, even though you don't realize the benefits of being a corporation.
 - d. Statements b and c are correct.
 - e. None of the statements above is correct.

Firm organization**Answer: a Diff: E**

4. Until this year, Cheers Inc. was organized as a partnership. This year, the partners have decided to organize the business as a corporation. As a result of this change in organizational form, which of the following statements is most correct?
- a. Cheers' shareholders (the ex-partners) will now have limited liability.
 - b. Cheers will now be subject to fewer regulations.
 - c. Cheers will now pay less in taxes.
 - d. Cheers' investors will now find it more difficult to transfer ownership.
 - e. Cheers will now find it more difficult to raise additional capital.

Firm organization**Answer: c Diff: E N**

5. Which of the following statements is most correct?
- a. Corporations generally face fewer regulations than sole proprietorships do.
 - b. Corporate shareholders have unlimited liability.
 - c. It is usually easier to transfer ownership in a corporation than it is to transfer ownership in a sole proprietorship.
 - d. All of the above statements are correct.
 - e. None of the above statements is correct.

Corporate form**Answer: c Diff: E**

6. Which of the following could explain why a business might choose to organize as a corporation rather than as a sole proprietorship or a partnership?
- a. Corporations generally face fewer regulations.
 - b. Corporations generally face lower taxes.
 - c. Corporations generally find it easier to raise capital.
 - d. Corporations enjoy unlimited liability.
 - e. Statements c and d are correct.

Corporate form**Answer: a Diff: E**

7. Which of the following statements is most correct?
- a. One drawback of forming a corporation is that it subjects the firm to additional regulations.
 - b. One drawback of forming a corporation is that it subjects the firm to limited liability.
 - c. One drawback of forming a corporation is that it makes it more difficult for the firm to raise capital.
 - d. All of the statements above are correct.
 - e. Statements b and c are correct.

Goal of firm**Answer: d Diff: E**

8. The primary goal of a publicly-owned firm interested in serving its stockholders should be to
- a. Maximize expected total corporate profit.
 - b. Maximize expected EPS.
 - c. Minimize the chances of losses.
 - d. Maximize the stock price per share.
 - e. Maximize expected net income.

Agency**Answer: d Diff: E**

9. Which of the following statements is most correct?
- a. Compensating managers with stock can reduce the agency problem between stockholders and managers.
 - b. Restrictions are included in credit agreements to protect bondholders from the agency problem that exists between bondholders and stockholders.
 - c. The threat of a takeover can reduce the agency problem between bondholders and stockholders.
 - d. Statements a and b are correct.
 - e. All of the statements above are correct.

Agency**Answer: a Diff: E**

10. Which of the following work to reduce agency conflicts between stockholders and bondholders?
- a. Including restrictive covenants in the company's bond contract.
 - b. Providing managers with a large number of stock options.
 - c. The passage of laws that make it easier for companies to resist hostile takeovers.
 - d. Statements b and c are correct.
 - e. All of the statements above are correct.

Agency**Answer: b Diff: E**

11. Which of the following actions are likely to reduce agency conflicts between stockholders and managers?
- a. Paying managers a large fixed salary.
 - b. Increasing the threat of corporate takeover.
 - c. Placing restrictive covenants in debt agreements.
 - d. All of the statements above are correct.
 - e. Statements b and c are correct.

Agency**Answer: d Diff: E**

12. Which of the following actions are likely to reduce the agency problem between stockholders and managers?
- a. Congress passes a law that severely restricts hostile takeovers.
 - b. A manager receives a lower salary but receives additional shares of the company's stock.
 - c. The board of directors has become more vigilant in its oversight of the company's management.
 - d. Statements b and c are correct.
 - e. All of the statements above are correct.

Managerial incentives**Answer: e Diff: E**

13. Which of the following mechanisms is used to motivate managers to act in the interest of shareholders?
- a. Bond covenants.
 - b. The threat of a takeover.
 - c. Pressure from the board of directors.
 - d. Statements a and b are correct.
 - e. Statements b and c are correct.

Managerial incentives**Answer: e Diff: E N**

14. Which of the following is likely to encourage a firm's managers to make decisions that are in the best interest of shareholders?
- a. Executive compensation comes primarily in the form of stock options.
 - b. The state legislature recently passed a law that makes it more difficult to successfully complete a hostile takeover.
 - c. Institutional investors such as mutual funds and pension funds hold large amounts of the firm's stock.
 - d. Statements a and b are correct.
 - e. Statements a and c are correct.

Miscellaneous concepts**Answer: c Diff: E**

15. Which of the following statements is most correct?
- a. A good goal for a corporate manager is maximization of expected EPS.
 - b. Most business in the U.S. is conducted by corporations; corporations' popularity results primarily from their favorable tax treatment.
 - c. A good example of an agency relationship is the one between stockholders and managers.
 - d. Corporations and partnerships have an advantage over proprietorships because a sole proprietor is subject to unlimited liability, but investors in the other types of businesses are not.
 - e. Firms in highly competitive industries find it easier to exercise "social responsibility" than do firms in oligopolistic industries.

Miscellaneous concepts

Answer: e Diff: E

16. Which of the following statements is most correct?

- a. One advantage of organizing your business as a corporation is that your shareholders are not subject to limited liability.
- b. Restrictive covenants in debt agreements are an effective way to reduce agency conflicts between stockholders and managers.
- c. Managers generally welcome hostile takeovers since they often increase the company's stock price.
- d. Statements a and b are correct.
- e. None of the answers above is correct.

Miscellaneous concepts

Answer: c Diff: E

17. Which of the following statements is most correct?

- a. Bond covenants are a good way to resolve agency conflicts between stockholders and managers.
- b. Hostile takeovers tend to reduce a company's stock price.
- c. Corporations have limited liability.
- d. Statements a and b are correct.
- e. Statements a, b, and c are correct.

Miscellaneous concepts

Answer: a Diff: E

18. Which of the following statements is most correct?

- a. Hostile takeovers are most likely to occur when a firm's stock is undervalued, relative to its potential, because of poor management.
- b. One advantage to remaining a sole proprietor is that you have limited liability.
- c. In general, bondholders have a greater preference for riskier projects than do stockholders.
- d. Statements b and c are correct.
- e. All of the statements above are correct.

Miscellaneous concepts

Answer: b Diff: E

19. Which of the following statements is most correct?

- a. One disadvantage of forming a corporation is that your shareholders have limited liability.
- b. Relative to sole proprietorships, corporations generally face more regulations, but find it easier to raise capital.
- c. Bondholders generally want managers to select risky projects, but shareholders prefer that managers select safe projects.
- d. Statements a and b are correct.
- e. All of the statements above are correct.

Miscellaneous concepts**Answer: e Diff: E N**

20. Which of the following statements is most correct?

- a. Since they are guaranteed a certain set of cash flows, corporate bondholders generally want corporate managers to select high risk/high return projects.
- b. One advantage of forming a corporation is that you can deduct your corporate taxes, and thereby eliminate the double taxation that you would face as a sole proprietor.
- c. One drawback of forming a corporation is that you lose the limited liability that you would otherwise receive as a sole proprietor.
- d. All of the statements above are correct.
- e. None of the statements above is correct.

Medium:**Business ethics****Answer: e Diff: M**

21. Which of the following is an example of an area of business in which the use of "questionable" ethics is considered a necessity?

- a. Attracting and sustaining new customers.
- b. Hiring and keeping skilled employees.
- c. Keeping up with competition.
- d. Dealing with firms who use "questionable" ethics.
- e. None of the statements above is correct.

Social welfare**Answer: a Diff: M**

22. Which of the following statements is most correct?

- a. The ability of firms to engage in socially beneficial projects that involve voluntary costs is constrained by competition and the need of firms to attract capital at low cost.
- b. The actions that maximize a firm's stock price are inconsistent with maximizing social welfare.
- c. The concepts of social responsibility and ethical responsibility on the part of corporations are completely different and neither is relevant in maximizing stock price.
- d. In a competitive market, if a group of firms do not spend resources making social welfare improvements, but another group does, in general, this will not affect the second group's ability to attract capital.
- e. If government did not mandate socially responsible corporate actions, such as those relating to product safety and fair hiring practices, most firms in competitive markets would still pursue such policies voluntarily.

Corporate charter and bylaws**Answer: b Diff: M**

23. Which of the following statements is most correct?

- a. The corporate bylaws are the set of rules drawn up by the state to enable managers to run the firm in accordance with state laws.
- b. Procedures for electing corporate directors are contained in bylaws, while the declaration of the activities that the firm will pursue and the number of directors are included in the corporate charter.
- c. Procedures that govern changes in the bylaws of the corporation are contained in the corporate charter.
- d. Although most companies design a charter, only the bylaws are legally required to be filed with the secretary of state in order for a corporation to be in official existence.
- e. None of the statements above is correct.

Corporate form**Answer: d Diff: M**

24. Which of the following statements is most correct?

- a. A hostile takeover is the main method of transferring ownership interest in a corporation.
- b. The corporation is a legal entity created by the state and is a direct extension of the legal status of its owners and managers, that is, the owners and managers are the corporation.
- c. Unlimited liability and limited life are two key advantages of the corporate form over other forms of business organization.
- d. In part due to limited liability and ease of ownership transfer, corporations have less trouble raising money in financial markets than other organizational forms.
- e. Although stockholders of the corporation are insulated by limited legal liability, the legal status of the corporation does not protect the firm's managers in the same way.

Partnership form**Answer: d Diff: M**

25. Which of the following statements is most correct?

- a. In a partnership, liability for other partners' misdeeds is limited to the amount a particular partner has invested in the business.
- b. Partnerships must be formed according to specific rules that include the filing of a formal written agreement with state authorities where the partnership does business.
- c. A fast-growth company would be more likely to set up a partnership for its business organization than would a slow-growth company.
- d. Partnerships have difficulty attracting capital in part because of the other disadvantages of the partnership form of business, including impermanence of the organization.
- e. A major disadvantage of a partnership as a form of business organization is the high cost and practical difficulty of its formation.

Firm organization**Answer: c Diff: M**

26. Which of the following statements is most correct?

- a. Due to limited liability, unlimited lives, and ease of ownership transfer, the vast majority of U.S. businesses (in terms of number of businesses) are organized as corporations.
- b. Most businesses (by number and total dollar sales) are organized as proprietorships or partnerships because it is easier to set up and operate in one of these forms rather than as a corporation. However, if the business gets very large, it becomes advantageous to convert to a corporation, primarily because corporations have important tax advantages over proprietorships and partnerships.
- c. Due to legal considerations related to ownership transfers and limited liability, most business (measured by dollar sales) is conducted by corporations.
- d. Statements a, b, and c are correct.
- e. None of the statements above is correct.

Firm organization**Answer: e Diff: M**

27. Which of the following statements is most correct?

- a. Corporations are taxed more favorably than sole proprietorships.
- b. Corporations have unlimited liability.
- c. Because of their size, large corporations face fewer regulations than smaller corporations and sole proprietorships.
- d. Reducing the threat of corporate takeover increases the likelihood that managers will act in shareholders' interest.
- e. Bond covenants are designed to reduce potential conflicts between stockholders and bondholders.

Financial policy and cash flows**Answer: c Diff: M**

28. Which of the following statements is most correct?

- a. The optimal dividend policy is the one that satisfies the shareholders because they supply the firm's capital.
- b. The use of debt financing has no effect on cash flow or stock price.
- c. The riskiness of projected cash flows depends upon how the firm is financed.
- d. Stock price is dependent on the projected cash flows and the use of debt, but not on the timing of the cash flow stream.
- e. Dividend policy is one aspect of the firm's financial policy that is determined directly by the shareholders.

Corporate goals and control**Answer: e Diff: M**

29. Which of the following statements is most correct?

- a. The proper goal of the financial manager should be to maximize the firm's expected cash flow, because this will add the most wealth to each of the individual shareholders (owners) of the firm.
- b. One way to state the decision framework most useful for carrying out the firm's objective is as follows: "The financial manager should seek that combination of assets, liabilities, and capital that will generate the largest expected projected after-tax income over the relevant time horizon."
- c. The riskiness inherent in a firm's earnings per share (EPS) depends on the characteristics of the projects the firm selects, which means it depends upon the firm's assets, but EPS does not depend on the manner in which those assets are financed.
- d. Since large, publicly-owned firms are controlled by their management teams, and typically, ownership is widely dispersed, managers have great freedom in managing the firm. Managers may operate in stockholders' best interests, but they may also operate in their own personal best interests. As long as managers stay within the law, there simply aren't any effective controls over managerial decisions in such situations.
- e. Agency problems exist between stockholders and managers, and between stockholders and creditors.

Agency**Answer: c Diff: M**

30. Which of the following statements is most correct?

- a. Agency conflicts between stockholders and managers are not really a problem when outsiders (that is, non-managers) own shares in a corporation.
- b. Managers may operate in stockholders' best interests, or managers may operate in their own personal best interests. As long as managers stay within the law, there are no effective controls that stockholders can implement to control managerial decision making.
- c. The agency conflicts between bondholders and stockholders can be reduced with the use of restrictive bond covenants.
- d. An agency relationship exists when one or more persons hire another person to perform some service but withhold decision-making authority from that person.
- e. None of the statements above is correct.

Agency**Answer: d Diff: M**

31. Which of the following statements is most correct?

- a. One of the ways in which firms can mitigate or reduce agency problems between bondholders and stockholders is by increasing the amount of debt in the capital structure.
- b. The threat of takeover is one way in which the agency problem between stockholders and managers can be alleviated.
- c. Managerial compensation can be structured to reduce agency problems between stockholders and managers.
- d. Statements b and c are correct.
- e. All of the statements above are correct.

Miscellaneous concepts**Answer: e Diff: M**

32. Which of the following statements is most correct?

- a. Corporations face fewer regulations and taxes relative to sole proprietorships and partnerships.
- b. Managers who face the threat of hostile takeovers are less likely to pursue policies that maximize shareholder value compared to managers who do not face the threat of hostile takeovers.
- c. Bond covenants are an effective way to resolve agency conflicts between shareholders and managers.
- d. Because of their size, it is easier for sole proprietors and partnerships to raise outside capital than it is for a corporation.
- e. One advantage to forming a corporation is that the owners of the corporations have limited liability.

<p style="text-align: center;">CHAPTER 1 ANSWERS AND SOLUTIONS</p>
--

1. Firm organization

Answer: c Diff: E

Statement c is correct. Sole proprietorships pay personal income tax not corporate tax. The other statements are false. Corporations are subject to limited liability, but are subject to more regulations than the other forms of business organization.

2. Firm organization

Answer: c Diff: E

Statement c is correct. The other statements are false. The corporate form is subject to double taxation and partnerships are not easily transferred.

3. Firm organization

Answer: a Diff: E

Statement a is correct; the others are false. Corporations have limited liability; however, they face more regulations than the other forms of organization. Sole proprietorships do not pay corporate taxes.

4. Firm organization

Answer: a Diff: E

Except for statement a, all the other statements are exactly opposite for corporations.

5. Firm organization

Answer: c Diff: E N

The correct answer is statement c. Corporations face more regulations than sole proprietorships do, so statement a is incorrect. Corporate shareholders have limited liability. Shareholders can't be sued for the mistakes of the company, so statement b is incorrect.

6. Corporate form

Answer: c Diff: E

The advantages of incorporation are unlimited life, easy transferability of ownership interest, limited liability, and ease of raising money in the capital markets. Regulations and double taxation are disadvantages of corporations.

7. Corporate form

Answer: a Diff: E

Statement a is correct. The other statements are false. Limited liability is an advantage of the corporate form, and it is generally easier for corporations to raise capital as compared to partnerships or proprietorships.

8. Goal of firm

Answer: d Diff: E

9. **Agency** **Answer: d Diff: E**
- Both statements a and b are correct; therefore, statement d is the correct choice. The threat of a takeover alleviates the agency problem between managers and stockholders, not between bondholders and stockholders.
10. **Agency** **Answer: a Diff: E**
- Statement a is correct; the other statements are false. Restrictive covenants resolve differences between bondholders and stockholders.
11. **Agency** **Answer: b Diff: E**
- Statement b is true. Corporate takeovers are most likely to occur when a firm is underperforming. Managers who fear losing their jobs will try to maximize shareholder wealth. The other statements are false. Statement a will exacerbate the agency conflict, while statement c reduces the agency conflict between stockholders and bondholders.
12. **Agency** **Answer: d Diff: E**
- Statement a will serve to increase the agency problems by preventing takeovers. Both statements b and c will reduce agency problems.
13. **Managerial incentives** **Answer: e Diff: E**
- Statements b and c are true; therefore, statement e is the correct choice. Statement a is false, bond covenants force managers to act in the interest of bondholders.
14. **Managerial incentives** **Answer: e Diff: E N**
- The correct answer is statement e. If compensation comes primarily from stock options, then the managers will be shareholders and will share the same concerns as other shareholders. Therefore, they will make decisions that are in the best interests of shareholders, so statement a is correct. If it is more difficult for hostile takeovers to take place, managers will have less fear of being thrown out of their jobs. Therefore, they will be less concerned with the interests of shareholders. Statement b is incorrect. If institutional investors hold a large amount of the firm's stock, they will like to have more say in the management of the company. (Some may even make sure that they get board seats.) Since they are shareholders and have more influence, they will ensure that managers act in the best interests of shareholders, so statement c is true.
15. **Miscellaneous concepts** **Answer: c Diff: E**

16. Miscellaneous concepts

Answer: e Diff: E

Statements a, b, c, and d are all false; therefore, statement e is the correct choice. Shareholders of corporations are subject to limited liability. Restrictive bond covenants reduce agency conflicts between shareholders (through management) and bondholders. Managers' jobs are threatened by hostile takeovers.

17. Miscellaneous concepts

Answer: c Diff: E

Statement c is correct. Statement a is false; bond covenants reduce conflict between stockholders (through managers) and bondholders. Statement b is false; a takeover usually increases a firm's stock price. Statement c is true; therefore, the remaining statements are false.

18. Miscellaneous concepts

Answer: a Diff: E

If a firm's stock is undervalued relative to its potential, then someone can profit by taking it over and doing a better job running it. Therefore, statement a is true. A sole proprietor does not have limited liability; only a corporation has limited liability. Therefore, statement b is false. Bondholders get their payment as long as the firm is not in default. Therefore, they would like the firm to stay less risky so they get their interest payments. If they owned a bond that promised to pay them 5 percent, and then the firm became risky, the default risk premium would be higher. However, the bondholders would still be getting the 5 percent return that compensated them for the old level of default risk. Therefore, statement c is false. Since statements b and c are false, Statements d and e must also be false.

19. Miscellaneous concepts

Answer: b Diff: E

Limited liability is an advantage of forming a corporation, so statement a is false. Statement b is true. Statement c is the opposite of what is true. Bondholders get paid before shareholders do, so bondholders want the company to take as little risk as possible, and receive their interest payments. If there's anything left it goes to shareholders. On the other hand, shareholders would prefer the company to take a little extra risk to get a higher return to increase their chances of getting something after the bondholders. Therefore, statement c is false. Consequently, statements d and e are false.

20. Miscellaneous concepts

Answer: e Diff: E N

Statement a is incorrect; since bondholders' cash flows are contractual, they prefer managers to select low-risk projects to ensure that interest payments are made. Statement b is incorrect; corporations are not allowed to deduct their corporate taxes, in fact they do suffer from double taxation. Statement c is incorrect; by forming a corporation, you gain the comfort of unlimited liability. Therefore, statement e is the correct choice.

- | | | | |
|-----|---------------------------------|-----------|---------|
| 21. | Business ethics | Answer: e | Diff: M |
| 22. | Social welfare | Answer: a | Diff: M |
| 23. | Corporate charter and bylaws | Answer: b | Diff: M |
| 24. | Corporate form | Answer: d | Diff: M |
| 25. | Partnership form | Answer: d | Diff: M |
| 26. | Firm organization | Answer: c | Diff: M |
| 27. | Firm organization | Answer: e | Diff: M |
| 28. | Financial policy and cash flows | Answer: c | Diff: M |
| 29. | Corporate goals and control | Answer: e | Diff: M |
| 30. | Agency | Answer: c | Diff: M |

Statement c is true. Statement a is false because agency conflicts can and do occur when outsiders own shares in a corporation. Statement b is false. Even if managers stay within the law, the threat of firing and/or the threat of takeover may be used to keep managers' interests aligned with those of the shareholders. Statement d is false because the conflict exists when the decision-making authority is delegated to that person.

- | | | | |
|-----|--------|-----------|---------|
| 31. | Agency | Answer: d | Diff: M |
|-----|--------|-----------|---------|

Statement d is most correct. Statement a is incorrect, because increasing the amount of debt can increase agency problems.

- | | | | |
|-----|------------------------|-----------|---------|
| 32. | Miscellaneous concepts | Answer: e | Diff: M |
|-----|------------------------|-----------|---------|

Statement e is correct. The other statements are false. Corporations face more regulations and double taxation as compared to proprietorships and partnerships. The threat of a takeover will encourage managers to maximize shareholders' wealth. Failing to do so will result in the takeover--and in the managers losing their jobs. Bond covenants are a way to resolve conflicts between management and bondholders. In general, there is more uncertainty about the quality of small firms, compared to large firms. This makes it harder for small companies to raise outside capital.