Chapter 1—An Overview of Managerial Finance

TRUE/FALSE

1. In general, the role of the financial manager is to plan for the acquisition and use of funds so as to maximize the value of the firm.

   ANS: T PTS: 1 DIF: Easy TOP: Financial manager

2. 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.

   ANS: F PTS: 1 DIF: Easy TOP: Financial manager

3. 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.

   ANS: T PTS: 1 DIF: Easy TOP: Proprietorship

4. 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.

   ANS: F PTS: 1 DIF: Easy TOP: Hostile takeover

5. No firm can take cost-increasing, socially responsible actions in a competitive marketplace and expect to continue to compete, even if those cost-increasing actions yield significant benefits to the firm.

   ANS: F PTS: 1 DIF: Easy TOP: Social responsibility

6. 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.

   ANS: F PTS: 1 DIF: Easy TOP: Goal of firm

7. 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.

   ANS: F PTS: 1 DIF: Easy TOP: Objectives of firm

8. The riskiness inherent in a firm's earnings per share (EPS) depends on both the types of projects the firm takes on and the manner in which the projects are financed.

   ANS: T PTS: 1 DIF: Easy TOP: Risk and earnings

9. Cultural differences do not impact the multinational corporations as they expand into different geographic regions.

   ANS: F PTS: 1 DIF: Easy TOP: Multinational corporations

10. Normal profits are those that result in rates of return that are just sufficient to attract new capital in financial markets.

ANS: T PTS: 1 DIF: Easy TOP: Normal profits

11. 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.

ANS: T PTS: 1 DIF: Easy TOP: Social welfare and finance

12. 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.

ANS: F PTS: 1 DIF: Easy TOP: Business ethics

13. 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.

ANS: T PTS: 1 DIF: Easy TOP: Exchange rate risk

14. A financial manager's task is to make decisions concerning the acquisition and use of funds for the greatest benefit of the firm.

ANS: T PTS: 1 DIF: Easy TOP: Financial management

15. Incentive compensation plans are used to attract and retain top managerial talent as well as to align the interests of management with shareholders.

ANS: T PTS: 1 DIF: Easy TOP: Managerial incentives

16. The finance function is relatively independent of most other corporate functions. Marketing decisions, for example, might affect the firm's need for funds but are not affected by conditions in financial markets or other financing issues.

ANS: F PTS: 1 DIF: Medium TOP: Financial management

17. In a competitive marketplace, if managers deviate too far from making decisions that are consistent with stockholder wealth maximization, they risk being disciplined by the market. Part of this discipline involves the threat of being taken over by groups who are more aligned with stockholder interests.

ANS: T PTS: 1 DIF: Medium TOP: Managerial incentives

18. 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.

ANS: F PTS: 1 DIF: Medium TOP: Partnership

19. The term multinational corporation is used to describe a firm that operates in two more countries.

ANS: T PTS: 1 DIF: Medium TOP: Multinational corporations

20. Nations do not have the sovereignty to expropriate the assets of a firm without compensation.

ANS: F PTS: 1 DIF: Medium TOP: Political risk

21. Having the manager's compensation tied to the company's performance increases the agency problem that corporations face.

ANS: F PTS: 1 DIF: Medium TOP: Agency problem

22. Managers of firms using accounting manipulations to inflate current earnings are likely to generate long-term benefits to the shareholders of the firm.

ANS: F PTS: 1 DIF: Medium TOP: Business ethics

23. 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.

ANS: F PTS: 1 DIF: Medium TOP: Proprietorship

24. 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.

ANS: T PTS: 1 DIF: Medium
TOP: Corporate charter and bylaws

25. Industrial groups are organizations comprised of companies in different industries with common ownership interests, which include firms necessary to sell and manufacture products.

ANS: T PTS: 1 DIF: Medium TOP: Foreign forms of business

MULTIPLE CHOICE

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

ANS: D PTS: 1 DIF: Easy OBJ: TYPE: Conceptual
TOP: Goal of firm

2. Which of the following mechanisms is not used by shareholders to get managers to act in shareholder's best interests?
   a. Threat of firing
   b. Managerial compensation.
   c. Golden parachute.
   d. Threat of takeover.
   e. Answers b and c above.

ANS: C PTS: 1 DIF: Easy OBJ: TYPE: Conceptual
TOP: Managerial incentives

3. Which of the following is a reason why companies move into international operations?
   a. To take advantage of lower production costs in regions of inexpensive labor.
   b. To develop new markets for their finished products.
   c. To better serve their primary customers.
   d. Because important raw materials are located abroad.
   e. All of the above.

   ANS: E PTS: 1 DIF: Easy OBJ: TYPE: Conceptual
   TOP: International operations motivation

4. Which of the following should be the *primary* goal pursued by the financial manager of a firm?
   a. Maximize net income (profits).
   b. Maximize the firm's net worth, or book value.
   c. Maximize dividends paid to common stockholders.
   d. Minimize variable operating expenses.
   e. Maximize the market value of the firm's stock.

   ANS: E PTS: 1 DIF: Easy OBJ: TYPE: Conceptual
   TOP: Agency costs

5. 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. a partnership has more owners than a proprietorship.
   b. the combined personal liability associated with a partnership is significantly less than the combined personal liability associated with a proprietorship.
   c. a partnership generally is easier to form than a proprietorship.
   d. the annual growth rate of a proprietorship is limited by law, whereas the growth rate of a partnership is always potentially unlimited.
   e. there are many more businesses that are formed as partnerships than proprietorships.

   ANS: A PTS: 1 DIF: Easy OBJ: TYPE: Conceptual
   TOP: Firm organization

6. The *primary* goal of a financial manager should be to ____.
   a. minimize operating costs
   b. minimize interest payments
   c. minimize tax payments
   d. maximize operating income each year
   e. maximize the value of the firm's stock

   ANS: E PTS: 1 DIF: Easy OBJ: TYPE: Conceptual
   TOP: Goal of firm

7. Which of the following statements is correct?
   a. Given the multi-owner nature of most large corporations, agency costs associated with perquisite consumption are not really a problem.
   b. 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.
   c. Shareholder agency costs include the opportunity costs associated with constraining managerial freedom but do not include managerial salaries.
   d. An agency relationship exists when one or more persons hire another person to perform some service but *withhold decision-making authority from that person*.
   e. All of the above statements are false.

ANS: C PTS: 1 DIF: Medium OBJ: TYPE: Conceptual
TOP: Agency costs

8. Which of the following is an example of an area of business where use of "questionable" ethics is considered a necessity?
   a. Attracting and sustaining new customers.
   b. Hiring and keeping skilled employees.
   c. Keeping up with competition.
   d. Dealing with firms who use "questionable" ethics.
   e. None of the above.

ANS: E PTS: 1 DIF: Medium OBJ: TYPE: Conceptual
TOP: Business ethics

9. Which of the following actions is consistent with social responsibility but is necessarily inconsistent with stockholder wealth maximization?
   a. Investing in a smokestack "scrubber" to reduce the firm's air pollution as mandated by law.
   b. 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.
   c. 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.
   d. 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.
   e. Each of the above actions is consistent with social responsibility and none are necessarily inconsistent with stockholder wealth maximization.

ANS: E PTS: 1 DIF: Medium OBJ: TYPE: Conceptual
TOP: Social responsibility

10. Which of the following statements is correct?
   a. The *corporate bylaws* are the set of rules drawn up by the state to enable managers to run the firm in accordance with state laws.
   b. Procedures for electing corporate directors are contained in *bylaws* while the declaration of the activities that the firm will pursue and the number of directors are included in the *corporate charter*.
   c. Procedures which govern changes in the *bylaws* of the corporation are contained in the corporate *charter*.
   d. Although most companies design a *charter*, only the *bylaws* are legally required to be filed with the secretary of state in order for a corporation to be in official existence.

ANS: B PTS: 1 DIF: Medium OBJ: TYPE: Conceptual
TOP: Corporate charter and bylaws

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

ANS: D PTS: 1 DIF: Medium OBJ: TYPE: Conceptual
TOP: Corporate form

12. Which of the following statements is correct?
   a. In a partnership, liability for other partners' misdeeds includes but is limited to the amount a particular partner has invested in the business.
   b. 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.
   c. A fast growth company would be more likely to set up a partnership for its business organization than would a slow-growth company.
   d. Partnerships have difficulty attracting capital in part because of the other disadvantages of the partnership form of business, including impermanence of the organization.
   e. A major disadvantage of a partnership as a form of business organization is the high cost and practical difficulty of its formation.

ANS: D PTS: 1 DIF: Medium OBJ: TYPE: Conceptual
TOP: Partnership

13. Which of the following statements is correct?
   a. 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.
   b. 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.
   c. 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.
   d. 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.
   e. 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.

ANS: C PTS: 1 DIF: Medium OBJ: TYPE: Conceptual
TOP: Firm organization

14. Which of the following statements is correct?
   a. The optimal dividend policy is the one that satisfies the shareholders because they supply the firm's capital.
   b. The use of debt financing has no effect on earnings per share (EPS) or stock price.
   c. The riskiness of projected EPS depends upon how the firm is financed.
   d. Stock price is dependent on the projected EPS and the use of debt but not on the timing of the earnings stream.
   e. Dividend policy is one aspect of the firm's financial policy that is determined directly by the shareholders.

ANS: C PTS: 1 DIF: Medium OBJ: TYPE: Conceptual
TOP: Financial policy and earnings

15. Which of the following statements about the corporate form of business organization is *incorrect*?
   a. The corporation is the easiest form of business organization to establish.
   b. In the United States, corporations generate a significantly greater percentage of total annual sales than either partnerships or proprietorships.
   c. Corporations generally are larger than either partnerships or proprietorships.
   d. One of the most important features of the corporate form of business organization is that

stockholders have limited liability.
e. None of the above.

ANS: A PTS: 1 DIF: Medium OBJ: TYPE: Conceptual
TOP: Firm organization

16. Which of the following statements is *incorrect*?
   a. Large European firms generally have many more individual owners than large U.S. firms.
   b. One reason domestic firms "go global" is to sell products in new markets.
   c. Often firms can avoid regulatory hurdles that apply to foreign manufacturers by establishing operations in the country where the hurdles apply.
   d. A difficulty associated with doing business in international markets is that not all countries have the same currency.
   e. Cultural differences among countries make it difficult for a multinational firm to use the same marketing strategy—that is, packaging, advertising, and so forth—in every country in which it operates.

ANS: A PTS: 1 DIF: Medium OBJ: TYPE: Conceptual
TOP: Multinational managerial finance

17. 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 ____.
   a. corporation; corporation
   b. corporation; proprietorship
   c. proprietorship; partnership
   d. proprietorship; corporation
   e. corporation; partnership

ANS: D PTS: 1 DIF: Medium OBJ: TYPE: Conceptual
TOP: Firm organization

18. Which of the following statements is *correct*?
   a. Other things held constant, it is generally safer to invest money in a proprietorship than in a corporation.
   b. 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.
   c. 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.
   d. According to the text, "agency problems" tend to *increase* when managers own larger relative amounts of the company's stock.
   e. 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).

ANS: E PTS: 1 DIF: Medium OBJ: TYPE: Conceptual
TOP: Corporate form

19. 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 ____.
   a. an agency problem.

b. an accounting glitch.
c. an appropriate use of the tax laws.
d. an appropriate action, because executive compensation should always be increased substantially each year.
e. 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.

ANS: A PTS: 1 DIF: Medium OBJ: TYPE: Conceptual
TOP: Agency costs

20. Compared to corporations, what is the *primary disadvantage* of partnerships as forms of business organizations?
a. The tax rates applied to partnership are higher than the tax rates applied to corporations.
b. 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.
c. Partnerships generally are much easier to form (start up) than corporations.
d. Partnerships have unlimited lives whereas corporations do not.
e. 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.

ANS: E PTS: 1 DIF: Medium OBJ: TYPE: Conceptual
TOP: Partnership

21. All else equal, in which of the following forms of business would the possibility of an agency problem be the *greatest*?
a. An U.S. corporation that is publicly traded.
b. A proprietorship.
c. A partnership in which all the partners share management and decision-making responsibilities equally.
d. A foreign corporation with concentrated ownership—that is, relatively few owners.

ANS: A PTS: 1 DIF: Medium OBJ: TYPE: Conceptual
TOP: Agency costs

22. All of the following are external factors that influence the stock prices of the firm except
a. legal constraints
b. capital structure
c. tax laws
d. general level of economic activity
e. conditions in the stock market

ANS: B PTS: 1 DIF: Medium OBJ: TYPE: Conceptual
TOP: Miscellaneous concepts

23. Management may expropriate wealth from bondholders to shareholders through which of the following actions:
a. take on new ventures with much greater risk than was anticipated by creditors.
b. take on more debt to increase the returns to shareholders.
c. issue more stock than was anticipated by creditors.
d. answers a and b are correct.
e. answers b and c are correct.

ANS: A PTS: 1 DIF: Medium OBJ: TYPE: Conceptual
TOP: Managerial incentives

24. Which of the following statements concerning "agency problems" is *most* correct?
   a. 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.
   b. One method of controlling agency problems is to engage in the taking of "poison pills."
   c. 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.
   d. 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.
   e. None of the above is a correct statement.

   ANS: C PTS: 1 DIF: Tough OBJ: TYPE: Conceptual
   TOP: Agency costs

25. Which of the following statements concerning a firm's quest to maximize wealth is correct?
   a. In extremely competitive industries, we would expect firms would voluntarily engage in many socially beneficial projects to try to maximize their stocks' values.
   b. Actions that maximize a firm's stock price are inconsistent with maximizing social welfare.
   c. The concepts of social responsibility and ethical responsibility on the part of corporations are completely different and neither is relevant in maximizing stock price.
   d. In a competitive market, if a group of firms 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.
   e. If government did not mandate socially responsible corporate actions, such as those relating to product safety and fair hiring practices, most firms in competitive markets probably would not pursue such policies voluntarily.

   ANS: E PTS: 1 DIF: Tough OBJ: TYPE: Conceptual
   TOP: Social responsibility

26. The 11 "titles" in the Sarbanes-Oxley Act of 2002 establish standards for accountability and responsibility of financial reporting information for major corporations. Which of the following activities does the act *not* provide rules that a corporation must abide by?
   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.

   ANS: C PTS: 1 DIF: Tough OBJ: TYPE: Conceptual
   TOP: Business ethics