Week 1 quiz

LATEST SUBMISSION GRADE

100%

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1. In an Initial Public Offering:

1 / 1 point

- ○ A private company turns into a sole trader
- ○ A partnership turns into a private company
- ○ A sole trader turns into a partnership
- ◉ A private company turns into a public company

Correct

Correct.

An initial public offering is where a private company turns into a public company. An IPO is also called a float or listing since the public company's stock is now listed on the public stock exchange and its price will 'float' up and down with the market, like a boat being tossed around by the waves.

2. When does the 'principal-agent problem' occur? Is it when:

1 / 1 point

I. The principal has conflicting incentives (moral hazard).

II. The agent has conflicting incentives (moral hazard).

III. The principal has incomplete information about the agent (asymmetric information).

IV. The agent has incomplete information about the principal (asymmetric information).

- ○ I and II
- ○ II And IV
- ◉ II and III
- ○ III and IV

Correct

Correct

The principal-agent problem occurs due to moral hazard and asymetric information. It occurs when:

- The agent has conflicting incentives, such as when a worker wants to get paid more while being lazy and not working hard; and
- The principal has incomplete information, such as when a boss cannot easily supervise workers since it's too expensive or impractical to follow them around or install cameras.

3. What creates interest tax shields for a company?

1 / 1 point

- ○ Debt assets
- ◉ Debt funding
- ○ Equity funding
- ○ Equity assets

Correct

Correct.

Debt funding (liabilities) create interest expense for companies which is tax deductible. Equity funding creates expectations for dividends but dividends are not tax deductible, unlike interest expense.

Dividends paid at the end of the year don't affect the profit in that year. Whereas interest expense incurred at the end of the year reduces the pre- and after-tax profit in that year.

Higher debt funding leads to higher interest expense, lower pre-tax profit, and therefore lower tax expense which is an advantage compared to equity funding.

Higher equity funding leads to higher dividends, which doesn't affect pre-tax profit, and therefore has no effect on tax expense.

4. Which business structure or structures have the advantage of limited liability for equity investors?

1 / 1 point

- ○ Sole traders
- ○ Partnerships

- (selected) Corporations
- All of the above

Correct

Correct.

Corporations have the advantage of limited liability, so equity investors will never lose more than the amount that they have invested in the company. On the other hand, sole traders and partners can be sued and forced to sell their personal assets such as their house and property if the business's assets are insufficient to cover its liabilities.

Therefore sole traders', partners' and corporate shareholders' business equity are at risk. But sole traders' and partners' personal assets are also at risk whereas corporate shareholders' personal assets are safe due to limited liability.

5. Who is most in danger of being **personally** bankrupt? Assume that all of their businesses' assets are highly liquid and can therefore be sold immediately.

1 / 1 point

- Billy has $10,000 cash, owes $6,000 credit card debt due immediately and 100% owns a corporate business with assets worth $3,000 and liabilities of $10,000.
- Carla has $6,000 cash, owes $10,000 credit card debt due immediately and 100% owns a corporate business with assets worth $10,000 and liabilities of $3,000.
- Alice has $6,000 cash, owes $10,000 credit card debt due immediately and 100% owns a sole tradership business with assets worth $10,000 and liabilities of $3,000.
- (selected) Darren has $10,000 cash, owes $6,000 credit card debt due immediately and 100% owns a sole tradership business with assets worth $3,000 and liabilities of $10,000.

Correct

Correct.

Darren has negative equity in his business. His business equity is -$7,000 since the business's liabilities of $10,000 are greater than its assets of $3,000. Since the business is a sole tradership rather than a company, Darren is personally liable for the business's debts.

Darren's non-business personal assets of $10,000 less personal liabilities of $6,000 net to $4,000. Therefore Darren's total personal wealth including the business is -$3,000 (=4,000-7,000), so he is most in danger of going bankrupt when the business's liabilities have to be repaid.

Notice that Billy's business also has negative equity of -7,000 (=3,000-10,000) and therefore his company is in danger of going bankrupt when its debts are due. However, since the business is a company, Billy will not be personally liable for those debts. He won't have to pay them, unlike Darren whose business is not a company.

6. A man is thinking about taking a day off from his casual painting job to relax.

1 / 1 point

He just woke up early in the morning and he's about to call his boss to say that he won't be coming in to work.

But he's thinking about the hours that he could work today (in the future) which are:

- ○ Sunk cost
- ◉ Opportunity cost
- ○ A depreciation expense
- ○ A negative side effect

Correct

correct.

The hours that he could work in the future are an opportunity cost of his decision to take a day off and relax, assuming that working is the 'next best alternative' to relaxing. The hours that he could spend working are not a sunk cost yet because they are in the future, they are an incremental cost of staying home to relax.

7. A man has taken a day off from his casual painting job to relax.

1 / 1 point

It's the end of the day and he's thinking about the hours that he could have spent working (in the past) which are now:

- ◉ A sunk cost
- ○ An opportunity cost
- ○ A negative side effect
- ○ A capital expense

Correct

Correct.

The hours that he took off from work are now a sunk cost because they are in the past and there is nothing that he can do to get them back, he should forget about them. As the saying goes, "don't cry over spilt milk".

8. Your supplier's credit terms are "**1/10 net 30**". Which of the following statements about these credit terms is **NOT** correct?

1 / 1 point

- ( ) Pay straight away then you only have to pay $99
- (●) Pay on the 0th day then you'll be asked to pay in full $100
- ( ) Pay on the 11th day the you'll be asked to pay the full $100
- ( ) Pay on the 30th day then you'll be asked to pay the full $100

✓ **Correct**

Correct.

9. Which of the following decisions relates to the current assets and current liabilities of the firm?

1 / 1 point

- ( ) Investment decision
- ( ) Financing decision
- (●) Working capital decision
- ( ) Payout policy decision

✓ **Correct**

Correct.

Working capital (also called net working capital) equals current assets less current liabilities.

NWC=CA−CL

Current assets and liabilities lasts for less than one year, such as cash (CA) or inventory (CA) or accounts payable (CL). Non-current assets and liabilities last for more than one year such as PPE (NCA) or bond liabilities that will mature in 3 years (NCL).

10. In his survey paper from 1956, John Lintner stated: "A prudent foresighted management will

1 / 1 point

always do its best to plan ahead in all aspects of financial policy to avoid getting into such uncomfortable situations where dividends have to be cut substantially below those which the company's previous practice would lead stockholders to expect on the basis of current earnings."

This is a statement about which business decision?

- (selected) Payout policy decision
- Investment decision
- Working capital decision
- Financing decision

Correct

Correct.

John Lintner's comment is about dividends which is payout policy. Payout policy is about paying out equity holders in the form of dividends or buybacks (also called repurchases). Lintner found that managers will rarely decrease dividends unless they are forced to due to a poor earnings outlook. This is because shareholders interpret a cut in the dividend as a signal from management that long term earnings and cash flow will be lower, which is bad news. If this bad news is a surprise then the stock price is likely to fall. Hence managers try to avoid ever having to cut dividends.