**CHAPTER 1**

AN OVERVIEW OF FINANCIAL MANAGEMENT AND THE FINANCIAL ENVIRONMENT

*Please see the preface for information on the AACSB letter indicators (F, M, etc.) on the subject lines.*

**True/False**

***Easy:***

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
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|  | **(1.2) Firm organization F M** | | | | | | | | | | | | | | **Answer: b** | | | | **EASY** | |
| [[1]](#endnote-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. | | | | | | | | | | | | | | | | | | | |
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|  | a. | True | | |  | |  | |  | |  | |  | | | | |  |  | |
|  | b. | False | | |  | |  | |  | |  | |  | | | | |  |  | |
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|  | **(1.2) Firm organization F M** | | | | | | | | | | | | | | **Answer: b** | | | | **EASY** | |
| [[2]](#endnote-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 | | |  | |  | |  | |  | |  | | | | |  |  | |
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|  | **(1.2) Partnership F M** | | | | | | | | | | | | | | **Answer: a** | | | | **EASY** | |
| [[3]](#endnote-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. | | | | | | | | | | | | | | | | | | | |
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|  | a. | True | | |  | |  | |  | |  | |  | | | | |  |  | |
|  | b. | False | | |  | |  | |  | |  | |  | | | | |  |  | |
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|  | **(1.2) Proprietorship F M** | | | | | | | | | | | | | | **Answer: a** | | | | **EASY** | |
| [[4]](#endnote-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 | | |  | |  | |  | |  | |  | | | | |  |  | |
|  |  | |  | |  | |  | |  | |  | |  | | | | |  |  | |
|  | **(1.2) Limited liability F M** | | | | | | | | | | | | | | | **Answer: a** | | | **EASY** | |
| [[5]](#endnote-5). | One key value of limited liability is that it lowers owners' risks and thereby enhances a firm's value. | | | | | | | | | | | | | | | | | | | |
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|  | a. | True | | | |  | |  | |  | |  | |  | | |  | |  | |
|  | b. | False | | | |  | |  | |  | |  | |  | | |  | |  | |
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|  | **(1.3) Value maximization F M** | | | | | | | | | | | | | | | **Answer: b** | | | **EASY** | |
| [[6]](#endnote-6). | 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 | | | |  | |  | |  | |  | |  | | |  | |  | |
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|  | **(1.4) Financial intermediaries F M** | | | | | | | | | | | | | | | **Answer: a** | | | **EASY** | |
| [[7]](#endnote-7). | 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 | | | |  | |  | |  | |  | |  | | |  | |  | |
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|  | **(1.8) Financial markets F H** | | | | | | | | | | | | | | | **Answer: b** | | | **EASY** | |
| [[8]](#endnote-8). | If an individual investor buys or sells a currently outstanding stock through a broker, this is a primary market transaction. | | | | | | | | | | | | | | | | | | | |
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|  | a. | True | | | |  | |  | |  | |  | |  | | |  | |  | |
|  | b. | False | | | |  | |  | |  | |  | |  | | |  | |  | |
|  |  | | |  | |  | |  | |  | |  | |  | | |  | |  | |
|  | **(1.8) Financial markets F H** | | | | | | | | | | | | | | | **Answer: a** | | | **EASY** | |
| [[9]](#endnote-9). | 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 | | | |  | |  | |  | |  | |  | | |  | |  | |
|  |  | | |  | |  | |  | |  | |  | |  | | |  | |  | |
|  | **(1.11) Stock market transactions F H** | | | | | | | | | | | | | | | **Answer: a** | | | **EASY** | |
| [[10]](#endnote-10). | One of the functions of NYSE specialists is to facilitate trading by keeping an inventory of shares of the stocks in which they specialize, buying when investors want to sell and selling when they want to buy. They change the bid and ask prices of the securities so as to keep supply and demand in balance. | | | | | | | | | | | | | | | | | | | |
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|  | a. | True | | | |  | |  | |  | |  | |  | | |  | | |  |
|  | b. | False | | | |  | |  | |  | |  | |  | | |  | | |  |

***Medium:***

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|  | **(1.2) Partnership F M** | | | | | | | | **Answer: b** | | **MEDIUM** |
| [[11]](#endnote-11). | 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 | |  |  |  |  |  | |  |  |
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|  | **(1.2) Proprietorship F M** | | | | | | | | **Answer: a** | | **MEDIUM** |
| [[12]](#endnote-12). | 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 | |  |  |  |  |  | |  |  |

**Multiple Choice: Conceptual**

***Easy:***

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|  | **(1.2) Firm organization C M** | | | | | | | | **Answer: d** | **EASY** |
| [[13]](#endnote-13). | 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. | | | | | | | | |
|  | 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. | | | | | | | | |
|  |  | |  |  |  |  |  |  |  |  |
|  | **(1.2) Firm organization C M** | | | | | | | | **Answer: a** | **EASY** |
| [[14]](#endnote-14). | 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. | | | | | | | | |
|  | **(1.2) Firm organization C M** | | | | | | | | **Answer: d** | **EASY** |
| [[15]](#endnote-15). | 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. | | | | | | | | |
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|  | **(1.2) Firm organization C M** | | | | | | | | **Answer: c** | **EASY** |
| [[16]](#endnote-16). | 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. | | | | | | | | |
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|  | **(1.2) Firm organization C M** | | | | | | | | **Answer: a** | **EASY** |
| [[17]](#endnote-17). | 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 disadvantages of incorporation. | | | | | | | | |
|  | e. | Shareholders in a regular corporation (not an S corporation) pay higher taxes than owners of an otherwise identical proprietorship. | | | | | | | | |
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|  | **(1.2) Corporate form of organization C M** | | | | | | | | **Answer: c** | **EASY** |
| [[18]](#endnote-18). | 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. | | | | | | | | |
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|  | **(1.4) Financial transactions C H** | | | | | | | | **Answer: c** | **EASY** |
| [[19]](#endnote-19). | 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. | | | | | | | | |
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|  | **(1.6) Interest rates C H** | | | | | | | | **Answer: a** | **EASY** |
| [[20]](#endnote-20). | 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. | | | | | | | | |
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|  | **(1.7) Hedge funds C O** | | | | | | | | **Answer: e** | **EASY** |
| [[21]](#endnote-21). | 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 have more in common with commercial banks than with any other type of financial institution. | | | | | | | | |
|  | c. | Hedge funds have more in common with investment banks than with any other type of financial institution. | | | | | | | | |
|  | d. | Hedge funds are legal in the United States, but they are not permitted to operate in Europe or Asia. | | | | | | | | |
|  | e. | The justification for the "light" regulation of hedge funds is that only “sophisticated” investors with high net worths and high incomes are permitted to invest in these funds, and such investors supposedly can do the necessary “due diligence” on their own rather than have it done by the SEC or some other regulator. | | | | | | | | |
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|  | **(1.8) Money markets C O** | | | | | | | | **Answer: d** | **EASY** |
| [[22]](#endnote-22). | 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. | | | | | | |  |  |
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|  | **(1.8) Financial markets C H** | | | | | | | | **Answer: b** | **EASY** |
| [[23]](#endnote-23). | Which of the following is a primary market transaction? | | | | | | | | | |
|  |  | |  |  |  |  |  |  |  |  |
|  | a. | You sell 200 shares of IBM stock on the NYSE through your broker. | | | | | | | | |
|  | b. | IBM issues 2,000,000 shares of new stock and sells them to the public through an investment banker. | | | | | | | | |
|  | c. | 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. | | | | | | | | |
|  | d. | One financial institution buys 200,000 shares of IBM 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 IBM shares on the NYSE. | | | | | | | | |
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|  | **(1.8) Financial markets C H** | | | | | | | | **Answer: e** | **EASY** |
| [[24]](#endnote-24). | Which of the following statements is CORRECT? | | | | | | | | | |
|  |  | |  |  |  |  |  |  |  |  |
|  | a. | If Disney issues additional shares of common stock through an investment banker, this would be a secondary market transaction. | | | | | | | | |
|  | b. | If you purchased 100 shares of Disney stock from your brother-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. | | | | | | | | |
|  | **(1.8) Financial markets C H** | | | | | | | | **Answer: c** | **EASY** |
| [[25]](#endnote-25). | You recently sold to your brother 200 shares of Disney stock, and 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. | | | | | | | | |
|  |  | |  |  |  |  |  |  |  |  |
|  | **(Comp: 1.7-1.9) Financial markets C H** | | | | | | | | **Answer: a** | **EASY** |
| [[26]](#endnote-26). | Which of the following statements is CORRECT? | | | | | | | | | |
|  |  | |  |  |  |  |  |  |  |  |
|  | a. | The New York Stock Exchange is an auction market with a physical location. | | | | | | | | |
|  | b. | Capital market transactions involve only the purchase and sale of equity securities, i.e., common stocks. | | | | | | | | |
|  | c. | If an investor sells shares of stock through a broker, then this would be a primary market transaction. | | | | | | | | |
|  | d. | Consumer automobile loans are evidenced by legal documents called "promissory notes," and these individual notes are traded in the money market. | | | | | | | | |
|  | e. | While the distinctions are blurring as investment banks are today buying commercial banks, and vice versa, investment banks generally specialize in lending money, whereas commercial banks generally help companies raise capital from other parties. | | | | | | | | |
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|  | **(Comp: 1.7-1.9) Financial markets C H** | | | | | | | | **Answer: a** | **EASY** |
| [[27]](#endnote-27). | Which of the following statements is CORRECT? | | | | | | | | | |
|  |  | |  |  |  |  |  |  |  |  |
|  | a. | Capital market instruments include both long-term debt and common stocks. | | | | | | | | |
|  | b. | An example of a primary market transaction would be your uncle transferring 100 shares of Wal-Mart stock to you as a birthday gift. | | | | | | | | |
|  | c. | The NYSE does not exist as a physical location; rather, it represents a loose collection of dealers who trade stocks electronically. | | | | | | | | |
|  | 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. | | | | | | | | |
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|  | **(Comp: 1.7-1.9) Financial markets C H** | | | | | | | | | **Answer: e** | | **EASY** |
| [[28]](#endnote-28). | Which of the following statements is CORRECT? | | | | | | | | | | | |
|  |  | |  |  |  |  |  |  | |  | |  |
|  | a. | While the distinctions are blurring, investment banks generally specialize in lending money, whereas commercial banks generally help companies raise capital from other parties. | | | | | | | | | | |
|  | b. | A liquid security is a security whose value is derived from the price of some other “underlying” asset. | | | | | | | | | | |
|  | c. | Money market mutual funds usually invest most of their money in a well-diversified portfolio of liquid common stocks. | | | | | | | | | | |
|  | d. | Money markets are markets for long-term debt and common stocks. | | | | | | | | | | |
|  | e. | The NYSE operates as an auction market, whereas the Nasdaq is a dealer market. | | | | | | | | | | |
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***Medium:***

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|  | **(1.2) Corporate form of organization C M** | | | | | | | | **Answer: a** | | **MEDIUM** | |
| [[29]](#endnote-29). | 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. | | | | | | | | | | |
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|  | **(1.2) Corporate form of organization C M** | | | | | | | | **Answer: c** | | **MEDIUM** | |
| [[30]](#endnote-30). | Which of the following statements is CORRECT? | | | | | | | | | | | |
|  |  | |  |  |  |  |  |  | |  | |  |
|  | a. | A hostile takeover is the main method of transferring ownership interest in a corporation. | | | | | | | | | | |
|  | b. | Unlimited liability and limited life are two key advantages of the corporate form over other forms of business organization. | | | | | | | | | | |
|  | c. | A corporation is a legal entity that is generally created by a state, and it has a life and existence that 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 legal status of the corporation 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. | | | | | | | | | | |
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|  | **(1.2) Partnership form of organization C M** | | | | | | | | **Answer: b** | | **MEDIUM** | |
| [[31]](#endnote-31). | 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. | 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. | | | | | | | | | | |
|  | 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. | In a limited partnership, the limited partners have voting control, while the general partner has operating 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 relative to all corporations is the fact that federal income taxes must be paid by the partners rather than by the firm itself. | | | | | | | | | | |
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|  | **(1.2) Partnership form of organization C M** | | | | | | | | **Answer: d** | | **MEDIUM** | |
| [[32]](#endnote-32). | Which of the following statements is CORRECT? | | | | | | | | | | | |
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|  | 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. | | | | | | | | | | |
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|  | **(1.2) Firm organization C M** | | | | | | | | **Answer: c** | | **MEDIUM** | |
| [[33]](#endnote-33). | Which of the following statements is CORRECT? | | | | | | | | | | | |
|  |  | |  |  |  |  |  |  | |  | |  |
|  | a. | Most businesses (by number and total dollar sales) are organized as proprietorships or partnerships 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, primarily 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. | Due to legal considerations related to ownership transfers and limited liability, most business (measured by dollar sales) is conducted by corporations in spite of large corporations’ often less favorable tax treatment. | | | | | | | | | | |
|  | d. | Large corporations are taxed more favorably than sole proprietorships. | | | | | | | | | | |
|  | e. | Corporate stockholders are exposed to unlimited liability. | | | | | | | | | | |
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|  | **(1.2) Firm organization C M** | | | | | | | | **Answer: b** | | **MEDIUM** | |
| [[34]](#endnote-34). | 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? | | | | | | | | | | | |
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|  | 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. | | | | | | | | | | |
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|  | **(1.2) Corporate charter and bylaws C M** | | | | | | | | **Answer: e** | | **MEDIUM** | |
| [[35]](#endnote-35). | 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. | | | | | | | | | | |
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|  | **(1.3) Business ethics B M** | | | | | | | | **Answer: c** | | **MEDIUM** | |
| [[36]](#endnote-36). | With which of the following statements would most people in business agree? | | | | | | | | | | | |
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|  | 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. | 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. | It is not useful for a large corporation to develop a formal set of rules defining ethical and unethical behavior. 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. | “Whistle blowers,” because of the courage it takes to blow the whistle, are generally promoted more rapidly than other employees. | | | | | | | | | | |
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|  | **(1.3) Goal of firm C M** | | | | | | | | **Answer: a** | | **MEDIUM** | |
| [[37]](#endnote-37). | 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. | | | | | | | | | | |
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|  | **(1.3) Corporate goals and control C M** | | | | | | | | **Answer: d** | | **MEDIUM** | |
| [[38]](#endnote-38). | Which of the following statements is CORRECT? | | | | | | | | | | | |
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|  | a. | The proper goal of the financial manager should be to attempt to maximize the firm’s expected cash flows, because this will add the most to the wealth of the individual shareholders. | | | | | | | | | | |
|  | 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 stockholders and managers, 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 AT&T and GM are controlled by their management teams. Ownership is generally widely dispersed, hence managers have great freedom in how they manage the firm. Managers may operate in stockholders’ best interests, but they may also operate in their own personal best interests. As long as managers stay within the law, there is no way to either force or motivate them to act in the stockholders’ best interests. | | | | | | | | | | |
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|  | **(1.6) Security prices and interest rates C H** | | | | | | | | **Answer: e** | | **MEDIUM** | |
| [[39]](#endnote-39). | 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. | | | | | | | | | | |
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|  | **(1.6) Interest rates C H** | | | | | | | | **Answer: d** | | **MEDIUM** | |
| [[40]](#endnote-40). | 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. | | | | | | | | | | |
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|  | **(1.6) Interest rates C H** | | | | | | | | **Answer: e** | | **MEDIUM** | |
| [[41]](#endnote-41). | Which of the following factors would be most likely to lead to an increase in interest rates in the economy? | | | | | | | | | | | |
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|  | 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. | | | | | | | | | | |
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|  | **(Comp: 1.8,1.9,1.11) Financial transactions C H** | | | | | | | | **Answer: d** | | **MEDIUM** | |
| [[42]](#endnote-42). | Which of the following statements is CORRECT? | | | | | | | | | | | |
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|  | a. | If General Electric were to issue new stock this year it would be considered a secondary market transaction since the company already has stock outstanding. | | | | | | | | | | |
|  | b. | Capital market transactions only include preferred stock and common stock transactions. | | | | | | | | | | |
|  | c. | The distinguishing feature between spot markets versus futures markets transactions is the maturity of the investments. That is, 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. | | | | | | | | | | |
|  | d. | Both Nasdaq "dealers" and NYSE “specialists” hold inventories of stocks. | | | | | | | | | | |
|  | e. | An electronic communications network (ECN) is a physical location exchange. | | | | | | | | | | |
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|  | **(Comp: 1.2,1.3) Miscellaneous concepts C M** | | | | | | | | **Answer: c** | | **MEDIUM** | |
| [[43]](#endnote-43). | Which of the following statements is CORRECT? | | | | | | | | | | | |
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|  | a. | Corporations generally are subject to fewer regulations and more favorable tax treatment than sole proprietorships and partnerships. This 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. | | | | | | | | | | |
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|  | **(Comp: 1.2,1.3) Miscellaneous concepts C M** | | | | | | | | **Answer: e** | | **MEDIUM** | |
| [[44]](#endnote-44). | Which of the following statements is CORRECT? | | | | | | | | | | | |
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|  | 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. | | | | | | | | | | |
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|  | **(Comp: 1.2,1.3) Miscellaneous concepts C M** | | | | | | | | **Answer: d** | | **MEDIUM** | |
| [[45]](#endnote-45). | Which of the following statements is CORRECT? | | | | | | | | | | | |
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|  | 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 stockholders and bondholders 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. | | | | | | | | | | |
|  | 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, and this makes it easier for corporations to raise capital. | | | | | | | | | | |

***Medium/Hard:***

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|  | **(1.8) Ownership and going public C M** | | | | | | | | **Answer: b** | | **MEDIUM/HARD** | |
| [[46]](#endnote-46). | 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. | | | | | | | | | | |

CHAPTER 1

ANSWERS AND SOLUTIONS

1. . (1.2) Firm organization F M Answer: b EASY [↑](#endnote-ref-1)
2. . (1.2) Firm organization F M Answer: b EASY [↑](#endnote-ref-2)
3. . (1.2) Partnership F M Answer: a EASY [↑](#endnote-ref-3)
4. . (1.2) Proprietorship F M Answer a EASY [↑](#endnote-ref-4)
5. . (1.2) Limited liability F M Answer: a EASY [↑](#endnote-ref-5)
6. . (1.3) Value maximization F M Answer: b EASY [↑](#endnote-ref-6)
7. . (1.4) Financial intermediaries F M Answer a EASY [↑](#endnote-ref-7)
8. . (1.8) Financial markets F H Answer: b EASY [↑](#endnote-ref-8)
9. . (1.8) Financial markets F H Answer: a EASY [↑](#endnote-ref-9)
10. . (1.11) Stock market transactions F H Answer: a EASY [↑](#endnote-ref-10)
11. . (1.2) Partnership F M Answer: b MEDIUM [↑](#endnote-ref-11)
12. . (1.2) Proprietorship F M Answer: a MEDIUM [↑](#endnote-ref-12)
13. . (1.2) Firm organization C M Answer: d EASY

    Sole proprietorships and partnerships pay personal income tax, but they avoid the corporate income tax. Small corporations that meet certain requirements can elect to be classified as S Corporations, and then the business is taxed as a partnership. [↑](#endnote-ref-13)
14. . (1.2) Firm organization C M Answer: a EASY [↑](#endnote-ref-14)
15. . (1.2) Firm organization C M Answer: d EASY

    Corporations have limited liability; however, they face more regulations than the other forms of organization. [↑](#endnote-ref-15)
16. . (1.2) Firm organization C M Answer: c EASY [↑](#endnote-ref-16)
17. . (1.2) Firm organization C M Answer: a EASY

    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, and the corporation records the transfer on its books. [↑](#endnote-ref-17)
18. . (1.2) Corporate form of organization C M Answer: c EASY [↑](#endnote-ref-18)
19. . (1.4) Financial transactions C H Answer: c EASY [↑](#endnote-ref-19)
20. . (1.6) Interest rates C H Answer: a EASY [↑](#endnote-ref-20)
21. . (1.7) Hedge funds C O Answer: e EASY [↑](#endnote-ref-21)
22. . (1.8) Money markets C O Answer: d EASY [↑](#endnote-ref-22)
23. . (1.8) Financial markets C H Answer: b EASY

    Statement b is a primary market transaction, since the money and the security pass directly between the issuing firm and the investor. [↑](#endnote-ref-23)
24. . (1.8) Financial markets C H Answer: e EASY [↑](#endnote-ref-24)
25. . (1.8) Financial markets C H Answer: c EASY

    It is a secondary market transaction because the stock is transferred from one investor to another. [↑](#endnote-ref-25)
26. . (Comp: 1.7-1.9) Financial markets C H Answer: a EASY [↑](#endnote-ref-26)
27. . (Comp: 1.7-1.9) Financial markets C H Answer: a EASY [↑](#endnote-ref-27)
28. . (Comp: 1.7-1.9) Financial markets C H Answer: e EASY [↑](#endnote-ref-28)
29. . (1.2) Corporate form of organization C M Answer: a MEDIUM [↑](#endnote-ref-29)
30. . (1.2) Corporate form of organization C M Answer: c MEDIUM [↑](#endnote-ref-30)
31. . (1.2) Partnership form of organization C M Answer: b MEDIUM [↑](#endnote-ref-31)
32. . (1.2) Partnership form of organization C M Answer: d MEDIUM [↑](#endnote-ref-32)
33. . (1.2) Firm organization C M Answer: c MEDIUM [↑](#endnote-ref-33)
34. . (1.2) Firm organization C M Answer: b MEDIUM

    The S corporation would allow her to take early losses as deductions against her other income, hence save some taxes. Then, when the firm became profitable, she would receive dividends and pay taxes on them, but the firm itself would avoid corporate taxes and double taxation. [↑](#endnote-ref-34)
35. . (1.2) Corporate charter and bylaws C M Answer: e MEDIUM [↑](#endnote-ref-35)
36. . (1.3) Business ethics B M Answer: c MEDIUM

    It is important to have a specific set of rules that all employees are expected to follow. This helps constrain actions, and it is also important to "prove" that the company is trying to do right if some employee does something wrong. [↑](#endnote-ref-36)
37. . (1.3) Goal of firm C M Answer: a MEDIUM [↑](#endnote-ref-37)
38. . (1.3) Corporate goals and control C M Answer: d MEDIUM [↑](#endnote-ref-38)
39. . (1.5) Security prices and interest rates C H Answer: e MEDIUM [↑](#endnote-ref-39)
40. . (1.6) Interest rates C H Answer: d MEDIUM [↑](#endnote-ref-40)
41. . (1.6) Interest rates C H Answer: e MEDIUM

    An increase in the demand for capital by businesses will increase interest rates in the economy. [↑](#endnote-ref-41)
42. . (Comp: 1.8,1.9,1.11) Financial transactions C H Answer: d MEDIUM [↑](#endnote-ref-42)
43. . (Comp: 1.2,1.3) Miscellaneous concepts C M Answer: c MEDIUM [↑](#endnote-ref-43)
44. . (Comp: 1.2,1.3) Miscellaneous concepts C M Answer: e MEDIUM [↑](#endnote-ref-44)
45. . (Comp: 1.2,1.3) Miscellaneous concepts C M Answer: d MEDIUM [↑](#endnote-ref-45)
46. . (1.8) Ownership and going public C M Answer: b MEDIUM/HARD [↑](#endnote-ref-46)