

CHAPTER 1 - AN OVERVIEW OF FINANCIAL MANAGEMENT AND THE FINANCIAL ENVIRONMENT

1. The form of organization of a business is an important issue that reflects in some typical stages in the corporate life cycle.

- a. True
- b. False

ANSWER: True

2. Three disadvantages of a proprietorship are (1) the relative difficulty of raising new capital, (2) the owner's unlimited personal liability for the business's debts, and (3) that the proprietorship is easily but expensively formed.

- a. True
- b. False

ANSWER: False

3. Limited partners who are too involved in the business operation can keep their limited liability status.

- a. True
- b. False

ANSWER: False

4. Since a company's value is determined by properties of its cash flows, managers could increase the size of the expected cash flows or speed up their receipt to maximize the firm's value.

- a. True
- b. False

ANSWER: True

5. If Firm A's business is to obtain funds from savers in exchange for its own securities and then to use the money to invest in other businesses' securities, Firm A is a financial intermediary.

- a. True
- b. False

ANSWER: True

6. Today, banks can never provide trustee services and the difference between trusts and banks has become clear over time.

- a. True
- b. False

ANSWER: False

7. If an individual investor trades currently outstanding common shares through a broker, this is a primary market transaction.

- a. True
- b. False

ANSWER: False

8. In a limited liability partnership (LLP), only some partners enjoy limited liability with regard to their business

CHAPTER 1 - AN OVERVIEW OF FINANCIAL MANAGEMENT AND THE FINANCIAL ENVIRONMENT

partners' professional negligence, and their potential losses are limited to their investment in the LLP.

- a. True
- b. False

ANSWER:

False

9. Two key advantages to a proprietorship are that, as a business, it pays no corporate income tax and it is easy for a proprietorship to obtain the capital needed for growth.

- a. True
- b. False

ANSWER:

False

10. Equity instruments are a claim upon a residual value, but preferred shares have some features like debt and some like equity.

- a. True
- b. False

ANSWER:

True

11. Which of the following statements best describes firm organization?

- a. One of the disadvantages of a corporation is that the owners have unlimited liability when the firm goes bankrupt, which means losses can exceed the actual funds invested.
- b. In a sole proprietorship, the proprietor has limited personal liability for the business's debts and losses are limited to the money the proprietor invested in the business.
- c. Sole proprietorships and partnerships generally have a tax advantage over corporations, especially large ones.
- d. In both regular and limited partnerships, all partners are liable for the debts of the partnership.

ANSWER:

c

12. Which of the following statements best describes firm organization?

- a. One of the advantages of a corporation is that managers are always acting in the best interests of the owners, rather than their own best interests.
- b. It is generally more difficult to transfer one's ownership interest in a corporation than in a partnership.
- c. One of the advantages of the corporate form of organization is that its income is subject to only corporate taxation, rather than being taxed as a part of the proprietor's personal income.
- d. One of the disadvantages of a sole proprietorship is that the proprietor is exposed to unlimited liability.

ANSWER:

d

13. Which of the following statements best describes firm organization?

- a. One advantage of forming a corporation is that equity investors are usually exposed to less liability than in a regular partnership and sole proprietorship.
- b. One disadvantage of operating a business as a sole proprietorship is that the firm is subject to double

CHAPTER 1 - AN OVERVIEW OF FINANCIAL MANAGEMENT AND THE FINANCIAL ENVIRONMENT

taxation, at both the firm level and the owner level.

- c. It is generally more expensive to form a partnership than a corporation because a partnership requires extensive legal documents.
- d. In a limited partnership, the limited partners and general partners are liable only for the amount of their investment in the partnership.

ANSWER:

a

14. Cheers Canada operates as a partnership. What will be the effect if the partners decide to convert the business into a regular corporation?

- a. The transfer of ownership interests of Cheers Canada will be more difficult.
- b. Cheers Canada will be subject to more regulations.
- c. Cheers Canada will find it more difficult to obtain the capital needed for growth.
- d. Cheers Canada shareholders (the ex-partners) will be exposed to more liability.

ANSWER:

b

15. Which of the following statements best describes firm organization?

- a. Corporate shareholders are exposed to unlimited liability, and the losses may be amplified by the double taxation of incorporation.
- b. A corporation will stop operating if its original owners and managers are deceased.
- c. Partnerships generally face more regulations than corporations.
- d. It is usually easier to transfer ownership in a corporation than it is to transfer ownership in a partnership.

ANSWER:

d

16. Why might a business choose to operate as a corporation rather than as a sole proprietorship or a partnership?

- a. Less of a corporation's income is generally subjected to taxes than would be true if the firm were a sole proprietorship.
- b. It is difficult for a corporation to obtain the capital needed for growth.
- c. Corporate shareholders escape unlimited liability for the firm's debts, but this factor may be offset by the double taxation of the corporation.
- d. Corporations can be easily formed and generally face relatively few regulations.

ANSWER:

c

17. What should be done to maximize shareholder wealth and thus the value of the firm?

- a. Reduce the size of expected cash flows of the company.
- b. Increase the free cash flows of the business.
- c. Increase the risk level of the firm.
- d. Arrange for cash to be received later.

ANSWER:

b

CHAPTER 1 - AN OVERVIEW OF FINANCIAL MANAGEMENT AND THE FINANCIAL ENVIRONMENT

18. You recently sold 200 shares of your new company, ABC Corporation, to your brother at a family reunion. At the reunion your brother gave you a cheque for the shares and you gave your brother the share certificates. Which of the following best describes this transaction?

- a. a direct transfer of capital
- b. an indirect transfer of capital through investment bankers
- c. an indirect transfer through a financial intermediary
- d. an exchange of physical assets

ANSWER:

a

19. Which of the following statements best describes interest rates?

- a. If an investment opportunity's future cash flows are very uncertain and might be much lower than expected, providers require a lower expected return.
- b. The cost of money to fund users is basically determined by the rate of return required by fund providers.
- c. If companies have more good investment opportunities, interest rates are likely to decrease.
- d. If expected inflation decreases, interest rates are likely to increase.

ANSWER:

b

20. Which of the following statements best describes hedge funds?

- a. Hedge funds always have low risk because they hedge their investments.
- b. Like mutual funds, hedge funds can have thousands of investors.
- c. Hedge funds are risky, although they may be market-neutral.
- d. Hedge funds are more regulated than mutual funds since they use derivatives to form portfolios.

ANSWER:

c

21. What is traded on money markets?

- a. corporate shares
- b. short-term, highly liquid debt securities
- c. intermediate-term debt securities
- d. long-term bonds

ANSWER:

b

22. Which of the following is an example of a primary market transaction?

- a. Apple issues 10,000,000 new shares and sells them to the public through an investment banker.
- b. You invest \$20,000 in a mutual fund, which then uses the money to buy \$20,000 of Apple shares on the TSX.
- c. One financial institution sells 300,000 Apple shares to another institution with the help of an investment banker.
- d. You sell 500 Apple shares on the TSX through your broker.

ANSWER:

a

CHAPTER 1 - AN OVERVIEW OF FINANCIAL MANAGEMENT AND THE FINANCIAL ENVIRONMENT

23. Which of the following statements best describes financial markets?

- a. If Apple issues an additional 1,000,000 shares through an investment banker, this would be a secondary market transaction.
- b. Capital market transactions involve highly liquid debt securities with maturities of less than one year.
- c. The IPO market is a major part of the primary market.
- d. Bank loans and private placements of debt with insurance companies are examples of private public market transactions.

ANSWER:

c

24. You recently sold 500 shares of Alphabet stock; the transfer was made through a broker, and the trade occurred on the TSX. Which type of transaction is this?

- a. a futures market transaction
- b. an IPO market transaction
- c. a primary market transaction
- d. a secondary market transaction

ANSWER:

d

25. Which of the following statements best describes financial markets?

- a. If an investor buys shares through a broker, then this would be an indirect finance transaction.
- b. Commercial paper is issued by firms to larger investors and guaranteed by a bank.
- c. Bankers' acceptances have a high degree of default risk.
- d. Money market mutual funds have maturities longer than one year.

ANSWER:

a

26. Which of the following statements best describes financial markets?

- a. Financial asset markets include only long-term debt and common shares.
- b. Money market mutual funds have no default risk.
- c. Foreign banks are now less restricted from operating in Canada than in the past.
- d. The original maturity of a mortgage can go up to 40 years.

ANSWER:

c

27. Which of the following statements best describes financial markets?

- a. Rates of return on Government of Canada Treasury bills are the highest among all major financial securities.
- b. Corporate bonds are riskier than Canadian government debt and their risk depends on the strength of the issuer.
- c. Capital markets are markets for short-term, highly liquid debt securities.
- d. Commercial paper is illiquid.

ANSWER:

b

CHAPTER 1 - AN OVERVIEW OF FINANCIAL MANAGEMENT AND THE FINANCIAL ENVIRONMENT

28. What is one of the drawbacks of switching from a partnership to the corporate form of organization?
- a. It makes the firm's investors subject to unlimited potential personal liabilities.
 - b. It makes its income taxable only as a part of the proprietor's personal income.
 - c. It makes it more difficult for the firm's investors to transfer their ownership interests.
 - d. It subjects the firm to additional regulations.

ANSWER: d

29. Which of the following statements best describes partnerships and/or corporations?
- a. Corporations can attract large capital more easily due to factors such as limited liability, and the liquidity of the owners' interests.
 - b. In a regular partnership, liability for other partners' misdeeds is limited to the amount of a particular partner's investment in the partnership.
 - c. A fast-growth business, with great need for new capital, would be less likely to organize as a corporation than would a slow-growth business.
 - d. A major disadvantage of partnerships relative to corporations is the fact that taxes must be paid by the partners and the firm itself.

ANSWER: a

30. Which of the following statements best describes partnerships and/or corporations?
- a. In a regular partnership, a partner's liability for the firm's debts is limited to the amount they have invested in the business.
 - b. Corporations are at a disadvantage relative to partnerships because the earnings of the corporation are taxed at the firm level, not at the individual level.
 - c. There must be at least one general partner in a limited partnership.
 - d. A slow-growth business would be more likely to set up as a corporation for its business organization than would a fast-growth business.

ANSWER: c

31. Which of the following is an example of providers of cash?
- a. entrepreneurs with ideas
 - b. individuals who are saving for retirement
 - c. corporations with growth plans
 - d. students wishing to borrow money for tuition

ANSWER: b

32. Which statement regarding corporations is most accurate?
- a. Due to limited liability, unlimited lives, and ease of ownership transfer, the vast majority of businesses begin as corporations.
 - b. Large corporations have more tax advantages than partnerships.
 - c. Due to legal considerations related to ownership transfers and limited liability, most business is conducted by corporations in spite of large corporations' often less favourable tax treatment.

CHAPTER 1 - AN OVERVIEW OF FINANCIAL MANAGEMENT AND THE FINANCIAL ENVIRONMENT

d. Corporate shareholders have unlimited liability when the corporation becomes bankrupt.

ANSWER:

c

33. Which of the following statements best describes articles of incorporation and bylaws?

- a. The articles of incorporation are concerned with things like the share class description, whereas the bylaws are concerned with things like procedures for electing the board of directors.
- b. An initial registered office address and first board of directors form can be omitted when filed with Corporations Canada.
- c. A professional corporation formed by professionals such as doctors or lawyers can relieve the participation of professional (malpractice) liability.
- d. The corporate bylaws are a standard set of rules established by the state of incorporation, so these rules are identical for all corporations.

ANSWER:

a

34. Which of the following statements would most people in business agree with?

- a. A firm's commitment to business ethics can only be measured by the tendency of its employees to adhere to laws and regulations.
- b. Legal and ethical considerations make firms' profits and ethics always consistent.
- c. Canada's federal government passed the Sarbanes-Oxley Act, with a provision designed to protect "whistleblowers."
- d. Although moral character is developed differently, it is useful to educate people about the adverse consequences of unethical behaviour to themselves, their firms, and the nation.

ANSWER:

d

35. What should be the primary operating goal of a publicly owned firm interested in serving its shareholders?

- a. maximize the firm's expected sales revenue
- b. maximize the stock price during a specific period
- c. maximize the stock price per share, which is the stock's fundamental value, over the long run
- d. maximize the firm's expected EPS

ANSWER:

c

36. Which of the following statements best describes corporate goals and issues?

- 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. Potential agency problems can arise between shareholders and managers, because managers hired as agents to act on behalf of the owners may instead make decisions favourable to themselves rather than the shareholders.
- c. Large, publicly owned firms like Tesla and Apple 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 the shareholders' 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

CHAPTER 1 - AN OVERVIEW OF FINANCIAL MANAGEMENT AND THE FINANCIAL ENVIRONMENT

motivate managers to act in the shareholders' best interests.

- d. The primary goal of the corporation should be to maximize shareholder wealth, which means the managers should be unmindful of employee welfare or community concerns.

ANSWER:

b

37. Suppose the Bank of Canada announces plans to issue \$100 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 would decrease and interest rates would increase.
- b. Prices and interest rates would both increase.
- c. Prices would increase and interest rates would decrease.
- d. Prices and interest rates would both decrease.

ANSWER:

a

38. Which of the following statements best describes financial instruments?

- a. Investors will exchange cash for a financial instrument even if they expect to receive an unacceptable rate of return.
- b. Debt instruments usually do not have specified payments and a specified maturity.
- c. Equity instruments typically have specified payments and a specified maturity.
- d. Shareholders are entitled to cash flows after bondholders, creditors, and other claimants have been satisfied.

ANSWER:

d

39. Which circumstance would most likely lead to an increase in interest rates in the economy?

- a. The economy is experiencing a deflation.
- b. The economy falls into a recession.
- c. There is an increase in expected inflation.
- d. The federal government decides to promote economic activity.

ANSWER:

c

40. Which of the following financial intermediaries is a depository institution?

- a. commercial bank
- b. investment bank
- c. securities firm
- d. finance company

ANSWER:

a

41. Which of the following statements best describes income trusts?

- a. Since the goal is to distribute as little free cash flow as possible, businesses that have required significant capital expenditures in the past have been the best candidates.

CHAPTER 1 - AN OVERVIEW OF FINANCIAL MANAGEMENT AND THE FINANCIAL ENVIRONMENT

- b. Whereas dividends received by investors are taxed at both the corporate and individual levels, income trust cash distributions are taxed only at the corporate level.
- c. An income trust is an equity investment created to distribute all of a business's free cash flow to investors in a tax-efficient manner.
- d. Cash-producing assets such as real estate make up only a minority of income trusts.

ANSWER:

c

42. In Canada, the Canada Deposit Insurance Corporation (CDIC) insures personal bank account balances up to \$100,000. What is the primary reason for this provision?

- a. This can encourage banking institutions to expand their business.
- b. This can prevent a "bank run" and ensure stability in times of economic uncertainty.
- c. This would give the government more control over the banking system.
- d. This is a common practice in the U.S. and all other developed economies.

ANSWER:

b

43. Which of the following statements is true regarding hedge funds and private equity funds?

- a. Hedge funds own shares in other companies and often control those companies, but private equity funds usually own many different types of securities.
- b. Investing in hedge funds is far riskier than investing in private equity funds.
- c. Private equity funds are highly regulated, while there are even more controls over the activities of hedge funds.
- d. Both are limited to a relatively small number of large investors.

ANSWER:

d

44. Which of the following services will **NOT** be offered by life insurance companies?

- a. line of credit
- b. investing funds in shares, bonds, real estate, and mortgages
- c. offering a variety of tax-deferred savings plans
- d. making payments to beneficiaries

ANSWER:

a

45. Which of the following statements is correct?

- a. A good goal for a firm's management is maximization of stock price at a target date.
- b. Many Canadian companies' boards have directors who specifically represent the interests of employees and not just shareholders.
- c. Agency problems easily arise between shareholders and managers in corporations, but they can be addressed by corporate governance.
- d. Income trust cash distributions are taxed at both the trust and individual levels.

ANSWER:

c

46. Which of the following statements is **NOT** correct?

CHAPTER 1 - AN OVERVIEW OF FINANCIAL MANAGEMENT AND THE FINANCIAL ENVIRONMENT

- a. The initial public offering (IPO) market is a subset of the primary market.
- b. The Toronto Stock Exchange is a secondary market, since it deals in outstanding as opposed to newly issued shares.
- c. Since the transactions in private markets are private, they may be structured in any manner that appeals to the two parties.
- d. “Going public” establishes a firm’s true intrinsic value, and it also ensures that a highly liquid market will always exist for the firm’s shares.

ANSWER:

d

47. Which of the following represents the most significant reason for the collapse of the U.S. investment banks in 2008?

- a. In the 1990s, most large U.S. investment banks were reorganized into public trading companies (or were acquired and then operated as subsidiaries of public companies).
- b. In the 2000s, most investment banks started to generate most of their income from fees charged for underwriting, M&A consulting, asset management, and brokerage activities.
- c. New regulations introduced in the 2000s placed more restrictions on the operations of investment banks.
- d. A relaxation of regulations in the 2000s allowed investment banks to issue unprecedented amounts of debt to finance their activities.

ANSWER:

d

48. Besides strong relationships with groups outside the company, what else supports good businesses?

- a. adequate inventories
- b. adequate funding
- c. adequate self-interest
- d. adequate rules and laws

ANSWER:

b

49. Which of the following best describes the position of the bondholders of an incorporated firm?

- a. They are creditors of the firm and thus expect to be paid interest on their investment according to their bond indenture (contract).
- b. They have voting rights.
- c. They have the same rights and privileges as the preferred shareholders of the firm.
- d. They are owners of the firm, but they do not receive dividends.

ANSWER:

a

50. Which of the following best describes the market price of a stock?

- a. the price observed by investors on financial websites
- b. the price at which a security first trades when an exchange opens for the day
- c. the price observed in the broad financial markets

CHAPTER 1 - AN OVERVIEW OF FINANCIAL MANAGEMENT AND THE FINANCIAL ENVIRONMENT

- d. the price predicted by analysts in research reports

ANSWER:

c

51. If the market price of a stock reflects all relevant information, what does its market price reflect?

- a. the stock's historical value
- b. the stock's intrinsic value
- c. the stock's current value
- d. the stock's extrinsic value

ANSWER:

b

52. Which of the following is true of stock ownership in Canada?

- a. Most Canadian households directly own stock.
- b. 80% of Canadian households directly own stock.
- c. 61% of Canadian households directly own stock.
- d. 10% of Canadian households directly own stock.

ANSWER:

d

53. Share price maximization is good for society because consumers benefit. Which of the following best describes this idea?

- a. Firms that maximize share price minimize costs and produce high-quality goods and services that consumers demand.
- b. Firms that maximize share price minimize costs and produce low-quality goods and services, which benefits only producers.
- c. Firms that maximize share price maximize costs and produce high-quality goods and services, which benefits society.
- d. Firms that maximize share price maximize costs and produce low-quality goods and services, which benefits society.

ANSWER:

a

54. What does the separation theorem demonstrate?

- a. Firms that separate goods' prices and cost minimize costs and thus produce more goods, which benefits society.
- b. Firms should separate their management decisions between those that benefit consumers and those that benefit shareholders.
- c. Investors that prefer to receive dividend income now should be separated from investors that prefer to forgo dividends currently.
- d. All investors are better off when firms separate their investment decisions from the preferences of their owners/investors.

ANSWER:

d

55. Which of the following is **NOT** a variable used in the calculation of free cash flow (FCF)?

CHAPTER 1 - AN OVERVIEW OF FINANCIAL MANAGEMENT AND THE FINANCIAL ENVIRONMENT

- a. sales revenues
- b. interest and dividends
- c. required investments in operating capital
- d. operating costs

ANSWER: b

56. Which of the following is **NOT** a primary disadvantage of a regular partnership?

- a. ease in transferring ownership
- b. limited life of the organization
- c. unlimited life of the organization
- d. difficulty in transferring ownership

ANSWER: c

57. Recently, Hale Corporation, a public company, announced the sale of 4.5 million newly issued common shares at a price of \$32 per share. Hale sold the stock to an investment banker, which in turn sold it to individual and institutional investors. What is the name of the market for this transaction?

- a. private market
- b. primary market
- c. IPO market
- d. secondary market

ANSWER: b

58. In which type of organization do all partners enjoy limited liability regarding negligence and potential losses limited to their investment in the partnership?

- a. limited liability partnership (LLP)
- b. income trust
- c. sole proprietorship
- d. general partnership

ANSWER: a

59. What is the rate of return normally required by investors when investing in a firm?

- a. yield to maturity (YTM)
- b. weighted average cost of capital (WACC)
- c. internal rate of return (IRR)
- d. policy interest rate

ANSWER: b

60. Which of the following statements is true regarding a firm's value?

- a. A manager's primary job is to increase the company's EPS.
- b. The intrinsic value is the present value of the firm's expected free cash flows, discounted at the

CHAPTER 1 - AN OVERVIEW OF FINANCIAL MANAGEMENT AND THE FINANCIAL ENVIRONMENT

WACC.

- c. To increase the intrinsic value, a firm should increase WACC.
- d. To increase the intrinsic value, a firm should reduce FCF.

ANSWER:

b

61. The primary goal of a company's management is the maximization of which of the following?

- a. net profit
- b. market share
- c. dividends
- d. fundamental share price

ANSWER:

d