

Chapter 01 Introduction to Corporate Finance

Multiple Choice Questions

1. The balance sheet is made up of what five key components:
- A. fixed assets, current liabilities, long term debt, tangible current assets and shareholders' equity.
 - B. intangible fixed assets, current liabilities, long term debt, net income and current assets.
 - C. fixed assets, long term debt, current assets, current liabilities and shareholders' equity.
 - D. current assets, fixed assets, long term debt, shareholders equity and retained earnings.

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Blooms: Remember
Difficulty: Medium
Topic: 01-01 What is Corporate Finance?

2. In terms of the balance sheet model of the firm, the value of the firm in financial markets is equal to:
- A. tangible fixed assets plus intangible fixed assets.
 - B. sales minus costs.
 - C. cash inflow minus cash outflow.
 - D. the value of the debt plus the value of the equity.
 - E. the value of the debt minus the value of the equity.

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Difficulty: Easy
Topic: 01-01 What is Corporate Finance?

3. Inventory is a component of:

- A.** current assets.
- B. current liabilities.
- C. equity.
- D. fixed assets.

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Difficulty: Easy
Topic: 01-01 What is Corporate Finance?

4. Using the balance sheet model of the firm, finance may be thought of as analysis of three primary subject areas. Which of the following groups correctly lists these three areas?

- A.** Capital budgeting, capital structure, net working capital.
- B. Capital budgeting, capital structure, security marketing.
- C. Capital budgeting, net working capital, tax analysis.
- D. Capital budgeting, tax analysis, security marketing.
- E. Net working capital, tax analysis, security marketing.

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Difficulty: Easy
Topic: 01-01 What is Corporate Finance?

5. Which of the following is not considered one of the basic questions of corporate finance?

- A. What long-lived assets should the firm invest?
- B.** How much inventory should the firm hold?
- C. How can the firm raise cash for required capital expenditures?
- D. How should the short-term operating cash flows be managed?

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Difficulty: Easy
Topic: 01-01 What is Corporate Finance?

6. The need to manage net working capital arises because:
- A. financial management is naturally broken into those areas.
 - B. shareholders want to ensure they receive dividend payments.
 - C.** there is a mismatch between the timing of cash inflows and cash outflows.
 - D. the sum of current assets and current liabilities usually is zero.
 - E. the capital structure pie is limited in size.

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Blooms: Understand
Difficulty: Easy
Topic: 01-01 What is Corporate Finance?

7. Which one of these is a cash outflow from a corporation?
- A. sale of an asset
 - B.** dividend payment
 - C. sale of common stock
 - D. issuance of debt
 - E. profit retained by the firm

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Blooms: Understand
Difficulty: Easy
Topic: 01-01 What is Corporate Finance?

8. In the managerial structure of the corporation the two officers and their responsibilities that report directly to the Chief Financial Officer are:
- A. the credit manager who handles accounts receivable and the tax manager who minimizes tax payments.
 - B. the personnel manager who manages salaries and compensation and the production operations manager who manages facility operations.
 - C. the treasurer who is responsible handling cash flow and making financial decisions and the tax manager who minimizes tax payments.
 - D.** the controller who manages the accounting function and the treasurer who is responsible handling cash flow and making financial decisions.

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Blooms: Remember
Difficulty: Easy
Topic: 01-01 What is Corporate Finance?

9. Value is created and recognized over time if:

- A. cash raised is invested in the investment activities of the firm.
- B. funds are raised in the capital markets.
- C. cash paid to investors, shareholders and bondholders, is greater than cash raised in the financial markets.
- D. management pursues activities to reduce taxes to zero.

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Blooms: Understand

Difficulty: Medium

Topic: 01-01 What is Corporate Finance?

10. Time preference refers to the fact that:

- A. corporations match current assets with current liabilities to minimize the chance of bankruptcy.
- B. corporations match both current and long-term assets with current and long-term liabilities to minimize the change of bankruptcy.
- C. investors prefer current cash flows to future cash flows.
- D. investors seek to time cash flows to minimize tax liabilities.

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Blooms: Understand

Difficulty: Medium

Topic: 01-01 What is Corporate Finance?

11. A corporate security can be viewed as a contingent claim on the firm. This means that:

- A. debt holders will receive their payoff from the firm based on their fixed claim or the firm cash flows if less than the fixed claim.
- B. debt holders will receive the maximum of the firm cash flows or the fixed claim.
- C. no payoff will be made unless the firms makes more than the fixed claim of the debt.
- D. no debt payoff will be made if there is an equity payoff.

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Blooms: Understand

Difficulty: Medium

Topic: 01-02 The Balance-Sheet Model of the Firm

12. If a firm has debt outstanding the contingent claim of an equity shareholder is:
- A. equal to the payment to the debtholders
 - B. equal to the firm cash flows minus the fixed debt payment if the residual cash flows are positive**
 - C. equal to the firm cash flows minus the fixed debt payment whether positive or negative
 - D. equal to the debt payment plus the residual cash flow of the firm.

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Difficulty: Medium

Topic: 01-02 The Balance-Sheet Model of the Firm

13. The Simple Corporation has outstanding obligation to the Complex Corporation of \$250. It is year-end and the total cash flow of Simple from all sources is \$325. The contingent payoff to the debtholders and the equity shareholders is:
- A. \$250; \$325.
 - B. \$75; \$250.
 - C. \$250; \$75.**
 - D. \$325; \$250.

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Blooms: Analyze

Difficulty: Medium

Topic: 01-02 The Balance-Sheet Model of the Firm

14. The general partner(s) in a general partnership agree to share work, costs and profits and losses. Each partner:
- A. has liability only up to the amount of their investment.
 - B. has liability for the debts of the partnership.**
 - C. has liability only if it is formally documented.
 - D. never has any liability but the limited partners do.

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Difficulty: Medium

Topic: 01-03 Capital Structure

15. In a general partnership, the general partners have _____ liability and have _____ control over day-to-day operations.

- A. limited; no
- B. unlimited; total**
- C. limited; total
- D. unlimited; no
- E. no; total

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Blooms: Remember
Difficulty: Medium
Topic: 01-03 Capital Structure

16. The ultimate control of a corporation lies in the hands of the corporate:

- A. board of directors.
- B. shareholders**
- C. CEO of the firm
- D. chairman of the board
- E. government

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Blooms: Remember
Difficulty: Easy
Topic: 01-03 Capital Structure

17. The division of profits and losses among the members of a partnership is formalized in the:

- A. indemnity clause
- B. indenture contract
- C. statement of purpose
- D. partnership agreement**

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Blooms: Remember
Difficulty: Easy
Topic: 01-03 Capital Structure

18. The cheapest business entity to form is typically the:

- A. limited liability company.
- B. joint stock company.
- C. general partnership.
- D. limited partnership.
- E.** sole proprietorship.

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Blooms: Remember

Difficulty: Easy

Topic: 01-03 Capital Structure

19. The Splitz Corporation has borrowed \$5 million in debt with a promise to repay \$5.5 million in one year. The corporation had 10 million shares outstanding worth \$2 each at the time of the borrowing. Splitz earns \$6 million during the year. What is the debtholder's contingent claim; how much do the debtholders receive; and, how much do the equity holders receive?

- A. 5.5; 6; 20.
- B. 5; 5.5; 0.
- C. 5; 5.5; 20.
- D.** 5.5; 5.5; .5.

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Blooms: Analyze

Difficulty: Medium

Topic: 01-03 Capital Structure

20. The Splitz Corporation has borrowed \$5 million in debt with a promise to repay \$5.5 million in one year. The corporation had 10 million shares outstanding worth \$2 each at the time of the borrowing. Splitz earns \$5 million during the year. What is the debtholder's contingent claim; how much does the debtholder receive; and, how much do the equity holders receive?

A. 5; 5.5; 20.

B. 5.5; 5; 0.

C. 5; -.5; 20.

D. -.5; 5; 0.

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Blooms: Analyze

Difficulty: Medium

Topic: 01-03 Capital Structure

21. Corporate securities are contingent claims because:

A. they don't represent a direct claim on the firm.

B. the firm may be bought out.

C. the securities value is derived from the total value of the firm.

D. book value can be negative.

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Difficulty: Hard

Topic: 01-02 The Balance-Sheet Model of the Firm

22. Agency costs as the sum costs of:

A. monitoring costs of the shareholders and the residual loss of wealth due to divergent management behavior.

B. the costs of implementing control devices and the monitoring costs of the shareholders.

C. the costs of implementing control devices and the residual loss of wealth due to divergent management behavior.

D. the set-of-contracts needed to structure the firm and residual wealth.

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Blooms: Understand

Difficulty: Hard

Topic: 01-04 The Financial Manager

23. Which one of these best fits the description of an agency cost?

- A. increasing the dividend payments per share
- B. the benefits received from reducing production costs per unit
- C. the payment of corporate income taxes
- D.** the payment required for an outside audit of the firm
- E. the payment of interest on a firm's debts

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Blooms: Understand
Difficulty: Medium
Topic: 01-04 The Financial Manager

24. Agency costs refer to:

- A. the total dividends paid to stockholders over the lifetime of a firm.
- B. the costs that result from default and bankruptcy of a firm.
- C. corporate income subject to double taxation.
- D.** the costs of any conflicts of interest between stockholders and management.
- E. the total interest paid to creditors over the lifetime of the firm.

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Difficulty: Easy
Topic: 01-04 The Financial Manager

25. Managerial goals may differ from those of the shareholders. It is noted that managers may:

- A. have a preference for expense consumption.
- B. be motivated by controlling sufficient resources to stay in business.
- C.** avoid the control of the capital market and rely on internally generated funds.
- D. be wanted to depend on external parties.

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Blooms: Understand
Difficulty: Hard
Topic: 01-04 The Financial Manager

26. What is the primary goal of the corporation?

- A. Maximize the pay and compensation of employees and managers of the firm.
- B.** Maximize the value of the stockholders as they are the owners of the corporation.
- C. Minimize the wealth of the shareholders and maximize the wealth of managers.
- D. Maximize the societal value to minimize governmental interference.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Topic: 01-04 The Financial Manager

27. Financial markets are composed of:

- A. capital markets and equity markets.
- B. capital markets and debt markets.
- C.** capital markets and money markets.
- D. equity markets and money markets.

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Blooms: Remember
Difficulty: Easy
Topic: 01-05 Identification of Cash Flows

28. The primary market is defined as:

- A. the market for insured securities.
- B.** the market for new issues.
- C. the market for securities of the largest firms.
- D. the over-the-counter market.

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Blooms: Remember
Difficulty: Easy
Topic: 01-05 Identification of Cash Flows

29. Which one of the following is a primary market transaction?
- A. A dealer selling shares of stock to an individual investor.
 - B. A dealer buying newly issued shares of stock from a corporation.**
 - C. An individual investor selling shares of stock to another individual.
 - D. A bank selling shares of a medical firm to an individual.

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Difficulty: Medium
Topic: 01-05 Identification of Cash Flows

Short Answer Questions

30. Flea Fall Inc., a maker of dog flea collars, paid \$125,000 cash for inventory on January 1, 2014. On December 31, 2014, the company's sales total \$147,000 of which \$117,000 has been collected. If inventory represents Flea Falls only cost, calculate the firms accounting profit as well as its cash flow as of December 31.

Accounting Profit = Sales - Cost (\$147,000 - \$125,000 = \$22,000)
Cash Flow = Cash Inflow - Cash Outflow (\$117,000 - \$125,000 = \$8,000)

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Blooms: Analyze
Difficulty: Medium
Topic: 01-01 What is Corporate Finance?

31. The Harlow Corporation has promised to pay its debtholders an amount of \$2,700 over the next year. The firm's shareholders hold claim to whatever is left after the debtholders' claims have been satisfied. Calculate Harlow's debt and equity level if its assets total \$1100 at the end of the year. Recalculate for asset levels of \$2,200 and \$6,000.

If assets total \$1100: Value of Debt = \$1100, Value of Equity = \$0
If assets total \$2200: Value of Debt = \$2200, Value of Equity = \$0
If assets total \$6000: Value of Debt = \$2700, Value of Equity = \$3300

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Blooms: Analyze
Difficulty: Medium
Topic: 01-01 What is Corporate Finance?

32. A financial manager's most important job is to create value from capital budgeting, financing, and liquidity activities. Explain how financial managers create value.

Buy assets that generate more than their cost.

Sell financial securities that raise more cash than they cost.

Minimize cash payouts to non-investors, ie., taxes to governments.

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Difficulty: Medium

Topic: 01-01 What is Corporate Finance?

33. List and briefly describe the three basic areas addressed by a financial manager.

The three areas are:

1. Capital budgeting: The financial manager tries to identify investment opportunities that are worth more to the firm than they cost to acquire.
2. Capital structure: This refers to the specific mixture of current and long-term debt and equity a firm uses to finance its operations.
3. Working capital management: This refers to a firm's short-term assets and short-term liabilities. Managing the firm's working capital is a day-to-day activity that ensures the firm has sufficient resources to continue its operations and avoid costly interruptions.

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Blooms: Remember

Difficulty: Medium

Topic: 01-01 What is Corporate Finance?

34. The decision to incorporate must consider the fact that earnings will be taxed at both the corporate and personal levels. Since this is disadvantageous, provide three reasons why one may want to incorporate.

Easier access to capital markets.
Retention of funds for reinvestment opportunities.
Market pricing and trading of securities.

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Blooms: Understand
Difficulty: Hard
Topic: 01-03 Capital Structure

35. How can shareholders attempt to control managerial behavior to match shareholder interest?

Vote for directors with shareholder's interest to select management.
Provide incentive contracts; performance shares or options.
Outside threat of takeover, (Board should not be willing to launch poison pills.)
Managerial labor market.

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Difficulty: Hard
Topic: 01-04 The Financial Manager

36. Do you think agency problems arise in sole proprietorships and/or partnerships?

Agency conflicts typically arise when there is a separation of ownership and management of a business. In a sole proprietorship and a small partnership, such separation is not likely to exist to the degree it does in a corporation. However, there is still potential for agency conflicts. For example, as employees are hired to represent the firm, there is once again a separation of ownership and management.

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Difficulty: Hard
Topic: 01-04 The Financial Manager

37. If the corporate form of business organization has so many advantages over the sole proprietorship, why is it so common for small businesses to initially be formed as sole proprietorships?

A significant advantage of the sole proprietorship is that it is cheap and easy to form. If the sole proprietor has limited capital to start with, it may not be desirable to spend part of that capital forming a corporation. Also, limited liability for business debts may not be a significant advantage if the proprietor has limited capital, most of which is tied up in the business anyway. Finally, for a typical small business, the heart and soul of the business is the person who founded it, so the life of the business may effectively be limited to the life of the founder during its early years.

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Difficulty: Medium
Topic: 01-03 Capital Structure

38. One thing lenders sometimes require when loaning money to a small corporation is an assignment of the common stock as collateral on the loan. Then, if the business fails to repay its loan, the ownership of the stock certificates can be transferred directly to the lender. Why might a lender want such an assignment? What advantage of the corporate form of organization comes into play here?

In the event of a loan default, a lender may wish to liquidate the business. Often it is time consuming and difficult to take title of all of the business assets individually. By taking control of the stock, the lender is able to sell the business simply by reselling the stock in the business. This illustrates the ease of transfer of ownership of a corporation.

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Difficulty: Medium
Topic: 01-03 Capital Structure