

Foundations of Finance, 10e (Keown/Martin/Petty)
Chapter 1 An Introduction to the Foundations of Financial Management

Learning Objective 1.1

1) Financial management deals with the maintenance and creation of economic value or wealth.

Answer: TRUE

Diff: 1 Page Ref: 3

Keywords: Financial Management

Learning Obj.: L.O. 1.1

AACSB: Reflective Thinking

2) Each financial decision made by a corporate manager can be evaluated by its direct impact on the corporation's stock price.

Answer: FALSE

Diff: 1 Page Ref: 4

Keywords: Goal of the Firm

Learning Obj.: L.O. 1.1

AACSB: Reflective Thinking

3) The fundamental goal of a business is to maximize the retained earnings available to the corporation's shareholders.

Answer: FALSE

Diff: 1 Page Ref: 3

Keywords: Goal of the Firm

Learning Obj.: L.O. 1.1

AACSB: Reflective Thinking

4) Shareholder wealth maximization means maximizing the price of the existing common stock.

Answer: TRUE

Diff: 1 Page Ref: 3

Keywords: Shareholder Wealth, Goal of the Firm

Learning Obj.: L.O. 1.1

AACSB: Reflective Thinking

5) It is important to evaluate a corporate manager's financial decision by measuring the effect the decision *should have* on the corporation's stock price if everything else were held constant.

Answer: TRUE

Diff: 2 Page Ref: 4

Keywords: Goal of the Firm, Maximize Shareholder Wealth

Learning Obj.: L.O. 1.1

AACSB: Reflective Thinking

6) Corporate managers should accept investment projects that maximize profits in the short run because of the time value of money.

Answer: FALSE

Diff: 2 Page Ref: 4

Keywords: Goal of the Firm, Profits, Time Value of Money

Learning Obj.: L.O. 1.1

AACSB: Reflective Thinking

7) The goal of the firm's financial managers should be the maximization of the total value of the firm's stock.

Answer: TRUE

Diff: 1 Page Ref: 3

Keywords: Goal of the Firm

Learning Obj.: L.O. 1.1

AACSB: Reflective Thinking

8) The payment of a dividend to current shareholders will have no impact on a corporation's share price because the cash paid is not available to future potential shareholders who may want to buy the corporation's stock.

Answer: FALSE

Diff: 1 Page Ref: 4

Keywords: Goal of the Firm

Learning Obj.: L.O. 1.1

AACSB: Reflective Thinking

9) One problem with maximization of shareholder wealth as a goal is that it ignores risk taken by the firm's financial decisions.

Answer: FALSE

Diff: 1 Page Ref: 4

Keywords: Goal of the Firm

Learning Obj.: L.O. 1.1

AACSB: Reflective Thinking

10) The goal of profit maximization ignores the risk of financial decisions.

Answer: FALSE

Diff: 1 Page Ref: 4

Keywords: Goal of the Firm

Learning Obj.: L.O. 1.1

AACSB: Reflective Thinking

11) Only a firm's financial decisions affect its stock prices.

Answer: FALSE

Diff: 1 Page Ref: 4

Keywords: Determinants of Stock Price

Learning Obj.: L.O. 1.1

AACSB: Reflective Thinking

12) Shareholders react to poor investment or dividend decisions by causing the total value of the firm's stock to fall, and they react to good decisions by bidding the price of the stock up.

Answer: TRUE

Diff: 2 Page Ref: 4

Keywords: Determinants of Stock Price

Learning Obj.: L.O. 1.1

AACSB: Reflective Thinking

13) The primary goal of a publicly owned corporation is to

- A) maximize dividends per share
- B) maximize shareholder wealth
- C) maximize earnings per share after taxes
- D) minimize shareholder risk

Answer: B

Diff: 1 Page Ref: 3

Keywords: Goal of the Firm, Corporation

Learning Obj.: L.O. 1.1

AACSB: Reflective Thinking

14) Maximization of shareholder wealth

- A) represents a zero sum game in which one corporation gains at the expense of others.
- B) provides benefits to society as scarce resources are directed to their most productive use.
- C) is not a practical goal since it cannot be measured effectively.
- D) is achieved only if cash flows exceed accounting profits.

Answer: B

Diff: 1 Page Ref: 3

Keywords: Goal of the Firm, Maximize Shareholder Wealth

Learning Obj.: L.O. 1.1

AACSB: Reflective Thinking

15) A financial manager is considering two projects, A and B. A is expected to add \$2 million to profits this year while B is expected to add \$1 million to profits this year. Which of the following statements is MOST correct?

- A) The manager should select project A because it maximizes profits.
- B) The manager should select the project that maximizes long-term profits, not just one year of profits.
- C) The manager should select project A or he is irrational.
- D) The manager should select the project that causes the stock price to increase the most, which could be A or B.

Answer: D

Diff: 2 Page Ref: 4

Keywords: Goal of the Firm

Learning Obj.: L.O. 1.1

AACSB: Analytical Thinking

- 16) Shareholder wealth maximization means
- A) maximizing earnings per share.
 - B) maximizing dividends per share.
 - C) maximizing the price of existing common stock.
 - D) maximizing stockholders equity.

Answer: C

Diff: 1 Page Ref: 4

Keywords: Goal of the Firm, Maximize Shareholder Wealth

Learning Obj.: L.O. 1.1

AACSB: Reflective Thinking

- 17) The goal of the firm should be
- A) maximization of profits (net income per share).
 - B) maximization of shareholder wealth.
 - C) maximization of market share.
 - D) maximization of sales.

Answer: B

Diff: 1 Page Ref: 3

Keywords: Goal of the Firm, Maximize Shareholder Wealth

Learning Obj.: L.O. 1.1

AACSB: Reflective Thinking

- 18) Which of the following goals of the firm are synonymous (equivalent) to the maximization of shareholder wealth?

- A) profit maximization
- B) risk minimization
- C) maximization of the total market value of the firm's common stock
- D) none of the above

Answer: C

Diff: 1 Page Ref: 4

Keywords: Goal of the Firm, Maximize Shareholder Wealth

Learning Obj.: L.O. 1.1

AACSB: Reflective Thinking

- 19) Which of the following is the most important goal that a corporation should strive for?

- A) maximize current profits
- B) maximize market share
- C) maximize revenue
- D) maximize shareholder wealth

Answer: D

Diff: 1 Page Ref: 3

Keywords: Goal of the Firm, Maximize Shareholder Wealth

Learning Obj.: L.O. 1.1

AACSB: Reflective Thinking

20) One of the causes of the recent financial crisis in the United States has been excessive risk taking due to underestimation of risk. How does this relate to shareholder wealth maximization and financial leverage? Can overestimation of risk also be detrimental?

Answer: Underestimation of risk can lead managers to borrow excessively to fund more and more projects. High levels of debt require interest and principal payments which may become impossible to make if the company's cash flows are reduced, even for short periods of time. Overestimation of risk can also be problematic. Managers who take on too little risk may be passing up desirable projects that could increase shareholder wealth. The principle that risk requires a reward does not mean that all risk is bad, but rather that additional risk is ok if additional expected returns are high enough. If all risk was bad, companies would go out of business and all investors would buy U.S. Treasury bills.

Diff: 2 Page Ref: 4, 9

Keywords: Risk Requires a Reward, Goal of the Firm

Learning Obj.: L.O. 1.1

AACSB: Reflective Thinking

21) Documents uncovered after the Exxon Valdez oil spill in Alaska revealed that Exxon could have used double-hulled oil tankers that would have prevented the spill, but the cost of refitting their fleet of single-hulled tankers was considered too high. Exxon determined that the cost of cleaning up an oil spill would be less than the cost of refitting the ships, thus increasing shareholder value. Several years after the oil spill, however, Exxon was fined billions of dollars for the spill. How do the costs of the cleanup and the fines pertain to a discussion of maximizing shareholder value and ethical responsibility?

Answer: Managers are supposed to maximize shareholder value. Exxon's analysis of the costs of an oil spill versus the cost of improving their tankers seems to have been a reasonable one at the time it was undertaken. The social costs of killing birds and fish were expected to be low. The outrage at Exxon's conduct and the subsequent large fines will change the estimation of future costs for similar situations. Managers need to consider the impact of their decisions on their companies' cash flows. Socially undesirable activities may lead to boycotts, protests, lower sales, fines, etc. These costs must be included in their analyses. Society sets limits within which corporations must operate or the corporations, and their shareholders, will suffer. Therefore, acting in ethical and socially responsible ways is congruent with the goal of shareholder wealth maximization.

Diff: 2 Page Ref: 4, 9, 10

Keywords: Goal of the Firm, Maximizing Shareholder Value, Ethical Responsibility, Cash Flow

Learning Obj.: L.O. 1.1

AACSB: Reflective Thinking

Learning Objective 1.2

1) When making financial decisions, managers should always look at marginal, or incremental cash flows.

Answer: TRUE

Diff: 1 Page Ref: 5

Keywords: Marginal or Incremental Cash Flows

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

2) An investment project is acceptable if the total cash received over the life of the project exceeds the total cash spent over the life of the project.

Answer: FALSE

Diff: 2 Page Ref: 5

Keywords: Cash Flow, Time Value of Money

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

3) If two companies have the same net income and the same level of risk, they must also have the same stock price or the market is not in equilibrium.

Answer: FALSE

Diff: 2 Page Ref: 4

Keywords: Net Income, Risk, Timing of Cash Flow

Learning Obj.: L.O. 1.2

AACSB: Analytical Thinking

4) Profits represent money that can be spent, and as such, form the basis for determining the value of financial decisions.

Answer: FALSE

Diff: 2 Page Ref: 4

Keywords: Profits, Cash Flow

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

5) The root cause of agency problems is conflicts of interest.

Answer: TRUE

Diff: 1 Page Ref: 8

Keywords: Agency Problems, Conflicts of Interest

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

6) Investors will be indifferent between two investments if both investments have the same expected return.

Answer: FALSE

Diff: 1 Page Ref: 5, 6

Keywords: Risk-Return Trade-off

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

7) If the stock market is efficient, then investors do not need to read the Wall Street Journal or research companies before they select which stocks to buy because market prices already reflect all publicly available information.

Answer: FALSE

Diff: 2 Page Ref: 6

Keywords: Efficient Markets

Learning Obj.: L.O. 1.2

AACSB: Analytical Thinking

8) Giving the company's CEO stock options as part of his or her compensation package is an example of an agency cost.

Answer: TRUE

Diff: 2 Page Ref: 8

Keywords: Agency Costs

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

9) Cash flows and profits are synonymous; in other words, higher cash flows equal higher profits.

Answer: FALSE

Diff: 1 Page Ref: 4

Keywords: Cash Flow, Profit

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

10) Shareholder selection committees select potential board of director nominees ensuring that board members will monitor management sufficiently to protect shareholder interests.

Answer: FALSE

Diff: 1 Page Ref: 9

Keywords: Agency Problems, Board of Directors

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

11) Managers should not be concerned with business ethics because ethical behavior is inconsistent with the primary goal of maximizing shareholder value.

Answer: FALSE

Diff: 1 Page Ref: 10

Keywords: Ethics, Goal of the Firm

Learning Obj.: L.O. 1.2

AACSB: Ethical Understanding and Reasoning

12) One of the problems associated with maximization of total current stock value is that it ignores the timing of a project's return.

Answer: FALSE

Diff: 1 Page Ref: 4, 5

Keywords: Maximizing Shareholder Value, Timing of Returns

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

13) The risk-return trade-off is seen in many areas of finance.

Answer: TRUE

Diff: 1 Page Ref: 6

Keywords: Risk, Return

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

14) The risk-return trade-off implies that the return on a riskless asset must be zero.

Answer: FALSE

Diff: 1 Page Ref: 6

Keywords: Risk-Return Trade-off

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

15) When employees do what is in their best interest, they are also doing what is the best result for the organization they belong.

Answer: FALSE

Diff: 1 Page Ref: 9

Keywords: Agency Problems

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

16) An efficient market is one where the prices of the assets traded in that market fully reflect all available information at any instant in time.

Answer: TRUE

Diff: 1 Page Ref: 6

Keywords: Efficient Markets

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

17) The opportunity cost of any choice you make is the highest-valued alternative that you had to give up when you made the choice.

Answer: TRUE

Diff: 1 Page Ref: 5

Keywords: Opportunity Cost, Time Value of Money

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

18) While many factors contributed to the financial crisis of 2007 and beyond, it is safe to say that real estate loans were NOT much of a contributing factor.

Answer: FALSE

Diff: 1 Page Ref: 9

Keywords: Current Global Financial Crisis

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

19) The five basic principles of finance include all of the following EXCEPT

A) cash flow is what matters.

B) money has a time value.

C) risk requires a reward.

D) incremental profits determine value.

Answer: D

Diff: 1 Page Ref: 4

Keywords: Basic Principles of Finance

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

20) Suppose XYZ Corporation is traded on the New York Stock Exchange. XYZ's closing price on Monday is \$20 per share. After the market closes on Monday, XYZ makes a surprise announcement that it has obtained a major new customer. XYZ's stock will likely

A) open at \$20 per share on Tuesday and then increase as more investors read the announcement in the Wall Street Journal.

B) remain at \$20 per share because in efficient markets the price already reflects all information.

C) open above \$20 because the positive news will result in a higher valuation even though the stock has not yet traded.

D) open below \$20 because the surprise announcement creates more uncertainty.

Answer: C

Diff: 2 Page Ref: 6

Keywords: Efficient Markets

Learning Obj.: L.O. 1.2

AACSB: Analytical Thinking

21) A corporate manager decides to build a new store on a lot owned by the corporation that could be sold to a local developer for \$250,000. The lot was purchased for \$50,000 twenty years ago. When determining the value of the new store project,

A) the cost of the lot is zero since the corporation already owns it.

B) the opportunity cost of the lot is \$250,000 and should be included in calculating the value of the project.

C) the cost of the lot for valuation purposes is \$50,000 because land does not depreciate.

D) the incremental cash flow should be the \$50,000 original cost less accumulated amortization.

Answer: B

Diff: 2 Page Ref: 5

Keywords: Opportunity Cost

Learning Obj.: L.O. 1.2

AACSB: Analytical Thinking

22) To measure value, the concept of time value of money is used

A) to determine the interest rate paid on corporate debt.

B) to bring the future benefits and costs of a project, measured by its expected profits, back to the present.

C) to bring the future benefits and costs of a project, measured by its cash flows, back to the present.

D) to ensure that expected future profits exceed current profits today.

Answer: C

Diff: 1 Page Ref: 5

Keywords: Time Value of Money, Cash Flows

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

23) A financial manager is evaluating a project which is expected to generate profits of \$100,000 per year for the next 10 years. The project should be accepted if

A) the cost of the project is less than \$1,000,000.

B) the cost of the project is less than the present value of \$100,000 per year for 10 years.

C) this project's expected profits are higher than any other projects the corporation has available.

D) the present value of the project's cash inflows exceeds the present value of the project's cash outflows.

Answer: D

Diff: 2 Page Ref: 4, 5

Keywords: Time Value of Money, Cash Flows

Learning Obj.: L.O. 1.2

AACSB: Analytical Thinking

- 24) Investors want a return that satisfies the following expectation(s):
- A) A return for delaying consumption
 - B) An additional return for taking on risk
 - C) An additional return for accepting dividends rather than capital gains
 - D) Both A and B.

Answer: D

Diff: 2 Page Ref: 5,6

Keywords: Risk, Return

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

- 25) The expected return on a riskless asset is greater than zero due to
- A) an expected return for delaying consumption.
 - B) an expected return for opportunity costs.
 - C) an expected return for taxes.
 - D) irrational investors who believe risk is always present.

Answer: A

Diff: 1 Page Ref: 5

Keywords: Risk-Return Trade-off

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

- 26) Joe, a risk-averse investor, is trying to choose between investment A and investment B. If investment A is riskier than investment B and Joe selects investment A anyway, then
- A) the actual return for investment A will be higher than the actual return for investment B.
 - B) the actual return for investment A will be higher than the expected return for investment B.
 - C) the expected return for investment A will be higher than the actual return for investment B.
 - D) the expected return for investment A will be higher than the expected return for investment B.

Answer: D

Diff: 1 Page Ref: 5, 6

Keywords: Risk-Return Trade-off

Learning Obj.: L.O. 1.2

AACSB: Analytical Thinking

- 27) The principle of risk-return trade-off means that
- A) higher risk investments must earn higher returns.
 - B) an investor who takes more risk will earn a higher return.
 - C) a rational investor will only take on higher risk if he expects a higher return.
 - D) an investor who bought stock in a small corporation five years ago has more money than an investor who bought U.S. Treasury bonds five years ago.

Answer: C

Diff: 2 Page Ref: 5, 6

Keywords: Risk-Return Trade-off, Expected Return, Actual Return

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

28) Project A is expected to generate positive cash flow of \$1 million in 10 years while Project B is expected to generate \$500,000 in 5 years. Therefore

- A) Project A is preferred because shareholder value is based on cash flow.
- B) Project B is preferred because its cash flow is expected to be received sooner than the cash flow from Project A.
- C) Both projects have equal value because they average \$100,000 per year.
- D) Project B may be preferred to Project A if the opportunity cost of money is high enough.

Answer: D

Diff: 2 Page Ref: 5

Keywords: Time Value of Money

Learning Obj.: L.O. 1.2

AACSB: Analytical Thinking

29) Company A reports sales of \$100,000 and net income of \$15,000. Company B reports sales of \$100,000 and net income of \$10,000. Therefore

- A) Company A's cash flow may be higher or lower than Company B's cash flow even though A's net income is higher.
- B) Company A's cash flow is \$5,000 more than Company B's cash flow.
- C) Company B is creating less value for its shareholders than Company A.
- D) Company B's accounts receivable must be higher than Company A's accounts receivable.

Answer: A

Diff: 2 Page Ref: 4, 5

Keywords: Cash Flow, Net Income

Learning Obj.: L.O. 1.2

AACSB: Analytical Thinking

30) Profits are down so the controller decides to change the corporation's accounting policy relating to inventory costing. The change will allow the corporation to report higher income and higher assets, although the physical inventory has not changed. Which of the following statements is MOST correct?

- A) The stock price is likely to increase because income is higher.
- B) The stock price is likely to be unaffected because the stock market is efficient.
- C) The stock price is likely to decrease because reported inventory is higher.
- D) If the stock price increases, the stock market is efficient.

Answer: B

Diff: 2 Page Ref: 6

Keywords: Efficient Markets

Learning Obj.: L.O. 1.2

AACSB: Analytical Thinking

- 31) All of the following statements about agency problems are true EXCEPT
- A) agency problems interfere with the goal of maximizing shareholder value.
 - B) agency costs are paid by the managers who do not act in the shareholders' best interest.
 - C) agency problems result from the separation of management and the ownership of a firm.
 - D) the root cause of agency problems is conflicts of interest.

Answer: B

Diff: 2 Page Ref: 8

Keywords: Agency Problems

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

- 32) A corporate financial manager trying to maximize shareholder value
- A) is not concerned with ethics but rather with writing iron-clad contracts.
 - B) can safely ignore ethics as long as no laws are broken.
 - C) must behave ethically in order to stay out of jail.
 - D) is concerned with ethics because unethical behavior destroys trust, and businesses cannot function without a certain degree of trust.

Answer: D

Diff: 1 Page Ref: 9, 10

Keywords: Ethics, Maximizing Shareholder Value

Learning Obj.: L.O. 1.2

AACSB: Ethical Understanding and Reasoning

- 33) John invested \$1,000 in a risky investment and Bill invested \$1,000 in a less risky investment. One year later, Bill's investment is worth \$1,030. Which of the following statements is MOST correct?

- A) If John's investment is worth less than \$1,030, then John was irrational to invest in the risky project.
- B) John's investment must be worth more than \$1,030 because of the risk-return trade-off, given that John's investment was more risky.
- C) If John's investment is worth more than \$1,030, then Bill was irrational to invest in the less risky investment.
- D) The worth of John's investment cannot be determined with the information given.

Answer: D

Diff: 2 Page Ref: 5, 6

Keywords: Risk-Return Trade-off, Expected Return, Actual Return

Learning Obj.: L.O. 1.2

AACSB: Analytical Thinking

34) In order to reduce agency problems, managers may be provided compensation that includes
A) a fixed salary so managers' pay is not at risk, allowing managers to focus on the company's business.

B) a bonus based on the level of profit achieved during the year.

C) an option to buy the company's stock.

D) incentive pay for achieving higher sales than last year.

Answer: C

Diff: 2 Page Ref: 8, 9

Keywords: Agency Problems, Stock Option, Incentive Compensation

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

35) An investor is considering two equally risky investments. Investment A is expected to return \$1,000 per year for the next 5 years. Investment B is expected to return \$6,000 at the end of 5 years. Which of the following statements is MOST correct if both investments A and B have the same cost?

A) A risk averse investor will select investment B because it is expected to provide the most cash (\$6,000 > \$5,000).

B) A risk averse investor will select investment A because it provides cash earlier than investment B.

C) The investor will select investment A only if the cost is less than \$1,000.

D) The investor may select investment A or investment B depending on the opportunity cost of money.

Answer: D

Diff: 2 Page Ref: 4, 5

Keywords: Time Value of Money, Cash Flows

Learning Obj.: L.O. 1.2

AACSB: Analytical Thinking

36) The CEO of High Tech International decides to change an accounting method at the end of the current year. The change results in reported profits increasing by 5%, but the company's cash flows are not changed. If capital markets are efficient, then

A) the stock price will not be affected by the accounting change.

B) the stock price will increase due to higher profits.

C) the stock price will increase only if the accounting change will also result in higher profits in the next year.

D) the stock price will decrease because accounting method changes are not permitted under generally accepted accounting principles.

Answer: A

Diff: 1 Page Ref: 4, 6

Keywords: Efficient Markets

Learning Obj.: L.O. 1.2

AACSB: Analytical Thinking

37) When evaluating an investment project, which of the following best describes the financial information needed by the decision maker?

- A) after-tax accounting profits
- B) after-tax incremental cash flows to the company as a whole
- C) incremental cash flows before taxes so the decision will not be biased by a tax code that may change in the future
- D) pre-tax accounting profits adjusted for any accounting method changes

Answer: B

Diff: 1 Page Ref: 4, 5

Keywords: After-tax Incremental Cash Flows

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

38) The CEO of JLI Corp. decided to expand into a new market in 2010. At the end of 2010, JLI's stock price had decreased 5% since the beginning of the year. Which of the following statements is MOST correct?

- A) The CEO made a poor decision to expand because the stock price decreased during the year.
- B) The CEO made a poor decision to expand because the company's profits for the year obviously decreased, causing the drop in stock price.
- C) The CEO's decision may have been optimal, keeping the stock price from falling more than 5% for the year.
- D) CEO decisions are irrelevant because the efficient market determines the value of a company's stock.

Answer: C

Diff: 2 Page Ref: 6, 7

Keywords: Stock Price Maximization, Efficient Markets

Learning Obj.: L.O. 1.2

AACSB: Analytical Thinking

39) High Tech Corp. cut its research and development budget in 2010 by \$4,000,000 in order to improve its cash flow for the year. Which of the following statements is MOST correct?

- A) The stock price will likely increase because the value of stock is based on reported cash flow.
- B) The stock price may decrease because investors may predict that future cash flows will decrease due to the lack of innovation and new products.
- C) The change will have no impact on stock price because the company's profits will not change in 2010.
- D) The stock price will increase only if reported profits in 2010 are higher than profits reported in 2009.

Answer: B

Diff: 2 Page Ref: 4

Keywords: Stock Price, Cash Flow

Learning Obj.: L.O. 1.2

AACSB: Analytical Thinking

40) In which of the following cases will the agency problem between shareholders and managers be the greatest?

A) 100% of the common stock is owned by the founder of the company who decided to retire and hired a manager to run his business for him.

B) The Johnson family owns 50% of the common stock of the company. The other 50% is owned by 5 mutual funds.

C) The common stock of the company is owned by many diverse shareholders, with no shareholder owning more than 1% of the outstanding stock.

D) All top managers in the company own significant amounts of stock and stock options.

Answer: C

Diff: 2 Page Ref: 8, 9

Keywords: Agency Problems

Learning Obj.: L.O. 1.2

AACSB: Analytical Thinking

41) Executive compensation in the United States

A) is dominated by performance-based compensation that ensures fair and just pay for corporate executives.

B) is dominated by performance-based compensation designed to reduce agency problems.

C) cannot be linked to stock prices as this would create a conflict of interest with existing shareholders.

D) is well below levels in Europe and Asia.

Answer: B

Diff: 2 Page Ref: 8, 9

Keywords: Agency Problems, Executive Compensation

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

42) Ethical behavior

A) is the fifth basic principles of finance.

B) cannot be a concern to managers who are expected to maximize shareholder value.

C) in the corporate world means not breaking any laws.

D) is essential in business because unethical behavior destroys trust and business relationships.

Answer: D

Diff: 1 Page Ref: 9

Keywords: Ethics

Learning Obj.: L.O. 1.2

AACSB: Ethical Understanding and Reasoning

- 43) Investors generally don't like risk. Therefore, a typical investor
- A) will not be induced to take on any risk.
 - B) will only take on the least risk possible.
 - C) will only take on additional risk if he expects to be compensated in the form of additional return.
 - D) will only accept a zero return if the risk is zero.

Answer: C

Diff: 2 Page Ref: 5, 6

Keywords: Risk-Return Trade-off

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

- 44) In finance, we assume that investors are generally

- A) neutral to risk.
- B) averse to risk.
- C) fond of risk.
- D) none of the above

Answer: B

Diff: 1 Page Ref: 5, 6

Keywords: Risk-Return Trade-off

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

- 45) Consider the after-tax cash flows for Project S and Project L:

	Project S	Project L
Year 1	\$3000	0
Year 2	0	\$3000

A rational person would prefer

- A) Project S because the money can be reinvested sooner
- B) Project L because they can avoid taxes by receiving cash flows later
- C) information about profits instead of cash flows
- D) neither investment over the other

Answer: A

Diff: 1 Page Ref: 5

Keywords: Time Value of Money

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

46) Assume that an investor is offered a choice of a risk-free government bond or a high-risk corporate stock. Further assume that the expected return is the same for both. According to one of the axioms of finance, which investment would be chosen?

- A) the corporate stock
- B) the government bond
- C) neither, the investor would be indifferent
- D) none of the above

Answer: B

Diff: 1 Page Ref: 5, 6

Keywords: Risk-Return Trade-off

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

47) Assume that an investor is offered a choice of a risk-free government bond that is expected to return 3.5% or a high-risk corporate stock. According to one of the principles of finance, what would induce the investor to purchase the corporate stock?

- A) a return that is substantially lower than 3.5%
- B) cash dividends
- C) a return that is substantially higher than 3.5%
- D) none of the above

Answer: C

Diff: 1 Page Ref: 5, 6

Keywords: Risk-Return Trade-off

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

48) Assume that you went to Las Vegas and hit the jackpot for \$5 million. Further assume that you were offered a choice to receive the \$5 million today, or receive it in two years. According to one of the principles of finance, which would you take?

- A) the \$5 million in two years because you would be afraid of spending it all right away
- B) the \$5 million in two years because it would be worth more than if you would receive it today
- C) You would be indifferent as to when you would receive the \$5 million.
- D) the \$5 million today because it would be worth more than if you would receive it in two years

Answer: D

Diff: 1 Page Ref: 5

Keywords: Time Value of Money

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

49) Assume that you won the Lotta Dough Lotto jackpot for \$20 million. Further assume that you were offered a choice to receive the \$20 million today, or receive it in equal installments of \$1 million per year for 20 years. According to one of the principles of finance, which would you take?

A) the \$20 million in equal installments of \$1 million per year for 20 years because you would be afraid of spending it all right away

B) the \$20 million today because it would be worth more than if you would receive it in equal installments of \$1 million per year for 20 years

C) You would be indifferent as to when you would receive the \$20 million since the total number of dollars received is the same either way.

D) the \$20 million in equal installments of \$1 million per year for 20 years because it would be worth more than if you would receive it today

Answer: B

Diff: 1 Page Ref: 5

Keywords: Time Value of Money

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

50) Which of the following statements best represents the "Agency Problem"?

A) Managers might attempt to benefit themselves in terms of salary and perquisites at the expense of shareholders.

B) The agency problem results from the separation of management and the ownership of the firm.

C) The agency problem may interfere with the implementation of maximizing shareholder wealth.

D) All of the above.

Answer: D

Diff: 1 Page Ref: 8

Keywords: Agency Problems

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

51) Short-term United States Treasury bills are widely used as proxies for risk-free assets, yet the returns on these T-bills are consistently greater than zero. Is this consistent with the concept of a risk-return trade-off?

Answer: Yes. Investors also require a return for delaying consumption as well as a return for taking on risk.

Diff: 1 Page Ref: 5, 6

Keywords: Risk-Return Trade-off, Return for Delaying Consumption

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

52) John won the lottery on Monday and can take either \$50,000 per year for 20 years, or \$500,000 today. Bill won the same lottery on Tuesday and has the same options for receiving the cash. A well respected financial advisor is hired by both John and Bill. The advisor recommends that John take the \$50,000 per year for 20 years but advises Bill to take the \$500,000 up front payment. How is it possible to give different advice to two clients regarding the exact same cash flows?

Answer: The time value of money is based on opportunity cost. If John and Bill have different opportunity costs for funds, they can each be making rational choices. For example, suppose Bill can earn 20% on the funds he receives by investing them in his business, but John expects to earn only 2% by investing the lottery winnings in a certificate of deposit. Bill will end up with more cash if he takes the \$500,000 up front and invests it wisely, even though he is giving up \$500,000 of future winnings. John, however, is better off taking the \$50,000 per year, for a total of \$1,000,000 over 20 years, because he would not be able to make up the lost \$500,000 by earning only 2% per year.

Diff: 3 Page Ref: 5

Keywords: Opportunity Cost, Time Value of Money

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

53) The manager of Golden Ray Corporation receives a bonus if company profits exceed \$1,000,000 this year. During the final week of the year, the manager changes an accounting policy that will increase reported profits from \$950,000 to \$1,025,000, triggering his bonus. The change in profits of \$75,000 will reverse itself in the next year, and the accounting change has no impact on Golden Ray's cash flow. Discuss the above situation as it relates to both an agency problem and efficient markets.

Answer: An agency problem exists when a manager (agent) acts in his or her own self-interest rather than in the best interests of the shareholders (principals). In order to reduce agency problems, management activity may be monitored, such as through audits and performance reviews, and management compensation can be designed to align the interests of the managers with the interests of the shareholders. A bonus based on profits encourages the manager to focus on profits, rather than on shareholder value. A better compensation scheme may include direct stock ownership by managers, stock options for managers, or performance incentives based on the company's stock price.

Given efficient markets, one would expect the increase in profits to have little effect on the company's stock price. Stock values are based on cash flows, not profits, and the stock market is not fooled by an accounting change that artificially increases short-term profits. In this case, the stock price could go down because the company has to pay higher compensation to the manager even though the company's cash flows have not increased.

Diff: 3 Page Ref: 4, 6, 8

Keywords: Agency Problems, Efficient Markets, Incentive Alignment, Cash Flow Versus Profits

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

54) Your friend Ricky took a finance class and learned about the risk-return trade-off. Wanting a high return, Ricky invested in a risky, start-up technology company. A year later the company went bankrupt and Ricky lost his entire investment. Ricky is furious with his finance professor for misleading him, claiming he was taught that higher return goes with higher risk. Explain how Ricky misinterpreted the risk-return trade-off.

Answer: The risk-return trade-off deals with expected returns, not actual returns. For risk averse investors, higher expected returns are required before they will take on higher risks. However, higher expected returns do not always materialize. Risky projects sometimes result in lower actual returns. This is what makes them risky.

Diff: 3 Page Ref: 5

Keywords: Risk-Return Trade-off, Actual Return, Expected Return, Risk

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

55) The board of directors of Wireless, Inc. is considering two compensation plans for the CEO of the company. The first would pay the CEO a salary of \$250,000 for the upcoming year. The second would pay the CEO a salary of \$100,000 and provide the CEO with a stock option to buy 100,000 shares of stock for \$11 per share. The current price per share of Wireless, Inc. stock is \$10 per share. The stock option expires at the end of the year. Why might shareholders prefer the second payment plan? As part of your answer, calculate the breakeven point for the CEO to obtain the same compensation under option two as he or she would under option one.

Answer: Shareholders may prefer the compensation package that includes stock options because the options give the CEO the incentive to maximize the price of the company's stock, thus benefiting the shareholders. A fixed salary, regardless of stock price performance, can lead to a CEO who is willing to do the minimum necessary to maintain the job, but who is not motivated to work extra hard for the shareholders. For every dollar the price of the stock exceeds \$11 per share, the CEO will make an additional \$100,000. Thus, if the share price increases to \$12.50, the profit on the stock option $[(\$12.50 - \$11.00) \times 100,000 \text{ shares}]$ of \$150,000 plus the fixed salary of \$100,000 will equal the total compensation from option one of \$250,000. Stock options help to align the incentives of managers with the goals of shareholders.

Diff: 3 Page Ref: 8

Keywords: Agency Costs, Incentive Alignment, Stock Options

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

56) Your friend, John, believes that since capital markets are efficient, he doesn't need to read the financial press or be involved in stock research before purchasing stocks for his portfolio. He simply throws darts at the stock pages and buys the stocks the darts hit. Is stock research and analysis important when buying and selling stocks in an efficient market?

Answer: Yes! Efficient capital markets theory suggests that investors will not be able to outperform the market in the long-run using just publicly available information. This is due to the fact that market prices very quickly adjust to information. If an investor only knows what all other investors know, then he or she cannot use that information to earn abnormal returns. However, an uninformed investor can certainly underperform the market.

Diff: 2 Page Ref: 6, 7

Keywords: Efficient Capital Markets

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

Learning Objective 1.3

1) A corporate treasurer is typically responsible for cash management, credit management, and raising capital.

Answer: TRUE

Diff: 1 Page Ref: 12

Keywords: Treasurer, Financial Managers

Learning Obj.: L.O. 1.3

AACSB: Reflective Thinking

2) Determining how a firm should raise money to fund its long-term investments is referred to as capital structure decisions.

Answer: TRUE

Diff: 1 Page Ref: 10

Keywords: Capital Structure Decisions

Learning Obj.: L.O. 1.3

AACSB: Reflective Thinking

3) The chief financial officer (CFO) is responsible for overseeing financial planning, corporate strategic planning, and controlling the firm's cash flow.

Answer: TRUE

Diff: 1 Page Ref: 11

Keywords: Chief Financial Officer

Learning Obj.: L.O. 1.3

AACSB: Reflective Thinking

4) The financial manager most directly responsible for producing the company's financial statements and directing its cost accounting functions is the

- A) chief financial officer.
- B) controller.
- C) treasurer.
- D) vice president-financier.

Answer: B

Diff: 1 Page Ref: 11, 12

Keywords: Controller, Financial Managers

Learning Obj.: L.O. 1.3

AACSB: Reflective Thinking

5) A corporate treasurer is typically responsible for each of the following duties EXCEPT

- A) cash management.
- B) credit management.
- C) capital expenditures.
- D) cost accounting.

Answer: D

Diff: 1 Page Ref: 11, 12

Keywords: Treasurer, Financial Managers

Learning Obj.: L.O. 1.3

AACSB: Reflective Thinking

6) The three basic types of issues addressed by the study of finance are

- A) capital budgeting, capital structure decisions, and working capital management.
- B) capital budgeting, working capital management, and investment analysis.
- C) capital structure decisions, working capital management, and sustained profitability.
- D) capital budgeting, investment analysis, and cash management.

Answer: A

Diff: 1 Page Ref: 10

Keywords: Capital Budgeting, Capital Structure, Working Capital Management

Learning Obj.: L.O. 1.3

AACSB: Reflective Thinking

7) Cash and credit management are typically the responsibility of the

- A) controller.
- B) vice president of production and operations.
- C) chief executive officer, or CEO.
- D) treasurer.

Answer: D

Diff: 1 Page Ref: 12

Keywords: Treasurer

Learning Obj.: L.O. 1.3

AACSB: Reflective Thinking

- 8) Working capital management is concerned with
- A) how a firm can best manage its cash flows as they arise in its day-to-day operations.
 - B) how a firm should raise money to fund its investments.
 - C) what long-term investments a firm should undertake.
 - D) managing a firm's capital stock.

Answer: A

Diff: 1 Page Ref: 10

Keywords: Working Capital Management

Learning Obj.: L.O. 1.3

AACSB: Reflective Thinking

- 9) Capital budgeting is concerned with
- A) whether a company's assets should be financed with debt or equity.
 - B) managing a firm's cash budgeting procedures.
 - C) what long-term investments a firm should undertake.
 - D) planning sales of a corporation's equity capital.

Answer: C

Diff: 1 Page Ref: 10

Keywords: Capital Budgeting

Learning Obj.: L.O. 1.3

AACSB: Reflective Thinking

- 10) Determining the best way to raise money to fund a firm's long-term investments is called
- A) the capital budgeting decision.
 - B) the portfolio decision.
 - C) the money flow processing decision.
 - D) the capital structure decision.

Answer: D

Diff: 1 Page Ref: 10

Keywords: Capital Structure Decisions

Learning Obj.: L.O. 1.3

AACSB: Reflective Thinking

- 11) What are the duties of a treasurer? Of a controller?

Answer: The treasurer generally handles the firm's financial activities, including cash and credit management, making capital expenditure decisions, raising funds, financial planning, and managing any foreign currency received by the firm. The controller is responsible for managing the firm's accounting duties, including producing financial statements, cost accounting, paying taxes, and gathering and monitoring the data necessary to oversee the firm's financial well-being. In this textbook, we focus on the duties generally associated with the treasurer and on how investment decisions are made.

Diff: 2 Page Ref: 14

Keywords: Treasurer, Financial Managers

Learning Obj.: L.O. 1.3

AACSB: Reflective Thinking

Learning Objective 1.4

1) The sole proprietorship is for all practical purposes the absence of any formal *legal* business structure.

Answer: TRUE

Diff: 1 Page Ref: 13

Keywords: Sole Proprietorship, Legal Forms of Business

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

2) A general partnership, unlike a limited partnership, is an entity that legally functions separate and apart from its owners.

Answer: FALSE

Diff: 2 Page Ref: 13

Keywords: General Partnership, Limited Partnership, Legal Forms of Business

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

3) The best form of business entity to attract new capital is the sole proprietorship because investors only need to deal with one owner.

Answer: FALSE

Diff: 1 Page Ref: 15

Keywords: Legal Forms of Business, Sole Proprietorship

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

4) S-type corporations and limited liability companies are taxed like partnerships, but have the advantage of limited liability for their owners.

Answer: TRUE

Diff: 1 Page Ref: 14

Keywords: Legal Forms of Business, S-Corporation, Limited Liability Company

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

5) Limited liability companies are more flexible than S-type Corporations because limited liability companies operate under state laws.

Answer: FALSE

Diff: 2 Page Ref: 14

Keywords: Legal Forms of Business, S-Corporation, Limited Liability Company

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

6) A limited liability company (LLC) is taxed like a partnership but provides limited liability for its owners, similar to a corporation.

Answer: TRUE

Diff: 1 Page Ref: 14

Keywords: Limited Liability Company, Partnership, Corporation, Limited Liability

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

7) Its ability to raise capital by selling stock makes the corporation the best form of organization in terms of raising capital.

Answer: TRUE

Diff: 1 Page Ref: 16

Keywords: Corporation, Advantages of Corporate Form

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

8) There is no legal distinction made between the assets of the business and the personal assets of any of the owners in the limited partnership.

Answer: FALSE

Diff: 2 Page Ref: 13

Keywords: Limited Partnership

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

9) The owners of a corporation enjoy limited liability.

Answer: TRUE

Diff: 1 Page Ref: 13

Keywords: Corporation, Limited Liability

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

10) The corporation is a legal entity separate from its owners; thus it is possible for the corporation to continue even upon the death of one or more shareholders.

Answer: TRUE

Diff: 2 Page Ref: 13, 14

Keywords: Corporation, Unlimited Life

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

11) In a sole proprietorship, the owner is personally responsible without limitation for the liabilities incurred.

Answer: TRUE

Diff: 1 Page Ref: 12

Keywords: Sole Proprietorship, Unlimited Liability

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

12) The procedure by which significant changes may be made to a partnership, such as admission of a new partner or termination of the partnership, are governed by each state so no partnership agreement is needed.

Answer: FALSE

Diff: 1 Page Ref: 13

Keywords: Partnership, Partnership Agreement

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

13) In a limited partnership at least one general partner must exist; that general partner has unlimited liability.

Answer: TRUE

Diff: 2 Page Ref: 13

Keywords: Limited Partnership, General Partner, Unlimited Liability

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

14) A limited partnership provides limited liability to

A) all general partners.

B) only limited partners responsible for day to day management of the firm.

C) only to limited partners who do not participate in the management of the business.

D) all partners.

Answer: C

Diff: 1 Page Ref: 13

Keywords: Limited Partnership, Legal Forms of Business

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

15) The sole proprietorship has no legal business structure separate from its owner.

Answer: TRUE

Diff: 1 Page Ref: 14

Keywords: Sole Proprietorship

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

16) Joe is deciding whether or not to invest \$10,000 in a business that has pending lawsuits against it. If Joe invests and the business loses the lawsuits, the most Joe can lose is

A) \$10,000 if Joe is a general partner.

B) \$10,000 if Joe is a sole proprietor.

C) \$10,000 if Joe is a limited partner.

D) \$10,000 plus his share of the lawsuits if Joe is a limited partner.

Answer: C

Diff: 2 Page Ref: 13

Keywords: Limited Partnership, Legal Forms of Business

Learning Obj.: L.O. 1.4

AACSB: Analytical Thinking

17) S-type corporations have all of the following advantages EXCEPT

- A) they are taxed as partnerships.
- B) the owners have limited liability.
- C) distributions are taxed twice, similar to corporate dividend payments.
- D) all owners must be people, no corporations.

Answer: C

Diff: 2 Page Ref: 14

Keywords: S-type Corporations, Legal Forms of Business

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

18) All of the following business organizations provide limited liability to their owners EXCEPT

- A) general partnership.
- B) S-type corporation.
- C) corporation.
- D) limited liability company.

Answer: A

Diff: 2 Page Ref: 13

Keywords: General Partnership, Legal Forms of Business

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

19) Bill, a local inventor, developed a diet pill that he believes will solve the obesity problem in the United States. Bill wants to create a new company, 50% owned by Bill and 50% owned by a major drug company. Although he believes the pills are safe, Bill is concerned about liability if someone becomes sick or dies. The best form of business organization for the new company is

- A) sole proprietorship with Bill as owner and the drug company as creditor.
- B) general partnership with Bill and the drug company as equal partners.
- C) S-type corporation with Bill and the drug company owning equal shares.
- D) limited liability company with Bill and the drug company owning equal shares.

Answer: D

Diff: 2 Page Ref: 14, 15

Keywords: Limited Liability Company, Legal Forms of Business

Learning Obj.: L.O. 1.4

AACSB: Analytical Thinking

20) Which of the following statements about the corporate form of business organization is true?

- A) The corporate form has the disadvantage of double taxation relative to a sole proprietorship.
- B) The corporate form is preferred over the sole proprietorship because a corporation is easier to form and faces less regulation.
- C) Sole proprietorships are the most common form of business organization because liability is limited to the amount invested in the business by the sole proprietor.
- D) The corporate form has the advantage of unlimited liability.

Answer: A

Diff: 2 Page Ref: 12, 13

Keywords: Corporation, Sole Proprietorship

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

21) Limited partnerships are not as prevalent as corporations because

- A) limited partners can lose up to three times the amount they invested in the partnership if the business goes bankrupt.
- B) limited partnerships have the disadvantage of double taxation.
- C) the general partner has no liability, making it difficult for the partnership to borrow money.
- D) it is easier to transfer ownership by selling common stock than it is to sell partnership.

Answer: D

Diff: 3 Page Ref: 13

Keywords: Limited Partnership, Corporation

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

22) Which of the following is an advantage of the sole proprietorship?

- A) limited liability for its owners
- B) double taxation for its owners
- C) no significant legal requirements for starting the business
- D) easily transferred ownership

Answer: C

Diff: 1 Page Ref: 13

Keywords: Sole Proprietorship

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

23) Which of the following is NOT true for a limited partnership?

- A) It has limited liability for its owners.
- B) One general partner must exist who has unlimited liability.
- C) Only the name of general partners can appear in the name of the firm.
- D) Limited partners may sell their interest in the company.

Answer: A

Diff: 2 Page Ref: 13

Keywords: Limited Partnership, General Partner, Limited Partners

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

24) The true owners of the corporation are the

- A) holders of debt issues of the firm.
- B) preferred stockholders.
- C) board of directors of the firm.
- D) common stockholders.

Answer: D

Diff: 2 Page Ref: 13

Keywords: Stockholders, Corporation

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

25) In terms of the costs to organize each, which of the following sequences is correct, moving from highest to lowest cost?

- A) general partnership, sole proprietorship, limited partnership, corporation
- B) sole proprietorship, general partnership, limited partnership, corporation
- C) corporation, limited partnership, general partnership, sole proprietorship
- D) sole proprietorship, general partnership, corporation, limited partnership

Answer: C

Diff: 2 Page Ref: 12, 13

Keywords: Organizational Form

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

26) Which of the following categories of owners enjoy limited liability?

- A) all partners in a limited partnership
- B) common shareholders of a corporation
- C) in a partnership, only the general partners
- D) only B and C above

Answer: B

Diff: 2 Page Ref: 12, 13

Keywords: Limited Liability, Organizational Form

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

27) Which of the following categories of owners have unlimited liability?

- A) general partners in a limited partnership
- B) sole proprietors
- C) shareholders of a corporation
- D) both A and B

Answer: D

Diff: 1 Page Ref: 12, 13, 15

Keywords: Unlimited Liability, Limited Partnership, Sole Proprietorship, Corporation

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

28) Which of the following are characteristics of a limited partnership?

- A) Limited partners may not participate in the management of the limited partnership.
- B) There must be one or more general partners.
- C) General partners have unlimited liability.
- D) All of the above.

Answer: D

Diff: 1 Page Ref: 13

Keywords: Limited Partnership

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

29) Which of the following forms of organizations have earnings that are taxed twice, once as business income and once as personal income as the earnings are distributed to the owners in the form of dividends?

- A) corporations
- B) general partnerships
- C) limited partnerships
- D) both A and C

Answer: A

Diff: 1 Page Ref: 14, 15

Keywords: Double Taxation, Corporation

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

30) Which of the following categories of owners have limited liability?

- A) general partners
- B) sole proprietors
- C) shareholders of a corporation
- D) both A and B

Answer: C

Diff: 1 Page Ref: 13, 15

Keywords: Limited Liability, Organizational Form

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

31) Which of the following forms of business organizations provide limited liability to all its owners?

- A) general partnership
- B) limited partnership
- C) corporation
- D) both B and C

Answer: C

Diff: 2 Page Ref: 13, 15

Keywords: Limited Liability, Organizational Form

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

32) All of the following forms of business organizations provide limited liability to all owners EXCEPT

- A) limited liability company.
- B) S-type corporation.
- C) corporation.
- D) limited partnership.

Answer: D

Diff: 2 Page Ref: 13, 15

Keywords: Organizational Form, Limited Partnership, S-Type Corporation, Limited Liability Company

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

33) Which of the statements below are true?

- A) The sole proprietorship and the general partnership both feature unlimited liability.
- B) A corporation is the business form that is typically the most complicated (legally) to establish.
- C) The corporation and the limited partnership both provide at least some owners with limited liability.
- D) All of the above.

Answer: D

Diff: 1 Page Ref: 13

Keywords: Sole Proprietorship, Legal Forms of Business

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

34) Advantages of the corporate form of business organization include

- A) easier transfer of ownership.
- B) double taxation.
- C) minimal legal requirements.
- D) none of the above.

Answer: A

Diff: 1 Page Ref: 13

Keywords: Corporation, Organizational Form

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

35) Which form of organization is free of initial legal requirements?

- A) sole proprietorship
- B) general partnership
- C) corporation
- D) both A and B

Answer: D

Diff: 2 Page Ref: 13

Keywords: Organizational Form

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

36) Which of the following forms of business organization limits the liability of owners?

- A) sole proprietorship
- B) general partnership
- C) corporation
- D) two person partnership

Answer: C

Diff: 1 Page Ref: 12, 13

Keywords: Organizational Form, Limited Liability, Corporation

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

37) Which of the following forms of business organization has the greatest ability to attract new capital?

- A) sole proprietorship
- B) corporation
- C) general partnership
- D) limited partnership

Answer: B

Diff: 1 Page Ref: 13, 15

Keywords: Corporation, Organizational Form

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

38) Which of the following is NOT considered to be a disadvantage of the sole proprietorship form of business organization?

- A) limited ability to raise capital
- B) life is limited to that of the owner
- C) unlimited liability of business owners
- D) fewer regulations and reporting requirements

Answer: D

Diff: 2 Page Ref: 12, 13

Keywords: Sole Proprietorship, Organizational Form

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

39) Which of the following is an advantage of the general partnership form of business organization?

- A) limited liability of business owners
- B) low cost of formation
- C) easy ability to raise capital
- D) double taxation

Answer: B

Diff: 2 Page Ref: 13

Keywords: Organizational Form, Partnership

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

40) What are the primary differences among a sole proprietorship, a partnership, and a corporation?

Answer: The sole proprietorship is a business operation owned and managed by an individual. Initiating this form of business is simple and generally does not involve any substantial organizational costs. The proprietor has complete control of the firm but must be willing to assume full responsibility for its outcomes.

The general partnership, which is simply a coming together of two or more individuals, is similar to the sole proprietorship. The limited partnership is another form of partnership sanctioned by states to permit all but one of the partners to have limited liability if this is agreeable to all partners.

The corporation increases the flow of capital from public investors to the business community. Although larger organizational costs and regulations are imposed on this legal entity, the corporation is more conducive to raising large amounts of capital. Limited liability, continuity of life, and ease of transfer in ownership, which increase the marketability of the investment, have contributed greatly in attracting large numbers of investors to the corporate environment. The formal control of the corporation is vested in the parties who own the greatest number of shares. However, day-to-day operations are managed by the corporate officers, who theoretically serve on behalf of the firm's stockholders.

Diff: 2 Page Ref: 12, 13, 15

Keywords: Organizational Form

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

41) Explain why large and growing firms tend to choose the corporate form.

Answer: The advantages of the corporation begin to dominate as the firm grows and needs access to the capital markets to raise funds. Because of the limited liability, the ease of transferring ownership through the sale of common shares, and the flexibility in dividing the shares, the corporation is the ideal business entity in terms of attracting new capital.

Diff: 2 Page Ref: 13, 15

Keywords: Corporation, Advantages of Corporate Form

Learning Obj.: L.O. 1.4

AACSB: Reflective Thinking

Learning Objective 1.5

1) Due to unstable world markets, most large U.S. corporations do almost all of their business in the United States.

Answer: FALSE

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Keywords: Multinational Firm

Learning Obj.: L.O. 1.5

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2) Even though many U.S. companies, including General Electric, IBM, Walt Disney, and American Express, have successfully restructured their operations to expand internationally, not many foreign firms have made their mark in the United States.

Answer: FALSE

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Keywords: Multinationals

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3) In the search for profits, U.S. corporations have been forced to look beyond our country's borders. All of the following contributed to the movement EXCEPT

A) trade protectionism.

B) collapse of communism.

C) acceptance of the free market system in Third World countries.

D) information technology revolution.

Answer: A

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Keywords: Multinationals

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4) What has brought on the era of the multinational corporation?

Answer: In the search for profits, U.S. corporations have been forced to look beyond our country's borders. This movement was spurred on by the collapse of communism and the acceptance of the free market system in Third World countries. All this has taken place at a time when information technology has experienced a revolution brought on by the personal computer and the Internet. Concurrently, the United States went through an unprecedented period of deregulation of industries. These changes resulted in the opening of new international markets, and U.S. firms experienced a period of price competition here at home that made it imperative that businesses look across borders for investment opportunities.

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Keywords: Multinationals

Learning Obj.: L.O. 1.5

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5) Has looking beyond U.S. borders been a profitable experience for U.S. corporations?

Answer: Many U.S. companies, including General Electric, IBM, Walt Disney, and American Express, have restructured their operations to expand internationally. The bottom line is that what you think of as a U.S. firm may be much more of a multinational firm than you would expect. For example, Coca-Cola earns around 60 percent of its profits from overseas sales, and this is not uncommon for numerous U.S. firms.

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Keywords: Multinationals

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