Financial Management

FINA 2010, Semester II, 2020-2021

Assignment 1 (Solution)

11 January, 2021

1. Questions from the text book (Page 17, Concepts Review and Critical Thinking Questions)

Q4: In response to Sarbanes-Oxley, small firms have elected to go dark because of the costs of compliance. The costs to comply with Sarbox can be several million dollars, which can be a large percentage of a small firm's profits. A major cost of going dark is less access to capital. Since the firm is no longer publicly traded, it can no longer raise money in the public market. Although the company will still have access to bank loans and the private equity market, the costs associated with raising funds in these markets are usually higher than the costs of raising funds in the public market.

Q9: In auction markets like the NYSE, brokers and agents meet at a physical location (the exchange) to match buyers and sellers of assets. Dealer markets like NASDAQ consist of dealers operating at dispersed locales who buy and sell assets themselves, communicating with other dealers either electronically or literally over-the-counter.

Q12: An argument can be made either way. At the one extreme, we could argue that in a market economy, all of these things are priced. There is thus an optimal level of, for example, ethical and/or illegal behavior, and the framework of stock valuation explicitly includes these. At the other extreme, we could argue that these are noneconomic phenomena and are best handled through the political process. A classic (and highly relevant) thought question that illustrates this debate goes something like this: "A firm has estimated that the cost of improving the safety of one of its products is $30 million. However, the firm believes that improving the safety of the product will only save $20 million in product liability claims. What should the firm do?"

Q15: We would expect agency problems to be less severe in countries with a relatively small percentage of individual ownership. Fewer individual owners should reduce the number of diverse opinions concerning corporate goals. The high percentage of institutional ownership might lead to a higher degree of agreement between owners and managers on decisions concerning risky projects. In addition, institutions may be better able to implement effective monitoring mechanisms on managers than can individual owners, based on the institutions' deeper resources and experiences with their own management. The increase in institutional ownership of stock in the United States and the growing activism of these large shareholder groups may lead to a reduction in agency problems for U.S. corporations and a more efficient market for corporate control.

2. Which one of the following is defined as a firm's short-term assets and its short-term liabilities?
A. working capital
B. debt
C. investment capital
D. net capital
E. capital structure

3. A business owned by a solitary individual who has unlimited liability for its debt is called a:
A. corporation.
B. sole proprietorship.
C. general partnership.
D. limited partnership.
E. limited liability company.

4. A business formed by two or more individuals who each have unlimited liability for all of the firm's business debts is called a:
A. corporation.
B. sole proprietorship.
C. general partnership.
D. limited partnership.
E. limited liability company.

5. A business partner whose potential financial loss in the partnership will not exceed his or her investment in that partnership is called a:
A. generally partner.
B. sole proprietor.
C. limited partner.
D. corporate shareholder.
E. zero partner.

6. Which one of the following terms is defined as a conflict of interest between the corporate shareholders and the corporate managers?
A. articles of incorporation
B. corporate breakdown
C. agency problem
D. bylaws
E. legal liability

7. A stakeholder is:
A. a person who owns shares of stock.
B. any person who has voting rights based on stock ownership of a corporation.
C. a person who initially founded a firm and currently has management control over that firm.
D. a creditor to whom a firm currently owes money.
E. any person or entity other than a stockholder or creditor who potentially has a claim on the cash flows of a firm.

8. Which of the following questions are addressed by financial managers?
I. How should a product be marketed?
II. Should customers be given 30 or 45 days to pay for their credit purchases?
III. Should the firm borrow more money?
IV. Should the firm acquire new equipment?
A. I and IV only
B. II and III only
C. I, II, and III only
D. II, III, and IV only
E. I, II, III, and IV

9. Which one of the following correctly defines the upward chain of command in a typical corporate organizational structure?
A. The vice president of finance reports to the chairman of the board.
B. The chief executive officer reports to president.
C. The controller reports to the president.
D. The treasurer reports to the vice president of finance.
E. The chief operations officer reports to the vice president of production.

10. Which one of the following is a capital budgeting decision?
A. determining how many shares of stock to issue
B. deciding whether or not to purchase a new machine for the production line
C. deciding how to refinance a debt issue that is maturing
D. determining how much inventory to keep on hand
E. determining how much money should be kept in the checking account

11. Which one of the following is a capital structure decision?
A. determining which one of two projects to accept
B. determining how to allocate investment funds to multiple projects
C. determining the amount of funds needed to finance customer purchases of a new product
D. determining how much debt should be assumed to fund a project
E. determining how much inventory will be needed to support a project

12. Which one of the following is a working capital management decision?
A. determining the amount of equipment needed to complete a job
B. determining whether to pay cash for a purchase or use the credit offered by the supplier
C. determining the amount of long-term debt required to complete a project
D. determining the number of shares of stock to issue to fund an acquisition
E. determining whether or not a project should be accepted

13. Which one of the following best describes the primary advantage of being a limited partner instead of a general partner?
A. tax-free income
B. active participation in the firm's activities
C. no potential financial loss
D. greater control over the business affairs of the partnership
E. maximum loss limited to the capital invested

14. Which of the following are advantages of the corporate form of business ownership?
I. limited liability for firm debt
II. double taxation
III. ability to raise capital
IV. unlimited firm life
A. I and II only
B. III and IV only
C. I, III, and IV only
D. II, III, and IV only
E. I, II, III, and IV

15. The articles of incorporation:
I. describe the purpose of the firm.
II. are amended periodically.
III. set forth the number of shares of stock that can be issued.
IV. detail the method that will be used to elect corporate directors.
A. I and III only
B. I and IV only
C. II and III only
D. II and IV only
E. I, III, and IV only

16. Corporate bylaws:
A. must be amended should a firm decide to increase the number of shares authorized.
B. cannot be amended once adopted.
C. define the name by which the firm will operate.
D. describe the intended life and purpose of the organization.
E. determine how a corporation regulates itself.

17. Which one of the following business types is best suited to raising large amounts of capital?
A. sole proprietorship
B. limited liability company
C. corporation
D. general partnership
E. limited partnership

18. Which one of the following best illustrates that the management of a firm is adhering to the goal of financial management?
A. increase in the amount of the quarterly dividend
B. decrease in the per unit production costs
C. increase in the number of shares outstanding
D. decrease in the net working capital
E. increase in the market value per share

19. The Sarbanes-Oxley Act of 2002 is a U.S. governmental response to:
A. decreasing corporate profits.
B. the terrorists attacks on 9/11/2001.
C. a weakening economy.
D. deregulation of the stock exchanges.
E. management greed and abuses.

20. Which one of the following is not an intended result of the Sarbanes-Oxley Act?
A. more detailed and accurate financial reporting
B. increased management awareness of internal controls
C. corporations delisting from major exchanges
D. increased responsibility for corporate officers
E. identification of internal control weaknesses

21. Which one of the following is an agency cost?
A. accepting an investment opportunity that will add value to the firm
B. increasing the quarterly dividend
C. investing in a new project that creates firm value
D. hiring outside accountants to audit the company's financial statements
E. closing a division of the firm that is operating at a loss

22. Which one of the following is a primary market transaction?
A. sale of currently outstanding stock by a dealer to an individual investor
B. sale of a new share of stock to an individual investor
C. stock ownership transfer from one shareholder to another shareholder
D. gift of stock from one shareholder to another shareholder
E. gift of stock by a shareholder to a family member

23. Shareholder A sold 500 shares of ABC stock on the Hong Kong Stock Exchange. This transaction:
A. took place in the primary market.
B. occurred in a dealer market.
C. was facilitated in the secondary market.
D. involved a proxy.
E. was a private placement.

24. Shareholder A sold shares of Pinewood Cabinets stock to Shareholder B. The stock is listed on the Tokyo Stock Exchange. This trade occurred in which one of the following?
A. primary, dealer market
B. secondary, dealer market
C. primary, auction market
D. secondary, auction market
E. secondary, OTC market

25. Why are so many businesses structured as sole proprietorships when the corporate form of business offers more advantages?

A significant advantage of the sole proprietorship is that it is inexpensive and easy to form. If the sole proprietor has limited capital to start with, it may not be desirable to spend part of that capital forming a corporation. Also, limited liability for business debts may not be a significant advantage if the proprietor has most of his or her personal assets tied up in the business already. Finally, for a typical small firm, having an unlimited life for the business has no real advantage since the heart and soul of the business is the person who founded it, thereby effectively limiting the life of the business to that of its founder.

26. Give some examples of ways in which manager's goals can differ from those of shareholders.

The primary goal of a financial manager should be to maximize the current value of the outstanding stock. This goal focuses on enhancing the returns to stockholders who are the owners of the firm. However, managers frequently are more concerned with their personal benefits from employment, the prestige of their position, and the perks to which they feel entitled. There are numerous examples, some of which are excessive compensation packages, large corporate offices, excessive staffing, and first-class travel and conference locations, to name a few.

27. How might agency problems arise in partnerships?

Agency conflicts typically arise when there is a separation between the ownership and the management of a business. In a general partnership, especially if the partnership is small, there is less of a chance of an agency conflict if all the partners are involved with the business on a regular basis. However, in a limited partnership, the opportunity exists for an agency problem to arise between the general and the limited partners.