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Name:_____ Class:_____ Date:_____

Ch_01_An_Overview_of_Financial_Management_and_the_Financial_Environment

1. The form of organization for a business is not an important issue, as this decision has very little effect on the income and wealth of the firm's owners.

a. True

b. False

ANSWER: False

2. The major advantage of a regular partnership or a corporation as a form of business organization is the fact that both offer their owners limited liability, whereas proprietorships do not.

a. True

b. False

ANSWER: False

3. There are three primary disadvantages of a regular partnership: (1) unlimited liability, (2) limited life of the organization, and (3) difficulty of transferring ownership. These combine to make it difficult for partnerships to attract large amounts of capital and thus to grow to a very large size.

a. True

b. False

ANSWER: True

4. Two disadvantages of a proprietorship are (1) the relative difficulty of raising new capital and (2) the owner's unlimited personal liability for the business' debts.

a. True

b. False

ANSWER: True

5. One key value of limited liability is that it lowers owners' risks and thereby enhances a firm's value.

a. True

b. False

ANSWER: True

6. The disadvantages associated with a proprietorship are similar to those under a partnership. One exception relates to the more formal nature of the partnership agreement and the commitment of all partners' personal assets. As a result, partnerships do not have difficulty raising large amounts of capital.

a. True

b. False

ANSWER: False

7. The facts that a proprietorship, as a business, pays no corporate income tax, and that it is easily and inexpensively formed, are two key advantages to that form of business.

a. True

b. False

ANSWER: True

8. Which of the following statements is CORRECT?

a. One of the disadvantages of incorporating a business is that the owners then become subject to liabilities in the event the firm goes bankrupt.

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b. Sole proprietorships are subject to more regulations than corporations.
c. In any type of partnership, every partner has the same rights, privileges, and liability exposure as every other partner.
d. Sole proprietorships and partnerships generally have a tax advantage over many corporations, especially large ones.
e. Corporations of all types are subject to the corporate income tax.

ANSWER: d

9. Which of the following statements is CORRECT?
a. One of the disadvantages of a sole proprietorship is that the proprietor is exposed to unlimited liability.
b. It is generally easier to transfer one's ownership interest in a partnership than in a corporation.
c. One of the advantages of the corporate form of organization is that it avoids double taxation.
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: a

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

ANSWER: d

11. Cheers Inc. operates as a partnership. Now the partners have decided to convert the business into a regular corporation. Which of the following statements is CORRECT?
a. Assuming Cheers is profitable, less of its income will be subject to federal income taxes.
b. Cheers will now be subject to fewer regulations.
c. Cheers' shareholders (the ex-partners) will now be exposed to less liability.
d. Cheers' investors will be exposed to less liability, but they will find it more difficult to transfer their ownership.
e. Cheers will find it more difficult to raise additional capital.

ANSWER: c

12. Which of the following statements is CORRECT?
a. It is usually easier to transfer ownership in a corporation than it is to transfer ownership in a sole proprietorship.
b. Corporate shareholders are exposed to unlimited liability.
c. Corporations generally face fewer regulations than sole proprietorships.
d. Corporate shareholders are exposed to unlimited liability, and this factor may be compounded by the tax

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disadvantages of incorporation.

e. Shareholders in a regular corporation (not an S corporation) pay higher taxes than owners of an otherwise identical proprietorship.

ANSWER: a

13. Which of the following could explain why a business might choose to operate as a corporation rather than as a sole proprietorship or a partnership?

a. Corporations generally find it relatively difficult to raise large amounts of capital.

b. Less of a corporation's income is generally subjected to taxes than would be true if the firm were a partnership.

c. Corporate shareholders escape liability for the firm's debts, but this factor may be offset by the tax disadvantages of the corporate form of organization.

d. Corporate investors are exposed to unlimited liability.

e. Corporations generally face relatively few regulations.

ANSWER: c

14. One drawback of switching from a partnership to the corporate form of organization is the following:

a. It subjects the firm to additional regulations.

b. It cannot affect the amount of the firm's operating income that goes to taxes.

c. It makes it more difficult for the firm to raise additional capital.

d. It makes the firm's investors subject to greater potential personal liabilities.

e. It makes it more difficult for the firm's investors to transfer their ownership interests.

ANSWER: a

15. Which of the following statements is CORRECT?

a. The main method of transferring ownership interest in a corporation is by means of a hostile takeover.

b. Two key advantages of the corporate form over other forms of business organization are unlimited liability and limited life.

c. A corporation is a legal entity that is generally created by a state; its life and existence is separate from the lives of its individual owners and managers.

d. Limited liability of its stockholders is an advantage of the corporate form of organization, but corporations have more trouble raising money in financial markets because of the complexity of this form of organization.

e. Although its stockholders are insulated by limited legal liability, the corporation's legal status does not protect the firm's managers in the same way; i.e., bondholders can sue its managers if the firm defaults on its debt, even if the default is the result of poor economic conditions.

ANSWER: c

16. Which of the following statements is CORRECT?

a. In a regular partnership, liability for other partners' misdeeds is limited to the amount of a particular partner's investment in the business.

b. Attracting large amounts of capital is more difficult for partnerships than for 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.

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. The limited partners in a limited partnership have voting control, while the general partner has operating

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control over the business. Also, the limited partners are individually responsible, on a pro rata basis, for the firm's debts in the event of bankruptcy.

e. A major disadvantage of all partnerships compared to all corporations is the fact that federal income taxes must be paid by the partners rather than by the firm itself.

ANSWER: b

17. Which of the following statements is CORRECT?

a. Corporations are at a disadvantage relative to partnerships because they have to file more reports to state and federal agencies, including the Securities and Exchange Administration, even if they are not publicly owned.

b. In a regular partnership, liability for the firm's debts is limited to the amount a particular partner has invested in the business.

c. A fast-growth company would be more likely to set up as a partnership for its business organization than would a slow-growth company.

d. Partnerships have difficulty attracting capital in part because of their unlimited liability, the lack of impermanence of the organization, and difficulty in transferring ownership.

e. A major disadvantage of a partnership relative to a corporation as a form of business organization is the high cost and practical difficulty of its formation.

ANSWER: d

18. Which of the following statements is CORRECT?

a. Most businesses (by number and total dollar sales) are organized as partnerships or proprietorships because it is easier to set up and operate in one of these forms rather than as a corporation. However, if the business gets very large, it becomes advantageous to convert to a corporation, mainly because corporations have important tax advantages over proprietorships and partnerships.

b. 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.

c. Most business (measured by dollar sales) is conducted by corporations in spite of large corporations' often less favorable tax treatment, due to legal considerations related to ownership transfers and limited liability.

d. Large corporations are taxed more favorably than sole proprietorships.

e. Corporate stockholders are exposed to unlimited liability.

ANSWER: c

19. Jane Doe, who has substantial personal wealth and income, is considering the possibility of starting a new business in the chemical waste management field. She will be the sole owner, and she has enough funds to finance the operation. The business will have a relatively high degree of risk, and it is expected that the firm will incur losses for the first few years. However, the prospects for growth and positive future income look good, and Jane plans to have the firm pay out all of its income as dividends to her once it is well established. Which of the legal forms of business organization would probably best suit her needs?

a. Proprietorship, because of ease of entry.

b. S corporation, to gain some tax advantages and also to obtain limited liability.

c. Partnership, but only if she needs additional capital.

d. Regular corporation, because of the limited liability.

e. In this situation, the various forms of organization seem equally desirable.

ANSWER: b

20. Which of the following statements is CORRECT?

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a. The corporate bylaws are a standard set of rules established by the state of incorporation. These rules are identical for all corporations in the state, and their purpose is to ensure that the firm's managers run the firm in accordance with state laws.
b. The corporate charter is a standard document prescribed by the state of incorporation, and its purpose is to ensure that the firm's managers run the firm in accordance with state laws. Procedures for electing corporate directors are contained in bylaws, while the declaration of the activities that the firm will pursue and the number of directors are included in the corporate charter.
c. Companies must establish a home office, or domicile, in a particular state, and that state must be the one in which most of their business (sales, manufacturing, and so forth) is conducted.
d. Attorney fees are generally involved when a company develops its charter and bylaws, but since these documents are voluntary, a new corporation can avoid these costs by deciding not to have either a charter or bylaws.
e. The corporate charter is concerned with things like what business the company will engage in, whereas the bylaws are concerned with things like procedures for electing the board of directors.

ANSWER: e

21. If a firm's goal is to maximize its earnings per share, this is the best way to maximize the price of the common stock and thus shareholders' wealth.
a. True
b. False

ANSWER: False

22. With which of the following statements would most people in business agree?
a. The short-run profits of a corporation will almost always increase if the firm takes actions the government has determined are in the nation's best interests.
b. Government agencies and firms almost always agree with one another regarding the restrictions that should be placed on hiring and firing employees.
c. Although people's moral characters are probably developed before they get into a business school, it is still useful for business schools to cover ethics, including giving students an idea about the adverse consequences of unethical behavior to themselves, their firms, and the nation.
d. Developing a formal set of rules defining ethical and unethical behavior is not useful for a large corporation. Such rules generally can't be applied in many specific instances, so it is better to deal with ethical issues on a case-by-case basis.
e. Because of the courage it takes to blow the whistle, "whistle blowers" are generally promoted more rapidly than other employees.

ANSWER: c

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

ANSWER: a

24. Which of the following statements is CORRECT?

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a. The financial manager's proper goal should be to attempt to maximize the firm's expected cash flows, since that will add the most to the individual shareholders' wealth.
b. The financial manager should seek that combination of assets, liabilities, and capital that will generate the largest expected projected after-tax income over the relevant time horizon, generally the coming year.
c. The riskiness inherent in a firm's earnings per share (EPS) depends on the characteristics of the projects the firm selects, and thus on the firm's assets. However, EPS is not affected by the manner in which those assets are financed.
d. Potential agency problems can arise between managers and stockholders, because managers hired as agents to act on behalf of the owners may instead make decisions favorable to themselves rather than the stockholders.
e. Large, publicly owned firms like IBM and GE are controlled by their management teams. Ownership is generally widely dispersed; hence managers have great freedom in how they run the firm. Managers may operate in stockholders' best interests, but they also may operate in their own personal best interests. As long as they stay within the law, there is no way to either force or motivate managers to act in the stockholders' best interests.

ANSWER: d

25. Which of the following statements is CORRECT?
a. Corporations generally are subject to more favorable tax treatment and fewer regulations than partnerships and sole proprietorships, which is why corporations do most of the business in the United States.
b. Managers who face the threat of hostile takeovers are less likely to pursue policies that maximize shareholder value than are managers who do not face the threat of hostile takeovers.
c. One advantage of the corporate form of organization is that liability of the owners of the firm is limited to their investment in the firm.
d. Because of their simplified organization, it is easier for sole proprietorships and partnerships to raise large amounts of outside capital than it is for corporations.
e. Bond covenants are an effective way to resolve conflicts between shareholders and managers.

ANSWER: c

26. Which of the following statements is CORRECT?
a. A good goal for a firm's management is 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. Because most stock ownership is concentrated in the hands of a relatively small segment of society, firms' actions to maximize their stock prices have little benefit to society.
d. Corporations and partnerships have an advantage over proprietorships because a sole proprietor is exposed to unlimited liability, but the liability of all investors in the other types of businesses is more limited.
e. The potential exists for agency conflicts between stockholders and managers.

ANSWER: e

27. 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 partners.
b. There is no good reason to expect a firm's bondholders and stockholders to react differently to the types of new asset investments a firm makes.
c. Bondholders are generally more willing than stockholders to have managers invest in risky projects with high potential returns as opposed to safer projects with lower expected returns.

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d. Stockholders are generally more willing than bondholders to have managers invest in risky projects with high potential returns as opposed to safer projects with lower expected returns.

e. Relative to sole proprietorships, corporations generally face fewer regulations, which makes raising capital easier for corporations.

ANSWER: d

28. If Firm A's business is to obtain savings from individuals and then invest them in financial assets issued by other firms or individuals, Firm A is a financial intermediary.

a. True

b. False

ANSWER: True

29. You recently sold 100 shares of your new company, XYZ Corporation, 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 statements best describes this transaction?

a. This is an example of an exchange of physical assets.

b. This is an example of a primary market transaction.

c. This is an example of a direct transfer of capital.

d. This is an example of a money market transaction.

e. This is an example of a derivatives market transaction

ANSWER: c

30. Debt is a less risky than equity because a debtholder's claim has priority to an equity holder's claim.

a. True

b. False

ANSWER: True

31. Which of the following statements is CORRECT?

a. If expected inflation increases, interest rates are likely to increase.

b. If individuals in general increase the percentage of their income that they save, interest rates are likely to increase.

c. If companies have fewer good investment opportunities, interest rates are likely to increase.

d. Interest rates on all debt securities tend to rise during recessions because recessions increase the possibility of bankruptcy, hence the riskiness of all debt securities.

e. Interest rates on long-term bonds are more volatile than rates on short-term debt securities like T-bills.

ANSWER: a

32. Suppose the U.S. Treasury announces plans to issue $50 billion of new bonds. Assuming the announcement was not expected, what effect, other things held constant, would that have on bond prices and interest rates?

a. Prices and interest rates would both rise.

b. Prices would rise and interest rates would decline.

c. Prices and interest rates would both decline.

d. There would be no changes in either prices or interest rates.

e. Prices would decline and interest rates would rise.

ANSWER: e

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33. Which of the following would be most likely to lead to higher interest rates on all debt securities in the economy?
    a. Households start saving a larger percentage of their income.
    b. The economy moves from a boom to a recession.
    c. The level of inflation begins to decline.
    d. Corporations step up their expansion plans and thus increase their demand for capital.
    e. The Federal Reserve uses monetary policy in an attempt to stimulate the economy.

ANSWER: d

34. Which of the following factors would be most likely to lead to an increase in interest rates in the economy?
    a. Households reduce their consumption and increase their savings.
    b. The Federal Reserve decides to try to stimulate the economy.
    c. There is a decrease in expected inflation.
    d. The economy falls into a recession.
    e. Most businesses decide to modernize and expand their manufacturing capacity, and to install new equipment to reduce labor costs.

ANSWER: e

35.
If an individual investor buys or sells a currently outstanding stock through a broker, this is a primary market transaction.

    a. True
    b. False

ANSWER: False

36. Recently, Hale Corporation announced the sale of 2.5 million newly issued shares of its stock at a price of $21 per share. Hale sold the stock to an investment banker, who in turn sold it to individual and institutional investors. This is a primary market transaction.
    a. True
    b. False

ANSWER: True

37. Which of the following is a primary market transaction?
    a. You sell 200 shares of Johnson & Johnson stock on the NYSE through your broker.
    b. Johnson & Johnson issues 2,000,000 shares of new stock and sells them to the public through an investment banker.
    c. You buy 200 shares of Johnson & Johnson stock from your younger brother. You just give him cash and he gives you the stock—the trade is not made through a broker.
    d. One financial institution buys 200,000 shares of Johnson & Johnson stock from another institution. An investment banker arranges the transaction.
    e. You invest $10,000 in a mutual fund, which then uses the money to buy $10,000 of Johnson & Johnson shares on the NYSE.

ANSWER: b

38. Which of the following statements is CORRECT?

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a. If Apple issues additional shares of common stock through an investment banker, this would be a secondary market transaction.
b. If you purchased 100 shares of Apple stock from your sister-in-law, this would be an example of a primary market transaction.
c. The IPO market is a subset of the secondary market.
d. Only institutions, and not individuals, can participate in derivatives market transactions.
e. As they are generally defined, money market transactions involve debt securities with maturities of less than one year.

ANSWER: a

39. You recently sold 200 shares of Apple stock to your brother. The transfer was made through a broker, and the trade occurred on the NYSE. This is an example of:
a. A futures market transaction.
b. A primary market transaction.
c. A secondary market transaction.
d. A money market transaction.
e. An over-the-counter market transaction.

ANSWER: c

40. Which of the following statements is **NOT** CORRECT?
a. When a corporation's shares are owned by a few individuals and are not traded on public markets, we say that the firm is "closely, or privately, held."
b. "Going public" establishes a firm's true intrinsic value, and it also insures that a highly liquid market will always exist for the firm's shares.
c. When stock in a closely held corporation is offered to the public for the first time, the transaction is called "going public," and the market for such stock is called the new issue market.
d. Publicly owned companies have shares owned by investors who are not associated with management, and public companies must register with and report to a regulatory agency such as the SEC.
e. It is possible for a firm to go public and yet not raise any additional new capital at the time.

ANSWER: b

41. Money markets are markets for
a. Foreign stocks.
b. Consumer automobile loans.
c. U.S. stocks.
d. Short-term debt securities.
e. Long-term bonds.

ANSWER: d

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