

Chapter 1 Self-Study Questions

True/False

Indicate whether the sentence or statement is true or false.

- _____ 1. The financial manager must execute his or her duties independent of the other activities of the firm in order to properly maximize the value of the firm.
- _____ 2. Two key limitations of the proprietorship form of business involve potential difficulty in raising needed capital and the presence of unlimited personal liability for business debts.
- _____ 3. A hostile takeover involves an attempt by one group of stockholders to solicit votes from other stockholders in order to put a new management team into place and is usually motivated by low stock price.
- _____ 4. The proper goal of the financial manager should be to maximize the firm's expected profit, because this will add the most wealth to each of the individual shareholders (owners) of the firm.
- _____ 5. One way to state the decision framework most useful for carrying out the firm's objective is that the financial managers should seek that combination of assets, liabilities, and capital which will generate the largest expected projected income over the relevant time horizon.
- _____ 6. *Performance shares* are dollar bonuses awarded to managers on the basis of corporate performance.
- _____ 7. If a firm's managers want to maximize stock price it is in their best interests to operate efficient, low-cost plants, develop new and safe products that consumers want, and maintain good relationships with customers, suppliers, creditors, and the communities in which they operate.
- _____ 8. In a competitive marketplace "good ethics" is a wonderful idea but an impractical standard. There are simply too few benefits to be gained from maintaining high business ethics.
- _____ 9. Exchange rate risk is the risk that the cash flows from a foreign project will be worth less than those same cash flows denominated in the parent company's home currency.
- _____ 10. Restricted stock grants are a type of incentive plan in which the managers are awarded shares of stock on the basis of the firm's performance over given intervals with respect to earnings per share or other measures.
- _____ 11. The disadvantages associated with a proprietorship are similar to those under a partnership. One exception to this is due to the formal nature of the partnership agreement and the commitment of the partners' personal assets. As a result, partnerships do not have difficulty raising large amounts of capital.
- _____ 12. The term multinational corporation is used to describe a firm that operates in two more countries.
- _____ 13. Since 1985, for the most part, the government has discouraged mergers and acquisitions, which resulted in fewer mergers at historically low values taking place.
- _____ 14. A proprietorship is an unincorporated business owned by one individual and the owner benefits from the limited liability for business which limits his losses to what he has invested in the company.
- _____ 15. The corporate charter is a document filed with the secretary of the state in which the firm is incorporated that provides information about the company, including its name, address, directors, and amount of capital stock.

Multiple Choice

Identify the letter of the choice that best completes the statement or answers the question.

- _____ 16. The primary goal of a publicly-owned firm interested in serving its stockholders should be to
- Minimize the debt used by a firm.
 - Maximize expected EPS.
 - Minimize the chances of losses.
 - Maximize the stock price per share.
 - Maximize expected net income.
- _____ 17. Which of the following mechanisms is not used by shareholders to get managers to act in shareholder's best interests?
- Threat of firing
 - Managerial compensation.
 - Performance shares.
 - Threat of takeover.
 - Answers b and c above.
- _____ 18. Which of the following is a reason why companies move into international operations?
- To take advantage of lower production costs in regions of inexpensive labor.
 - To develop new markets for their finished products.
 - To better serve their primary customers.
 - Because important raw materials are located abroad.
 - All of the above.
- _____ 19. Which of the following should be the *primary* goal pursued by the financial manager of a firm?
- Maximize net income (profits).
 - Maximize the firm's net worth, or book value.
 - Maximize dividends paid to common stockholders.
 - Minimize variable operating expenses.
 - Maximize the market value of the firm's stock.
- _____ 20. Everything else equal, including firm size, dollar sales, type of product sold, and so forth, the primary difference between the proprietorship and partnership business forms is that
- a partnership has more owners than a proprietorship.
 - the combined personal liability associated with a partnership is significantly less than the combined personal liability associated with a proprietorship.
 - a partnership generally is easier to form than a proprietorship.
 - the annual growth rate of a proprietorship is limited by law, whereas the growth rate of a partnership is always potentially unlimited.
 - there are many more businesses that are formed as partnerships than proprietorships.
- _____ 21. The *primary* goal of a financial manager should be to _____.
- minimize operating costs
 - minimize interest payments
 - minimize tax payments
 - maximize operating income each year
 - maximize the value of the firm's stock

- _____ 22. Which of the following statements is correct?
- Given the multi-owner nature of most large corporations, agency costs associated with perquisite consumption are not really a problem.
 - Managers may operate in the stockholders' best interests, but they may also operate in their own personal best interests. As long as managers stay within the law, there simply are not any effective controls that stockholders can implement to control managerial decision making.
 - Shareholder agency costs include the opportunity costs associated with constraining managerial freedom but do not include managerial salaries.
 - An agency relationship exists when one or more persons hire another person to perform some service but *withhold decision-making authority from that person*.
 - All of the above statements are false.
- _____ 23. Which of the following is an example of an area of business where use of "questionable" ethics is considered a necessity?
- Attracting and sustaining new customers.
 - Hiring and keeping skilled employees.
 - Keeping up with competition.
 - Dealing with firms who use "questionable" ethics.
 - None of the above.
- _____ 24. Which of the following actions is consistent with social responsibility but is necessarily inconsistent with stockholder wealth maximization?
- Investing in a smokestack "scrubber" to reduce the firm's air pollution as mandated by law.
 - Voluntarily installing expensive machinery to treat effluent discharge which currently is being dumped into a river where it is ruining the drinking water of the community where the plant is located.
 - Investing in a smokestack filter to reduce sulphur-dioxide emissions in order to reduce the current tax being levied on the firm by the state for its pollution.
 - Making a large corporate donation to the local community in order to fund a recreation complex that will be used by the community and the firm's employees.
 - Each of the above actions is consistent with social responsibility and none are necessarily consistent with stockholder wealth maximization.
- _____ 25. Which of the following statements is correct?
- 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.
 - 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*.
 - Procedures which govern changes in the *bylaws* of the corporation are contained in the *corporate charter*.
 - 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.

- _____ 26. Which of the following statements is correct?
- A hostile takeover is a primary method of transferring ownership interest in a corporation.
 - 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.
 - Unlimited liability and limited life are two key advantages of the corporate form over other forms of business organization.
 - In part due to limited liability and ease of ownership transfer, corporations have less trouble raising money in financial markets than other organizational forms.
 - 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.
- _____ 27. Which of the following statements is correct?
- In a partnership, liability for other partners' misdeeds includes but is limited to the amount a particular partner has invested in the business.
 - Partnerships must be formed according to specific rules which include the filing of a formal written agreement with state authorities where the partnership does business.
 - A fast growth company would be more likely to set up a partnership for its business organization than would a slow-growth company.
 - Partnerships have difficulty attracting capital in part because of the other disadvantages of the partnership form of business, including impermanence of the organization.
 - A major disadvantage of a partnership as a form of business organization is the high cost and practical difficulty of its formation.
- _____ 28. Which of the following statements is correct?
- A major disadvantage of a regular partnership or a corporation as a form of business is the fact that they do not offer their owners limited liability, whereas proprietorships do.
 - An advantage of the corporate form for many businesses is the fact the corporate tax rate always exceeds the personal tax rate, which is the rate at which proprietorships and partnerships are taxed.
 - There are more partnerships and sole proprietorships than corporations in the U.S., but corporations produce more goods and services than do other forms of business.
 - Because corporations enjoy the benefits of limited liability, easy transferability of ownership interest, unlimited life, and favorable tax status relative to the situation for partnerships and proprietorships, most large businesses choose to incorporate.
 - Because lawyers have the incorporation process so automated (e.g., word processors for drawing up the necessary papers), it is less expensive to form a corporation than to form a proprietorship or partnership.
- _____ 29. Which of the following statements is correct?
- The optimal dividend policy is the one that satisfies the shareholders because they supply the firm's capital.
 - The use of debt financing has no effect on earnings per share (EPS) or stock price.
 - The riskiness of projected EPS depends upon how the firm is financed.
 - Stock price is dependent on the projected EPS and the use of debt but not on the timing of the earnings stream.
 - Dividend policy is one aspect of the firm's financial policy that is determined directly by the shareholders.

- _____ 30. Which of the following statements about the corporate form of business organization is *incorrect*?
- The corporation is the easiest form of business organization to establish.
 - In the United States, corporations generate a significantly greater percentage of total annual sales than either partnerships or proprietorships.
 - Corporations generally are larger than either partnerships or proprietorships.
 - One of the most important features of the corporate form of business organization is that stockholders have limited liability.
 - None of the above.
- _____ 31. In the United States, the *most common form* of business is the _____, and the form of business that *generates most of the sales and profits* is the _____.
- corporation; corporation
 - corporation; proprietorship
 - proprietorship; partnership
 - proprietorship; corporation
 - corporation; partnership
- _____ 32. Which of the following statements is *correct*?
- Other things held constant, it is generally safer to invest money in a proprietorship than in a corporation.
 - There really is no difference between a general partnership and a corporation, because both have multiple owners and both offer limited liability to the owners.
 - If you are planning to start a business, which you will run as the sole employee, and if you expect the business to earn \$1,000,000 per year before taxes, you *always* can minimize the total taxes you pay by setting up the business as a corporation.
 - According to the text, "agency problems" tend to *increase* when managers own larger relative amounts of the company's stock.
 - Maximizing the income statement item "net income" might not be the best goal for a corporation if the managers are interested in maximizing the economic welfare of the firm's stockholders (that is, the firm's stock price).
- _____ 33. Paying Payroll Service (PPS) recently declared bankruptcy. The price of PPS's stock has dropped from approximately \$10 per share one year ago to \$1 today. You can imagine that stockholders are not happy that the value of their stock has dropped so significantly. At the same time the financial position of the firm was deteriorating, PPS executives increased their salaries and perquisites substantially. Nothing they did violated any laws or was considered an unethical act. We would most likely describe this situation as _____.
- an agency problem.
 - an accounting glitch.
 - an appropriate use of the tax laws.
 - an appropriate action, because executive compensation should always be increased substantially each year.
 - acceptable, because it is obvious that the executives were trying to maximize the value of the firm, which is what the shareholders want them to do.
- _____ 34. Compared to corporations, what is the *primary disadvantage* of partnerships as forms of business organizations?
- The tax rates applied to partnership are higher than the tax rates applied to corporations.
 - Any dividends paid to the owners of a partnership business are taxed twice—once at the partnership level and once at the personal, or individual level.
 - Partnerships generally are much easier to form (start up) than corporations.
 - Partnerships have unlimited lives whereas corporations do not.
 - The owners of a partnership—that is, the partners—have unlimited liability when it comes to business obligations whereas the owners of a corporation have limited liability.

- _____ 35. All else equal, in which of the following forms of business would the possibility of an agency problem be the *greatest*?
- An U.S. corporation that is publicly traded.
 - A proprietorship.
 - A partnership in which all the partners share management and decision-making responsibilities equally.
 - A foreign corporation with concentrated ownership—that is, relatively few owners.
- _____ 36. All of the following are external factors that influence the stock prices of the firm except
- legal constraints
 - capital structure
 - tax laws
 - general level of economic activity
 - conditions in the stock market
- _____ 37. Management may expropriate wealth from bondholders to shareholders through which of the following actions:
- take on new ventures with much greater risk than was anticipated by creditors.
 - take on more debt to increase the returns to shareholders.
 - issue more stock than was anticipated by creditors.
 - answers a and b are correct.
 - answers b and c are correct.
- _____ 38. Which of the following statements concerning "agency problems" is *most* correct?
- Regardless of economic conditions, if a firm's stock price falls during the year, this indicates that the firm's managers *must not* be acting in the best interests of the shareholders.
 - One method of controlling agency problems is to engage in the taking of "poison pills."
 - One of the best means to control agency problems is to require the managers and other important decision makers of the firm to also be owners of the firm.
 - Agency problems probably would not exist if the important decisions of a firm were made by persons who *have no vested interests*, such as ownership, in the firm.
 - None of the above is a correct statement.
- _____ 39. Which of the following statements concerning a firm's quest to maximize wealth is correct?
- In extremely competitive industries, we would expect firms would voluntarily engage in many socially beneficial projects to try to maximize their stocks' values.
 - Actions that maximize a firm's stock price are inconsistent with maximizing social welfare.
 - The concepts of social responsibility and ethical responsibility on the part of corporations are completely different and neither is relevant in maximizing stock price.
 - In a competitive market, if a group of firms does not spend resources making social welfare improvements, but another group does, in general, this will not affect the second group's ability to attract funds.
 - 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 probably would not pursue such policies voluntarily.

Name: _____

ID: A

- _____ 40. The 11 "titles" in the Sarbanes–Oxley Act of 2002 establish standards for accountability and responsibility of financial reporting information for major corporations. For which of the following activities does the act *not* establish rules?
- a. The corporation must have a committee that consists of outside directors to oversee the firm's audits.
 - b. The corporation must hire an external auditor that will render an unbiased (independent) opinion concerning the firm's financial statement.
 - c. The corporation must maximize social welfare through funding of environmentally friendly activities.
 - d. The corporation must provide additional information about the procedures used to construct and report financial statements.
 - e. The firm's CEO and CFO must certify financial reports submitted to the Securities Exchange Commission.

Chapter 1 Self-Study Questions Answer Section

TRUE/FALSE

- | | | |
|------------|-------------|-----------------------------------|
| 1. ANS: F | DIF: Easy | TOP: Financial manager |
| 2. ANS: T | DIF: Easy | TOP: Proprietorship |
| 3. ANS: F | DIF: Easy | TOP: Hostile takeover |
| 4. ANS: F | DIF: Easy | TOP: Goal of firm |
| 5. ANS: F | DIF: Easy | TOP: Objectives of firm |
| 6. ANS: F | DIF: Easy | TOP: Managerial incentives |
| 7. ANS: T | DIF: Easy | TOP: Social welfare and finance |
| 8. ANS: F | DIF: Easy | TOP: Business ethics |
| 9. ANS: T | DIF: Easy | TOP: Exchange rate risk |
| 10. ANS: F | DIF: Easy | TOP: Managerial incentives |
| 11. ANS: F | DIF: Medium | TOP: Partnership |
| 12. ANS: T | DIF: Medium | TOP: Multinational corporations |
| 13. ANS: F | DIF: Medium | TOP: Government regulation |
| 14. ANS: F | DIF: Medium | TOP: Proprietorship |
| 15. ANS: T | DIF: Medium | TOP: Corporate charter and bylaws |

MULTIPLE CHOICE

- | | | |
|--|-------------|-----------------------|
| 16. ANS: D | DIF: Easy | OBJ: TYPE: Conceptual |
| TOP: Goal of firm | | |
| 17. ANS: D | DIF: Easy | OBJ: TYPE: Conceptual |
| TOP: Managerial incentives | | |
| 18. ANS: E | DIF: Easy | OBJ: TYPE: Conceptual |
| TOP: International operations motivation | | |
| 19. ANS: E | DIF: Easy | OBJ: TYPE: Conceptual |
| TOP: Agency costs | | |
| 20. ANS: A | DIF: Easy | OBJ: TYPE: Conceptual |
| TOP: Firm organization | | |
| 21. ANS: E | DIF: Easy | OBJ: TYPE: Conceptual |
| TOP: Goal of firm | | |
| 22. ANS: C | DIF: Medium | OBJ: TYPE: Conceptual |
| TOP: Agency costs | | |
| 23. ANS: E | DIF: Medium | OBJ: TYPE: Conceptual |
| TOP: Business ethics | | |
| 24. ANS: E | DIF: Medium | OBJ: TYPE: Conceptual |
| TOP: Social responsibility | | |
| 25. ANS: B | DIF: Medium | OBJ: TYPE: Conceptual |
| TOP: Corporate charter and bylaws | | |
| 26. ANS: D | DIF: Medium | OBJ: TYPE: Conceptual |
| TOP: Corporate form | | |

27. ANS: D DIF: Medium OBJ: TYPE: Conceptual
TOP: Partnership
28. ANS: C DIF: Medium OBJ: TYPE: Conceptual
TOP: Firm organization
29. ANS: C DIF: Medium OBJ: TYPE: Conceptual
TOP: Financial policy and earnings
30. ANS: A DIF: Medium TOP: Firm organization
31. ANS: D DIF: Medium OBJ: TYPE: Conceptual
TOP: Firm organization
32. ANS: E DIF: Medium OBJ: TYPE: Conceptual
TOP: Corporate form
33. ANS: A DIF: Medium OBJ: TYPE: Conceptual
TOP: Agency costs
34. ANS: E DIF: Medium OBJ: TYPE: Conceptual
TOP: Partnership
35. ANS: A DIF: Medium OBJ: TYPE: Conceptual
TOP: Agency costs
36. ANS: B DIF: Medium OBJ: TYPE: Conceptual
TOP: Miscellaneous concepts
37. ANS: A DIF: Medium OBJ: TYPE: Conceptual
TOP: Managerial incentives
38. ANS: C DIF: Tough OBJ: TYPE: Conceptual
TOP: Agency costs
39. ANS: E DIF: Tough OBJ: TYPE: Conceptual
TOP: Social responsibility
40. ANS: C DIF: Tough OBJ: TYPE: Conceptual
TOP: Business ethics