Chapter 1: An Overview of Financial Management

Note that there is an overlap between the T/F and multiple-choice questions, as some of the T/F statements are used in multiple-choice questions.

Multiple Choice: True/False

1. In most corporations, the CFO ranks under the CEO.
   a. True
   b. False

   ANSWER: True

2. The Chairman of the Board must also be the CEO.
   a. True
   b. False

   ANSWER: False

3. The board of directors is the highest ranking body in a corporation, and the chairman of the board is the highest ranking individual. The CEO generally works under the board and its chairman, and the board generally has the authority to remove the CEO under certain conditions. The CEO, however, cannot remove the board, but he or she can endeavor to have the board voted out and a new board voted in should a conflict arise. It is possible for a person to simultaneously serve as CEO and chairman of the board, though many corporate control experts believe it is bad to vest both offices in the same person.
   a. True
   b. False

   ANSWER: True

4. Partnerships and proprietorships generally have a tax advantage over corporations.
   a. True
   b. False

   ANSWER: True

5. A disadvantage of the corporate form of organization is that corporate stockholders are more exposed to personal liabilities in the event of bankruptcy than are investors in a typical partnership.
   a. True
   b. False

   ANSWER: False

6. An advantage of the corporate form of organization is that corporations are generally less highly regulated than proprietorships and partnerships.
   a. True
   b. False

   ANSWER: False

7. Some partners in a partnership may have different rights, privileges, and responsibilities than other partners.
   a. True
   b. False

   ANSWER: True

8. One advantage of the corporate form of organization is that it avoids double taxation.
   a. True
   b. False

   ANSWER: False

9. It is generally harder to transfer one's ownership interest in a partnership than in a corporation.
   a. True
   b. False

   ANSWER: True

10. One danger of starting a proprietorship is that you may be exposed to personal liability if the business goes bankrupt. This problem would be avoided if you formed a corporation to operate the business.
    a. True
    b. False

    ANSWER: True

11. If a corporation elects to be taxed as an S corporation, then it can avoid the corporate tax. However, its stockholders will have to pay personal taxes on the firm's net income.
    a. True
    b. False

    ANSWER: True

12. If a corporation elects to be taxed as an S corporation, then both it and its stockholders can avoid all Federal taxes. This provision was put into the Federal Tax Code in order to encourage the formation of small businesses.
    a. True
    b. False

    ANSWER: False

13. It is generally less expensive to form a corporation than a proprietorship because, with a proprietorship, extensive legal documents are required.
    a. True
    b. False

    ANSWER: False

14. The more capital a firm is likely to require, the greater the probability that it will be organized as a corporation.
    a. True
    b. False

    ANSWER: True

15. One disadvantage of forming a corporation rather than a partnership is that this makes it more difficult for the firm's investors to transfer their ownership interests.
    a. True
    b. False

    ANSWER: False

16. Organizing as a corporation makes it easier for the firm to raise capital. This is because corporations' stockholders are not subject to personal liabilities if the firm goes bankrupt and also because it is easier to transfer shares of stock than partnership interests.
    a. True
    b. False

    ANSWER: True

17. In order to maximize its shareholders' value, a firm's management must attempt to maximize the stock price in the long run, or the stock's "intrinsic value."
    a. True
    b. False

    ANSWER: True

18. If management operates in a manner designed to maximize the firm's expected profits for the current year, this will also maximize the stockholders' wealth as of the current year.
    a. True
    b. False

    ANSWER: False

19. In order to maximize its shareholders' value, a firm's management must attempt to maximize the expected EPS.
    a. True
    b. False

    ANSWER: False

20. In order to maximize its shareholders' value, a firm's management must attempt to maximize the stock price on a specific target date.
    a. True
    b. False

    ANSWER: False

21. As a result of financial scandals occurring during the past decade, there has been a strong push to improve business ethics.
    a. True
    b. False

    ANSWER: True

22. There are many types of unethical business behavior. One example is where executives provide information that they know is incorrect to banks and to stockholders. It is illegal to provide such information to banks, but it is not illegal to provide it to stockholders because they are the owners of the firm, not outsiders.
    a. True
    b. False

    ANSWER: False

23. A stock's market price would equal its intrinsic value if all investors had all the information that is available about the stock. In this case the stock's market price would equal its intrinsic value.
    a. True
    b. False

    ANSWER: True

24. If a stock's market price is above its intrinsic value, then the stock can be thought of as being undervalued, and it would be a good buy.
    a. True
    b. False

    ANSWER: False

25. If a stock's intrinsic value is greater than its market price, then the stock is overvalued and should be sold.
    a. True
    b. False

    ANSWER: False

26. For a stock to be in equilibrium as the book defines it, its market price should exceed its intrinsic value.
    a. True
    b. False

    ANSWER: False

27. The term "marginal investor" means an investor who is active in the market and would tend to buy a stock if its price fell and sell it if it rose, barring any new information coming out about the stock. It is the "marginal investor" who determines the actual stock price.
    a. True
    b. False

    ANSWER: True

28. Managers always attempt to maximize the long-run value of their firms' stocks, or the stocks' intrinsic values. This is exactly what stockholders desire. Thus, conflicts between stockholders and managers are not possible.
    a. True
    b. False

    ANSWER: False

29. A hostile takeover is said to occur when another corporation or group of investors gains voting control over a firm and replaces the old managers. If the old managers were managing the firm inefficiently, then hostile takeovers can improve the economy. However, hostile takeovers are controversial, and legislative actions have been taken to make them more difficult to undertake.
   a. True
   b. False

   ANSWER: True

30. If a lower level person in a firm does something illegal, like "cooking the books," to understate costs and thereby increase profits above the correct profits <u>because he or she was told to do so by a superior</u>, the lower level person cannot be prosecuted but the superior can be prosecuted.
   a. True
   b. False

   ANSWER: False

31. If someone deliberately understates costs and thereby increases profits, this can cause the stock price to rise above its intrinsic value. The stock price will probably fall in the future. Also, those who participated in the fraud can be prosecuted, and the firm itself can be penalized.
   a. True
   b. False

   ANSWER: True

32. If a firm's board of directors wants to maximize value for its stockholders in general (as opposed to some specific stockholders), it should design an executive compensation system whose focus is on the firm's long-term value.
   a. True
   b. False

   ANSWER: True

Multiple Choice: Conceptual

Please note that some of the answer choices, or answers that are very close, are used in different questions. This has caused us no difficulties, but please take this into account when you make up exams.

33. Which of the following statements is CORRECT?
   a. One of the disadvantages of incorporating your business is that you could become subject to the firm's liabilities in the event of bankruptcy.
   b. Proprietorships are subject to more regulations than corporations.
   c. In any partnership, every partner has the same rights, privileges, and liability exposure as every other partner.
   d. Corporations of all types are subject to the corporate income tax.
   e. Proprietorships and partnerships generally have a tax advantage over corporations.

   ANSWER: e

   RATIONALE: Some corporations (S corporations) are able to avoid the corporate income tax. Proprietorships and partnerships pay personal income tax, but they avoid the corporate income tax.

34. Which of the following statements is CORRECT?
    a. One of the advantages of the corporate form of organization is that it avoids double taxation.
    b. It is easier to transfer one's ownership interest in a partnership than in a corporation.
    c. One of the disadvantages of a proprietorship is that the proprietor is exposed to unlimited liability.
    d. One of the advantages of a corporation from a social standpoint is that every stockholder has equal voting rights, i.e., "one person, one vote."
    e. Corporations of all types are subject to the corporate income tax.

    ANSWER: c

35. Which of the following statements is CORRECT?
    a. One advantage of forming a corporation is that equity investors are usually exposed to less liability than they would be in a partnership.
    b. Corporations face fewer regulations than proprietorships.
    c. One disadvantage of operating a business as a proprietor is that the firm is subject to double taxation, because taxes are levied at both the firm level and the owner level.
    d. It is generally less expensive to form a corporation than a proprietorship because, with a proprietorship, extensive legal documents are required.
    e. If a partnership goes bankrupt, each partner is exposed to liabilities only up to the amount of his or her investment in the business.

    ANSWER: a

    RATIONALE: Corporations have limited liability; however, they face more regulations than the other forms of organization. Proprietorships do not pay corporate taxes.

36. Relaxant Inc. operates as a partnership. Now the partners have decided to convert the business into a corporation. Which of the following statements is CORRECT?
    a. Relaxant's shareholders (the ex-partners) will now be exposed to less liability.
    b. The company will probably be subject to fewer regulations and required disclosures.
    c. Assuming the firm is profitable, none of its income will be subject to federal income taxes.
    d. The firm's investors will be exposed to less liability, but they will find it more difficult to transfer their ownership.
    e. The firm will find it more difficult to raise additional capital to support its growth.

    ANSWER: a

37. Which of the following statements is CORRECT?
   a. Corporations generally face fewer regulations than proprietorships.
   b. Corporate shareholders are exposed to unlimited liability.
   c. It is usually easier to transfer ownership in a corporation than in a partnership.
   d. Corporate shareholders are exposed to unlimited liability, but this factor is offset by the tax advantages of incorporation.
   e. There is a tax disadvantage to incorporation, and there is no way any corporation can escape this disadvantage, even if it is very small.

ANSWER: c

RATIONALE: If ownership in a proprietorship or partnership is transferred, the basic documents under which the firm operates must be rewritten, whereas for a corporation the seller simply sells shares to a buyer.

38. Which of the following could explain why a business might choose to operate as a corporation rather than as a proprietorship or a partnership?
   a. Corporations generally face fewer regulations.
   b. Less of a corporation's income is generally subject to federal taxes.
   c. Corporate shareholders are exposed to unlimited liability, but this factor is offset by the tax advantages of incorporation.
   d. Corporate investors are exposed to unlimited liability.
   e. Corporations generally find it easier to raise large amounts of capital.

ANSWER: e

RATIONALE: Outsiders thinking about investing in a business are generally not willing to be subjected to unlimited liability, and they also want to be able to sell their shares should they choose to do so. Corporations provide these advantages; hence, firms that need large amounts of capital that must be raised in capital markets generally choose to incorporate.

39. The primary operating goal of a publicly-owned firm interested in serving its stockholders should be to
   a. Maximize its expected total corporate income.
   b. Maximize its expected EPS.
   c. Minimize the chances of losses.
   d. Maximize the stock price per share over the long run, which is the stock's intrinsic value.
   e. Maximize the stock price on a specific target date.

ANSWER: d

RATIONALE: The primary operating goal should be to maximize the long-run stock price, or the intrinsic value.

40. Which of the following statements is CORRECT?
    a. In most corporations, the CFO ranks above the CEO.
    b. By law in most states, the chairman of the board must also be the CEO.
    c. The board of directors is the highest ranking body in a corporation, and the chairman of the board is the highest ranking individual. The CEO generally works under the board and its chairman, and the board generally has the authority to remove the CEO under certain conditions. The CEO, however, cannot remove the board, but he or she can endeavor to have the board voted out and a new board voted in should a conflict arise. It is possible for a person to simultaneously serve as CEO and chairman of the board, though many corporate control experts believe it is bad to vest both offices in the same person.
    d. The CFO generally reports to the firm's chief accounting officer, who is normally the controller.
    e. The CFO is responsible for raising capital and for making sure that capital expenditures are desirable, but he or she is not responsible for the validity of the financial statements, as the controller and the auditors have that responsibility.

    ANSWER: c

41. Which of the following statements is CORRECT?
    a. One drawback of forming a corporation is that it generally subjects the firm to additional regulations.
    b. One drawback of forming a corporation is that it subjects the firm's investors to increased personal liabilities.
    c. One drawback of forming a corporation is that it makes it more difficult for the firm to raise capital.
    d. One advantage of forming a corporation is that it subjects the firm's investors to fewer taxes.
    e. One disadvantage of forming a corporation is that it is more difficult for the firm's investors to transfer their ownership interests.

    ANSWER: a

    RATIONALE: Corporations have to do more reporting to state and federal agencies than other businesses.

42. Which of the following statements is CORRECT?
    a. If a corporation elects to be taxed as an S corporation, then both it and its stockholders can avoid all Federal taxes. This provision was put into the Federal Tax Code in order to encourage the formation of small businesses.
    b. The more capital a firm is likely to require, the smaller the probability that it will be organized as a corporation.
    c. It is generally easier to transfer one's ownership interest in a partnership than in a corporation.
    d. One danger of starting a proprietorship is that you may be exposed to personal liability if the business goes bankrupt. This problem would be avoided if you formed a corporation to operate the business.
    e. Corporate shareholders are exposed to unlimited liability, but this factor is offset by the tax advantages of incorporation.

    ANSWER: d

43. Which of the following statements is CORRECT?
    a. Due to limited liability, unlimited lives, and ease of ownership transfer, the vast majority of U.S. businesses (in terms of number of businesses) are organized as corporations.
    b. Most businesses (by number and total dollar sales) are organized as proprietorships or partnerships because it is easier to set up and operate one of these forms rather than as a corporation. However, if the business gets very large, it becomes advantageous to convert to a corporation, primarily because corporations have important tax advantages over proprietorships and partnerships.
    c. Due to legal considerations related to ownership transfers and limited liability, which affect the ability to attract capital, most business (measured by dollar sales) is conducted by corporations in spite of large corporations' less favorable tax treatment.
    d. Large corporations are taxed more favorably than proprietorships.
    e. Corporate stockholders are exposed to unlimited liability.

    ANSWER: c

44. Which of the following statements is CORRECT?
    a. A hostile takeover is the main method of transferring ownership interest in a corporation.
    b. A corporation is a legal entity created by a state, and it has a life and existence that is separate from the lives and existence of its owners and managers.
    c. Unlimited liability and limited life are two key advantages of the corporate form over other forms of business organization.
    d. Limited liability is an advantage of the corporate form of organization to its owners (stockholders), but corporations have more trouble raising money in financial markets because of the complexity of this form of organization.
    e. Although the 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, i.e., bondholders can sue the firm's managers if the firm defaults on its debt.

    ANSWER: b

45. Which of the following statements is CORRECT?
    a. In a typical partnership, liability for other partners' misdeeds is limited to the amount of a particular partner's investment in the business.
    b. In a limited partnership, the limited partners have voting control, while the general partner has operating control over the business, and the limited partners are individually responsible, on a pro rata basis, for the firm's debts in the event of bankruptcy.
    c. A slow-growth company, with little need for new capital, would be more likely to organize as a corporation than would a faster growing company.
    d. Partnerships have more difficulty attracting large amounts of capital than corporations because of such factors as unlimited liability, the need to reorganize when a partner dies, and the illiquidity (difficulty buying and selling) of partnership interests.
    e. A major disadvantage of a partnership relative to a corporation is the fact that federal income taxes must be paid by the partners rather than by the firm itself.

    ANSWER: d

46. The primary operating goal of a publicly-owned firm trying to best serve its stockholders should be to
    a. Maximize managers' own interests, which are by definition consistent with maximizing shareholders' wealth.
    b. Maximize the firm's expected EPS, which must also maximize the firm's price per share.
    c. Minimize the firm's risks because most stockholders dislike risk. In turn, this will maximize the firm's stock price.
    d. Use a well-structured managerial compensation package to reduce conflicts that may exist between stockholders and managers.
    e. Since it is impossible to measure a stock's intrinsic value, the text states that it is better for managers to attempt to maximize the current stock price than its intrinsic value.

    ANSWER: d

47. Which of the following actions would be most likely to <u>reduce</u> potential conflicts of interest between stockholders and managers?
    a. Pay managers large cash salaries and give them no stock options.
    b. Change the corporation's formal documents to make it easier for outside investors to acquire a controlling interest in the firm through a hostile takeover.
    c. Beef up the restrictive covenants in the firm's debt agreements.
    d. Eliminate a requirement that members of the board of directors must hold a high percentage of their personal wealth in the firm's stock.
    e. For a firm that compensates managers with stock options, reduce the time before options are vested, i.e., the time before options can be exercised and the shares that are received can be sold.

    ANSWER: b

    RATIONALE: Corporate takeovers are most likely to occur when a firm is underperforming. Managers who fear losing their jobs will try to maximize shareholder wealth.

48. Which of the following actions would be likely to <u>reduce</u> potential conflicts of interest between stockholders and managers?
    a. Congress passes a law that severely restricts hostile takeovers.
    b. A firm's compensation system is changed so that managers receive larger cash salaries but fewer long-term options to buy stock.
    c. The company changes the way executive stock options are handled, with all options vesting after 2 years rather than having 20% of the options awarded vest every 2 years over a 10-year period.
    d. The company's outside auditing firm is given a lucrative year-by-year consulting contract with the company.
    e. The composition of the board of directors is changed from all inside directors to all outside directors, and the directors are compensated with stock rather than cash.

    ANSWER: e

49. Which of the following mechanisms would be most likely to help <u>motivate</u> managers to act in the best interests of shareholders?
    a. Decrease the use of restrictive covenants in bond agreements.
    b. Take actions that reduce the possibility of a hostile takeover.
    c. Elect a board of directors that allows managers greater freedom of action.
    d. Increase the proportion of executive compensation that comes from stock options and reduce the proportion that is paid as cash salaries.
    e. Eliminate a requirement that members of the board of directors have a substantial investment in the firm's stock.

    ANSWER: d

50. Which of the following actions would be likely to <u>encourage</u> a firm's managers to make decisions that are in the best interests of shareholders?
    a. The percentage of executive compensation that comes in the form of cash is increased and the percentage coming from long-term stock options is reduced.
    b. The state legislature passes a law that makes it more difficult to successfully complete a hostile takeover.
    c. The percentage of the firm's stock that is held by institutional investors such as mutual funds, pension funds, and hedge funds rather than by small individual investors rises from 10% to 80%.
    d. The firm's founder, who is also president and chairman of the board, sells 90% of her shares.
    e. The firm's board of directors gives the firm's managers greater freedom to take whatever actions they think best without obtaining board approval.

    ANSWER: c

    RATIONALE: Small stockholders have little clout with management, while large institutional investors are better able to force managers to operate in stockholders' interests.

51. Which of the following actions would be most likely to <u>reduce</u> potential conflicts of interest between stockholders and bondholders?
    a. Compensating managers with stock options.
    b. Financing risky projects with additional debt.
    c. The threat of hostile takeovers.
    d. The use of covenants in bond agreements that limit the firm's use of additional debt and constrain managers' actions.
    e. Abolishing the Security and Exchange Commission.

    ANSWER: d

    RATIONALE: Stock options and the threat of takeovers reduce conflicts between managers and shareholders. Financing risky projects with additional debt increases the potential for conflicts between stockholders and bondholders. Adding covenants to bond agreements will reduce conflicts between stockholders and bondholders.

52. Which of the following actions would be most likely to reduce potential conflicts between stockholders and bondholders?
    a. Including restrictive covenants in the company’s bond indenture (which is the contract between the company and its bondholders).
    b. Compensating managers with more stock options and less cash income.
    c. The passage of laws that make it harder for hostile takeovers to succeed.
    d. A government regulation that banned the use of convertible bonds.
    e. The firm begins to use only long-term debt, e.g., debt that matures in 30 years or more, rather than debt that matures in less than one year.

    ANSWER: a

53. Which of the following statements is CORRECT?
    a. If a lower level person in a firm does something illegal, like “cooking the books,” to understate costs and thereby artificially increase profits because he or she was ordered to do so by a superior, the lower level person cannot be prosecuted but the superior can be prosecuted.
    b. There are many types of unethical business behavior. One example is where executives provide information that they know is incorrect to outsiders. It is illegal to provide such information to federally regulated banks, but it is not illegal to provide it to stockholders because they are the owners of the firm.
    c. If someone deliberately understates costs and thereby causes reported profits to increase, this can cause the stock price to rise above its intrinsic value. The stock will probably fall in the future. Both those who participated in the fraud and the firm itself can be prosecuted.
    d. Ethical behavior is not influenced by training and auditing procedures. People are either ethical or they are not, and this is what determines ethical behavior in business.
    e. Ethics is not an important consideration in business and in business schools.

    ANSWER: c

54. With which of the following statements would most people in business agree?
    a. A corporation’s short-run profits will almost always increase if the firm takes actions that the government has determined are in the best interests of the nation.
    b. Firms and government agencies almost always agree with one another regarding the restrictions that should be placed on hiring and firing employees.
    c. “Whistle blowers,” because of the courage it takes to blow the whistle, are generally promoted more rapidly than other employees.
    d. It is not useful for large corporations to develop a formal set of rules defining ethical and unethical behavior.
    e. Although people’s moral characters are probably developed before they are admitted to a business school, it is still useful for business schools to cover ethics, if only to give students an idea about the adverse consequences of unethical behavior to themselves, their firms, and the nation.

    ANSWER: e

55. Which of the following statements is CORRECT?
    a. One of the ways in which firms can mitigate or reduce potential conflicts between bondholders and stockholders is by increasing the amount of debt in the firm's capital structure.
    b. The threat of takeover generally increases potential conflicts between stockholders and managers.
    c. Managerial compensation plans cannot be used to reduce potential conflicts between stockholders and managers.
    d. The threat of takeovers tends to reduce potential conflicts between stockholders and managers.
    e. The creation of the Securities and Exchange Commission (SEC) has eliminated conflicts between managers and stockholders.

    ANSWER: d

56. Which of the following statements is CORRECT?
    a. Corporations are taxed more favorably than proprietorships.
    b. Corporations have unlimited liability.
    c. Because of their size, large corporations face fewer regulations than smaller corporations and proprietorships.
    d. Reducing the threat of corporate takeover increases the likelihood that managers will act in shareholders' interests.
    e. Bond covenants are designed to protect bondholders and to reduce potential conflicts between stockholders and bondholders.

    ANSWER: e

57. Which of the following statements is CORRECT?
    a. A good goal for a firm's management is the maximization of expected EPS.
    b. Most business in the U.S. is conducted by corporations, and corporations' popularity results primarily from their favorable tax treatment.
    c. Conflicts can exist between stockholders and managers, but potential conflicts are reduced by the possibility of hostile takeovers.
    d. Corporations and partnerships have an advantage over proprietorships because a proprietor is exposed to unlimited liability, but the liability of all investors in the other types of businesses is more limited.
    e. For a stock to be in equilibrium, its intrinsic value must be greater than the actual market price.

    ANSWER: c

58. Which of the following statements is CORRECT?
    a. One disadvantage of organizing a business as a corporation rather than a partnership is that the equity investors in a corporation are exposed to unlimited liability.
    b. Using restrictive covenants in debt agreements is an effective way to reduce conflicts between stockholders and managers.
    c. Managers generally welcome hostile takeovers since the "raider" generally offers a price for the stock that is higher than the price before the takeover action started.
    d. The managers of established, stable companies sometimes attempt to get their state legislatures to <u>impose</u> rules that make it more difficult for raiders to succeed with hostile takeovers.
    e. Most business in the U.S. is conducted by corporations, and corporations' popularity results primarily from their favorable tax treatment.

    ANSWER: d

59. Which of the following statements is CORRECT?
    a. Well-designed bond covenants are useful for reducing potential conflicts between stockholders and managers.
    b. The bid price in a hostile takeover is generally <u>above</u> the price before the takeover attempt is announced, because otherwise there would be no incentive for the stockholders to sell to the hostile bidder and the takeover attempt would probably fail.
    c. Stockholders in general would be better off if managers never disclosed favorable events and therefore caused the price of the firm's stock to sell at a price below its intrinsic value.
    d. Takeovers are most likely to be attempted if the target firm's stock price is above its intrinsic value.
    e. The efficiency of the U.S. economy would probably be increased if hostile takeovers were absolutely forbidden.

    ANSWER: b

60. Which of the following statements is CORRECT?
    a. Hostile takeovers are most likely to occur when a firm's stock is selling <u>below</u> its intrinsic value as a result of poor management.
    b. The efficiency of the U.S. economy would probably be increased if hostile takeovers were absolutely forbidden.
    c. The managers of established, stable companies sometimes attempt to get their state legislatures to <u>remove</u> rules that make it more difficult for raiders to succeed with hostile takeovers.
    d. In general, it is more in bondholders' interests than stockholders' interests for a firm to shift its investment focus away from safe, stable investments and into risky investments, especially those that primarily involve research and development.
    e. Stockholders in general would be better off if managers never disclosed favorable events and therefore caused the price of the firm's stock to sell at a price below its intrinsic value.

    ANSWER: a

    RATIONALE: If a firm's stock is undervalued relative to its potential, then someone can profit by taking the firm over and doing a better job running it.

61. Which of the following statements is CORRECT?
    a. One disadvantage of operating as a corporation rather than as a partnership is that corporate shareholders are exposed to more personal liability than are partners.
    b. Relative to proprietorships, corporations generally face <u>fewer</u> regulations, and they also find it easier to raise capital.
    c. There is no good reason to expect a firm's stockholders and bondholders to react differently to the types of assets in which it invests.
    d. Stockholders should generally be happier than bondholders to have managers invest in risky projects with high potential returns as opposed to safe projects with lower expected returns.
    e. Stockholders in general would be better off if managers never disclosed favorable events and therefore caused the price of the firm's stock to sell at a price below its intrinsic value.

    ANSWER: d

62. Which of the following statements is CORRECT?
    a. Because bankruptcy requires that corporate bondholders be paid in full before stockholders receive anything, bondholders generally prefer to see corporate managers invest in high risk/high return projects rather than low risk/low return projects.
    b. Since bondholders receive fixed payments, they do not share in the gains if risky projects turn out to be highly successful. However, they do share in the losses if risky projects fail and drive the firm into bankruptcy. Therefore, bondholders generally prefer to see corporate managers invest in low risk/low return projects rather than high risk/high return projects.
    c. One advantage of operating a business as a corporation is that stockholders can deduct their pro rata share of the taxes the firm pays, thereby eliminating the double taxation investors would face in a partnership.
    d. One drawback of forming a corporation is that you lose the limited liability that you would otherwise receive as a proprietor.
    e. Potential conflicts between stockholders and bondholders are increased if a firm's bonds are convertible into its common stock.

    ANSWER: b

63. Which of the following statements is CORRECT?
    a. Corporations face few regulations and more favorable tax treatment than do proprietorships and partnerships.
    b. Managers who face the threat of hostile takeovers are less likely to pursue policies that maximize shareholder value compared to managers who do not face the threat of hostile takeovers.
    c. Bond covenants are an effective way to resolve conflicts between shareholders and managers.
    d. Because of their simplified organization, it is easier for proprietors and partnerships to raise large amounts of outside capital than it is for corporations.
    e. One advantage to forming a corporation is that the owners of the firm have limited liability.

    ANSWER: e

Multiple Choice: Problems

64. New Business is just being formed by 10 investors, each of whom will own 10% of the business. The firm is expected to earn $1,000,000 before taxes each year. The corporate tax rate is 34% and the personal tax rate for the firm's investors is 35%. The firm does not need to retain any earnings, so all of its after-tax income will be paid out as dividends to its investors. The investors will have to pay personal taxes on whatever they receive. How much additional spendable income will each investor have if the business is organized as a partnership rather than as a corporation?

a. $20,384
b. $20,800
c. $21,225
d. $21,658
e. $22,100

ANSWER: e

RATIONALE:

Business income:	$1,000,000	Corporate tax rate (T_C):	34%
Number of investors (N):	10	Personal tax rate (T_P):	35%

Corporation:	
Corporate taxes	$ 340,000
Income after corporate tax, paid to investors (stockholders) as dividends	660,000
Tax on dividends	231,000
Spendable income	$ 429,000
Partnership:	
Taxes paid by business	$ 0
Income received by investors (partners)	1,000,000
Taxes paid by partners as personal income	650,000
Spendable income	$ 350,000
Difference in spendable income: total gain from being a partnership	$ 221,000
Individual investor gain	$ 22,100

65. Assume that the corporate tax rate is 34% and the personal tax rate is 35%. The founders of a newly formed business are debating between setting up the firm as a partnership versus a corporation. The firm will not need to retain any earnings, so all of its after-tax income will be paid out to its investors, who will have to pay personal taxes on whatever they receive. What is the difference in the percentage of the firm's pre-tax income that investors actually receive and can spend under the corporate and partnership forms of organization?
   a. 20.4%
   b. 20.8%
   c. 21.2%
   d. 21.7%
   e. 22.1%

ANSWER: e

RATIONALE: Corporate tax rate (T_C): 34% Personal tax rate (T_P): 35%

Corporation:

Corporate net = Business pre-tax income $(1 - T_C)$

Investors' net = Corporate net $(1 - T_P)$ = Business pre-tax net $(1 - T_C)(1 - T_P)$

= Business pre-tax net × 66% × 65% 42.9%

Partnership:

The business pays no tax, but investors pay tax on business income.

Investors' net = Business pre-tax net $(1 - T_P)$ = Business pre-tax net $(1 - T_P)$ 65%

Difference 22.1%

66. Charleston Corporation (CC) now operates as a “regular” corporation, but it is considering a switch to S Corporation status. CC is owned by 100 stockholders who each hold 1% of the stock, and each faces a personal tax rate of 35%. The firm earns $2,000,000 per year before taxes, and since it has no need for retained earnings, it pays out all of its earnings as dividends. Assume that the corporate tax rate is 34% and the personal tax rate is 35%. How much more (or less) spendable income would each stockholder have if the firm elected S Corporation status?
a. $ 2,565
b. $ 4,420
c. $ 8,580
d. $11,150
e. $13,000

ANSWER: b

RATIONALE:

Business income:	$2,000,000	Corporate tax rate (T_C):	34%
Number of investors (N):	100	Personal tax rate (T_P):	35%
Corporation:			
Corporate taxes			$ 680,000
Income after corporate tax, paid to investors (stockholders) as dividends			1,320,000
Tax on dividends			462,000
Spendable income, total			$ 858,000
Spendable income, each (100 investors)			$ 8,580
S Corporation:			
Taxes paid by business			$ 0
Income received by investors			2,000,000
Taxes paid by investors as personal income			700,000
Spendable income, total			$1,300,000
Spendable income, each (100 investors)			$ 13,000
Difference in spendable income: gain from being an S Corporation			$ 4,420

Note that there is an overlap between the T/F and multiple-choice questions, as some of the T/F statements are used in multiple-choice questions.

Multiple Choice: True/False

67. A financial intermediary is a corporation that takes funds from investors and then provides those funds to those who need capital. A bank that takes in demand deposits and then uses that money to make long-term mortgage loans is one example of a financial intermediary.
a. True
b. False

ANSWER: True

68. The NYSE is defined as a "spot" market purely and simply because it has a physical location. The NASDAQ, on the other hand, is not a spot market because it has no one central location.
    a. True
    b. False

    ANSWER: False

69. The NYSE is defined as a "primary" market because it is one of the largest and most important stock markets in the world.
    a. True
    b. False

    ANSWER: False

70. Primary markets are large and important, while secondary markets are smaller and less important.
    a. True
    b. False

    ANSWER: False

71. Private markets are those like the NYSE, where transactions are handled by members of the organization, while public markets are those like the NASDAQ, where anyone can make transactions.
    a. True
    b. False

    ANSWER: False

72. A share of common stock is not a derivative, but an option to buy the stock is a derivative because the value of the option is derived from the value of the stock.
    a. True
    b. False

    ANSWER: True

73. Financial institutions are more diversified today than they were in the past, when federal laws kept investment banks, commercial banks, insurance companies, and similar organizations quite separate. Today the larger financial services corporations offer a variety of services, ranging from checking accounts, to insurance, to underwriting securities, to stock brokerage.
    a. True
    b. False

    ANSWER: True

74. Hedge funds are somewhat similar to mutual funds. The primary differences are that hedge funds are less highly regulated, have more flexibility regarding what they can buy, and restrict their investors to wealthy, sophisticated individuals and institutions.
    a. True
    b. False

    ANSWER: True

75. Trades on the NYSE are generally completed by having a brokerage firm acting as a "dealer" buy securities and adding them to its inventory or selling from its inventory. The NASDAQ, on the other hand, operates as an auction market, where buyers offer to buy, and sellers to sell, and the price is negotiated on the floor of the exchange.
    a. True
    b. False

    ANSWER: False

76. The "over-the-counter" market received its name years ago because brokerage firms would hold inventories of stocks and then sell them by literally passing them over the counter to the buyer.
    a. True
    b. False

    ANSWER: True

77. If you decide to buy 100 shares of Google, you would probably do so by calling your broker and asking him or her to execute the trade for you. This would be defined as a secondary market transaction, not a primary market transaction.
    a. True
    b. False

    ANSWER: True

78. The term IPO stands for "individual purchase order," as when an individual (as opposed to an institution) places an order to buy a stock.
    a. True
    b. False

    ANSWER: False

79. In a "Dutch auction" for new stock, individual investors place bids for shares directly. Each potential bidder indicates the price he or she is willing to pay and how many shares he or she will purchase at that price. The highest price that permits the company to sell all the shares it wants to sell is determined, and this is the "market clearing price." All bidders who specified this price or higher are allowed to purchase their shares at the market clearing price.
    a. True
    b. False

    ANSWER: True

80. When a corporation's shares are owned by a few individuals who are associated with the firm's management, we say that the stock is <u>closely held</u>.
    a. True
    b. False

    ANSWER: True

81. A <u>publicly owned corporation</u> is a company whose shares are held by the investing public, which may include other corporations as well as institutional investors.
    a. True
    b. False

    ANSWER: True

82. If you wanted to know what rate of return stocks have provided in the past, you could examine data on the Dow Jones Industrial Index, the S&P 500 Index, or the NASDAQ Index.
    a. True
    b. False

    ANSWER: True

83. The annual rate of return on any given stock can be found as the stock's dividend for the year plus the change in the stock's price during the year, divided by its beginning-of-year price.
    a. True
    b. False

    ANSWER: True

84. The annual rate of return on any given stock can be found as the stock's dividend for the year plus the change in the stock's price during the year, divided by its beginning-of-year price. If you obtain such data on a large portfolio of stocks, like those in the S&P 500, find the rate of return on each stock, and then average those returns, this would give you an idea of stock market returns for the year in question.
    a. True
    b. False

    ANSWER: True

85. Each stock's rate of return in a given year consists of a dividend yield (which might be zero) plus a capital gains yield (which could be positive, negative, or zero). Such returns are calculated for all the stocks in the S&P 500. A weighted average of those returns, using each stock's total market value, is then calculated, and that average return is often used as an indicator of the "return on the market."
    a. True
    b. False

    ANSWER: True

86. Each stock's rate of return in a given year consists of a dividend yield (which might be zero) plus a capital gains yield (which could be positive, negative, or zero). Such returns are calculated for all the stocks in the S&P 500. A simple average of those returns (which gives equal weight to each company in the S&P 500) is then calculated. That average is called "the return on the S&P Index," and it is often used as an indicator of the "return on the market."
    a. True
    b. False

    ANSWER: False

Multiple Choice: Conceptual

87. You recently sold 100 shares of Microsoft stock to your brother at a family reunion. At the reunion your brother gave you a check for the stock and you gave your brother the stock certificates. Which of the following best describes this transaction?
    a. This is an example of a direct transfer of capital.
    b. This is an example of a primary market transaction.
    c. This is an example of an exchange of physical assets.
    d. This is an example of a money market transaction.
    e. This is an example of a derivative market transaction.

    ANSWER: a

88. Which of the following statements is CORRECT?
    a. The NYSE does not exist as a physical location. Rather it represents a loose collection of dealers who trade stock electronically.
    b. An example of a primary market transaction would be your uncle transferring 100 shares of Walmart stock to you as a birthday gift.
    c. Capital market instruments include both long-term debt and common stocks.
    d. If your uncle in New York sold 100 shares of Microsoft through his broker to an investor in Los Angeles, this would be a primary market transaction.
    e. While the two frequently perform similar functions, investment banks generally specialize in lending money, whereas commercial banks generally help companies raise large blocks of capital from investors.

    ANSWER: c

89. Which of the following is a primary market transaction?
    a. You sell 200 shares of IBM stock on the NYSE through your broker.
    b. You buy 200 shares of IBM stock from your brother. The trade is not made through a broker; you just give him cash and he gives you the stock.
    c. IBM issues 2,000,000 shares of new stock and sells them to the public through an investment banker.
    d. One financial institution buys 200,000 shares of IBM stock from another institution. An investment banker arranges the transaction.
    e. IBM sells 2,000,000 shares of treasury stock to its employees when they exercise options that were granted in prior years.

    ANSWER: c

90. Which of the following is an example of a capital market instrument?
    a. Commercial paper.
    b. Preferred stock.
    c. U.S. Treasury bills.
    d. Banker's acceptances.
    e. Money market mutual funds.

    ANSWER: b

91. Money markets are markets for
    a. Foreign currencies.
    b. Consumer automobile loans.
    c. Common stocks.
    d. Long-term bonds.
    e. Short-term debt securities such as Treasury bills and commercial paper.

    ANSWER: e

92. Which of the following statements is CORRECT?
    a. If you purchase 100 shares of Disney stock from your brother-in-law, this is an example of a primary market transaction.
    b. If Disney issues additional shares of common stock through an investment banker, this would be a secondary market transaction.
    c. The NYSE is an example of an over-the-counter market.
    d. Only institutions, and not individuals, can engage in derivative market transactions.
    e. As they are generally defined, money market transactions involve debt securities with maturities of less than one year.

    ANSWER: e

93. You recently sold 200 shares of Disney stock, and the transfer was made through a broker. This is an example of:
    a. A money market transaction.
    b. A primary market transaction.
    c. A secondary market transaction.
    d. A futures market transaction.
    e. An over-the-counter market transaction.

    ANSWER: c

94. Which of the following statements is CORRECT?
    a. Hedge funds are legal in Europe and Asia, but they are not permitted to operate in the United States.
    b. Hedge funds are legal in the United States, but they are not permitted to operate in Europe or Asia.
    c. Hedge funds have more in common with investment banks than with any other type of financial institution.
    d. Hedge funds have more in common with commercial banks than with any other type of financial institution.
    e. Hedge funds are not as highly regulated as most other types of financial institutions. The justification for this light regulation is that only "sophisticated investors" (i.e., those with high net worths and high incomes) are permitted to invest in these funds, and these investors supposedly can do any necessary "due diligence" on their own rather than have it done by the SEC or some other regulator.

    ANSWER: e

95. Which of the following statements is CORRECT?
    a. While the distinctions are becoming blurred, investment banks generally specialize in lending money, whereas commercial banks generally help companies raise capital from other parties.
    b. The NYSE operates as an auction market, whereas NASDAQ is an example of a dealer market.
    c. Money market mutual funds usually invest their money in a well-diversified portfolio of liquid common stocks.
    d. Money markets are markets for long-term debt and common stocks.
    e. A liquid security is a security whose value is derived from the price of some other "underlying" asset.

    ANSWER: b

96. Which of the following statements is CORRECT?
    a. The New York Stock Exchange is an auction market, and it has a physical location.
    b. Home mortgage loans are traded in the money market.
    c. If an investor sells shares of stock through a broker, then it would be a primary market transaction.
    d. Capital markets deal only with common stocks and other equity securities.
    e. While the distinctions are blurring, investment banks generally specialize in lending money, whereas commercial banks generally help companies raise capital from other parties.

    ANSWER: a

97. Which of the following statements is CORRECT?
    a. The term "IPO" stands for Introductory Price Offered, and it is the price at which shares of a new company are offered to the public.
    b. IPO prices are generally established by the market, and buyers of the new stock must pay the price that prevails at the close of trading on the day the stock is offered to the public.
    c. In a "Dutch auction," investors who want to buy shares in an IPO submit bids indicating how many shares they want to buy and the price they are willing to pay. The company determines how many shares it wants to sell. The highest price that enables the company to sell the desired number of shares is the price that all buyers must pay.
    d. It is possible that the price set in an IPO is so high that investors will refuse to buy the number of shares that the company wants to sell. In this situation, the IPO is said to be oversubscribed.
    e. It is possible that the price set in an IPO is so low that investors will want to buy more shares than the company wants to sell. In that case, the company will have to issue more shares than it wants to sell.

    ANSWER: c

98. Which of the following statements is CORRECT?
    a. The most important difference between spot markets versus futures markets is the maturity of the instruments that are traded. Spot market transactions involve securities that have maturities of less than one year whereas futures markets transactions involve securities with maturities greater than one year.
    b. Capital market transactions involve only preferred stock or common stock.
    c. If General Electric were to issue new stock this year, this would be considered a secondary market transaction since the company already has stock outstanding.
    d. Both NASDAQ dealers and "specialists" on the NYSE hold inventories of stocks.
    e. Money market transactions do not involve securities denominated in currencies other than the U.S. dollar.

    ANSWER: d

99. Which of the following statements is NOT CORRECT?
   a. When a corporation's shares are owned by a few individuals, we say that the firm is "closely, or privately, held."
   b. "Going public" establishes a firm's true intrinsic value and ensures that a liquid market will always exist for the firm's shares.
   c. The stock of publicly owned companies must generally be registered with and reported to a regulatory agency such as the SEC.
   d. When stock in a closely held corporation is offered to the public for the first time, the transaction is called "going public, or an IPO," and the market for such stock is called the new issue or IPO market.
   e. It is possible for a firm to go public and yet not raise any additional new capital for the firm itself.

   ANSWER: b