Chapter 01

Introduction to Corporate Finance

**Multiple Choice Questions**

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| 1. | This book is mainly about:      |  |  | | --- | --- | | A. | financial decisions made by corporations. |  |  |  | | --- | --- | | B. | financial decisions made by households. |  |  |  | | --- | --- | | C. | financial decisions made by governments. |  |  |  | | --- | --- | | D. | financial decisions made by employees. | |

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| 2. | Shareholders of a corporation may be, among others: I) individuals; II) pension funds; III) insurance companies      |  |  | | --- | --- | | A. | I only |  |  |  | | --- | --- | | B. | I and II only |  |  |  | | --- | --- | | C. | II only |  |  |  | | --- | --- | | D. | I, II, and III | |

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| 3. | Generally, a corporation is owned by its: I) managers; II) board of directors; III) shareholders      |  |  | | --- | --- | | A. | I only |  |  |  | | --- | --- | | B. | II and III |  |  |  | | --- | --- | | C. | III only |  |  |  | | --- | --- | | D. | I, II, and III | |

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| 4. | A corporation, potentially, has infinite life because it:      |  |  | | --- | --- | | A. | is a legal entity. |  |  |  | | --- | --- | | B. | has the same ownership and management. |  |  |  | | --- | --- | | C. | has limited liability. |  |  |  | | --- | --- | | D. | is closely regulated. | |

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| 5. | Limited liability is an important feature of:      |  |  | | --- | --- | | A. | sole proprietorships. |  |  |  | | --- | --- | | B. | partnerships. |  |  |  | | --- | --- | | C. | corporations. |  |  |  | | --- | --- | | D. | both partnerships and corporations. | |

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| 6. | As a legal entity a corporation can perform the following functions EXCEPT: I) borrow money; II) lend money; III) sue and be sued; IV) vote      |  |  | | --- | --- | | A. | I and II only |  |  |  | | --- | --- | | B. | I, II, and III only |  |  |  | | --- | --- | | C. | IV only |  |  |  | | --- | --- | | D. | I, II, III, and IV | |

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| 7. | Which of the following assets is tangible?      |  |  | | --- | --- | | A. | Exxon-Mobil's corporate headquarters building |  |  |  | | --- | --- | | B. | Apple Computer's trademark |  |  |  | | --- | --- | | C. | Hewlett-Packard's most recent printer patent |  |  |  | | --- | --- | | D. | Microsoft's technical expertise | |

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| 8. | Which of the following types of assets are intangible?      |  |  | | --- | --- | | A. | production machinery |  |  |  | | --- | --- | | B. | factories |  |  |  | | --- | --- | | C. | trademarks |  |  |  | | --- | --- | | D. | office equipment | |

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| 9. | A firm's investment decision is also called its:      |  |  | | --- | --- | | A. | financing decision. |  |  |  | | --- | --- | | B. | liquidity decision. |  |  |  | | --- | --- | | C. | capital budgeting decision. |  |  |  | | --- | --- | | D. | leasing decision. | |

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| 10. | Which of the following is not a financial asset?      |  |  | | --- | --- | | A. | common stock |  |  |  | | --- | --- | | B. | bank loans |  |  |  | | --- | --- | | C. | preferred stock |  |  |  | | --- | --- | | D. | buildings | |

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| 11. | The treasurer usually oversees the following functions of a corporation: I) preparation of financial statements; II) currency trading; III) cash management; IV) raising new capital      |  |  | | --- | --- | | A. | I and III only |  |  |  | | --- | --- | | B. | I, II, and III only |  |  |  | | --- | --- | | C. | III and IV only |  |  |  | | --- | --- | | D. | II, III, and IV only | |

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| 12. | The treasurer is usually responsible for the following functions of a corporation: I) tax obligations; II) investor relationships; III) cash management; IV) raising new capital      |  |  | | --- | --- | | A. | I only |  |  |  | | --- | --- | | B. | I and II only |  |  |  | | --- | --- | | C. | II, III, and IV only |  |  |  | | --- | --- | | D. | I, II, III, and IV | |

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| 13. | The controller usually oversees the following functions of a corporation: I) preparation of financial statements; II) internal accounting; III) cash management; and IV) taxes      |  |  | | --- | --- | | A. | I, II, and IV only |  |  |  | | --- | --- | | B. | III only |  |  |  | | --- | --- | | C. | I and II only |  |  |  | | --- | --- | | D. | II and III | |

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| 14. | The controller is usually responsible for the following functions of a corporation **EXCEPT**: I) preparation of financial statements; II) internal accounting; III) cash management; IV) taxes      |  |  | | --- | --- | | A. | I only |  |  |  | | --- | --- | | B. | III only |  |  |  | | --- | --- | | C. | I and II only |  |  |  | | --- | --- | | D. | IV only | |

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| 15. | Which of the following is an important function of financial markets? I) providing financing; II) providing liquidity; III) reducing risk; IV) providing information      |  |  | | --- | --- | | A. | I only |  |  |  | | --- | --- | | B. | I and II only |  |  |  | | --- | --- | | C. | I, II, III, and IV |  |  |  | | --- | --- | | D. | IV only | |

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| 16. | The chief financial officer (CFO) of a corporation oversees:      |  |  | | --- | --- | | A. | treasurer's functions. |  |  |  | | --- | --- | | B. | controller's functions. |  |  |  | | --- | --- | | C. | the chief operating officer's functions. |  |  |  | | --- | --- | | D. | both the treasurer and the controller's functions. | |

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| 17. | In the principal-agent framework:      |  |  | | --- | --- | | A. | shareholders are the principals. |  |  |  | | --- | --- | | B. | managers are the principals. |  |  |  | | --- | --- | | C. | managers are the agents. |  |  |  | | --- | --- | | D. | A and C. | |

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| 18. | Costs associated with the conflicts of interest between the bondholders and the shareholders of a corporation are called:      |  |  | | --- | --- | | A. | legal costs. |  |  |  | | --- | --- | | B. | bankruptcy costs. |  |  |  | | --- | --- | | C. | administrative costs. |  |  |  | | --- | --- | | D. | agency costs. | |

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| 19. | A corporation may incur agency costs because:      |  |  | | --- | --- | | A. | managers may not attempt to maximize the value of the firm to shareholders. |  |  |  | | --- | --- | | B. | shareholders incur monitoring costs. |  |  |  | | --- | --- | | C. | of the separation of ownership and management. |  |  |  | | --- | --- | | D. | all of the options. | |

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| 20. | The following groups are some of the claimants to a firm's income stream: I) shareholders; II) bondholders; III) employees; IV) management; V) government      |  |  | | --- | --- | | A. | I and II only |  |  |  | | --- | --- | | B. | I, II, and III only |  |  |  | | --- | --- | | C. | I, II, III, and IV only |  |  |  | | --- | --- | | D. | I, II, III, IV, and V | |

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| 21. | The financial goal of a corporation is to:      |  |  | | --- | --- | | A. | maximize profits. |  |  |  | | --- | --- | | B. | maximize sales. |  |  |  | | --- | --- | | C. | maximize the value of the firm for the shareholders. |  |  |  | | --- | --- | | D. | maximize managers' benefits. | |

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| 22. | The firm's purchase of real assets is also referred to as the:      |  |  | | --- | --- | | A. | capital structure decision. |  |  |  | | --- | --- | | B. | CFO decision. |  |  |  | | --- | --- | | C. | financing decision. |  |  |  | | --- | --- | | D. | investment decision. | |

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| 23. | The sale of financial assets by a corporation is also referred to as the:      |  |  | | --- | --- | | A. | capital budgeting decision. |  |  |  | | --- | --- | | B. | CFO decision. |  |  |  | | --- | --- | | C. | financing decision. |  |  |  | | --- | --- | | D. | investment decision. | |

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| 24. | The choice of the proper mixture of debt and equity, used to finance a corporation, is also referred to as the:      |  |  | | --- | --- | | A. | capital budgeting decision. |  |  |  | | --- | --- | | B. | capital structure decision. |  |  |  | | --- | --- | | C. | investment decision. |  |  |  | | --- | --- | | D. | liquidity decision. | |

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| 25. | Which of the following is not a common function of the firm's chief financial officer?      |  |  | | --- | --- | | A. | Hiring the firm's CEO |  |  |  | | --- | --- | | B. | Hiring the firm's controller |  |  |  | | --- | --- | | C. | Capital investment decisions |  |  |  | | --- | --- | | D. | Discussing earnings with investors | |

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| 26. | Which of the following groups are referred to as stakeholders? I) employees; II) customers; III) shareholders; IV) suppliers      |  |  | | --- | --- | | A. | I, II, and IV only |  |  |  | | --- | --- | | B. | III only |  |  |  | | --- | --- | | C. | I and II only |  |  |  | | --- | --- | | D. | I, II, III, and IV | |

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| 27. | The following are examples of real assets: I) machinery; II) office buildings; III) warehouses; IV) common stock      |  |  | | --- | --- | | A. | I, II, and III only |  |  |  | | --- | --- | | B. | I and II only |  |  |  | | --- | --- | | C. | IV only |  |  |  | | --- | --- | | D. | I only | |

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| 28. | The following are examples of tangible assets except: I) machinery; II) office buildings; III) warehouses; IV) training courses for employees      |  |  | | --- | --- | | A. | I only |  |  |  | | --- | --- | | B. | I and II only |  |  |  | | --- | --- | | C. | IV only |  |  |  | | --- | --- | | D. | I, II, and III only | |

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| 29. | The ultimate financial goal of a corporation is to:      |  |  | | --- | --- | | A. | minimize stockholder risk. |  |  |  | | --- | --- | | B. | maximize profit. |  |  |  | | --- | --- | | C. | maximize value of the corporation to the stockholders. |  |  |  | | --- | --- | | D. | increase size of the firm. | |

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| 30. | Mr. Free has $100 dollars income this year and zero income next year. The market interest rate is 10% per year. If Mr. Free consumes $30 this year and invests the rest in the market, what will be his consumption next year?      |  |  | | --- | --- | | A. | $50 |  |  |  | | --- | --- | | B. | $55 |  |  |  | | --- | --- | | C. | $77 |  |  |  | | --- | --- | | D. | $100 | |

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| 31. | Mr. Bird has $100 income this year and zero income next year. The market interest rate is 10% per year. Mr. Bird also has an investment opportunity in which he can invest $50 today and receive $80 next year. Suppose Mr. Bird consumes $30 this year and invests in the project. What will be his consumption next year?      |  |  | | --- | --- | | A. | $80 |  |  |  | | --- | --- | | B. | $82 |  |  |  | | --- | --- | | C. | $100 |  |  |  | | --- | --- | | D. | $102 | |

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| 32. | Ms. Venus has $100 income this year and $110 next year. The market interest rate is 10% per year. Suppose Ms. Venus consumes $60 this year. What will be her consumption next year?      |  |  | | --- | --- | | A. | $120 |  |  |  | | --- | --- | | B. | $154 |  |  |  | | --- | --- | | C. | $170 |  |  |  | | --- | --- | | D. | 210 | |

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| 33. | Mr. Thomas has $100 income this year and zero income next year. The market interest rate is 10% per year. Mr. Thomas also has an investment opportunity in which he can invest $50 this year and receive $80 next year. Suppose Mr. Thomas consumes $50 this year and invests in the project. What will be his consumption next year?      |  |  | | --- | --- | | A. | $50 |  |  |  | | --- | --- | | B. | $55 |  |  |  | | --- | --- | | C. | $80 |  |  |  | | --- | --- | | D. | $110 | |

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| 34. | Mr. Dell has $100 income this year and zero income next year. The market interest rate is 10% per year. Mr. Dell also has an investment opportunity—having the same risk as the market in which he can invest $50 this year and receive $80 next year. Suppose Mr. Dell consumes $50 this year and invests in the project. What is the NPV of the investment opportunity?      |  |  | | --- | --- | | A. | $0 |  |  |  | | --- | --- | | B. | $5 |  |  |  | | --- | --- | | C. | $22.73 |  |  |  | | --- | --- | | D. | none of the options | |

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| 35. | Ms. Anderson has $60,000 income this year and $40,000 next year. The market interest rate is 10% per year. Suppose Ms. Anderson consumes $80,000 this year. What will be her consumption next year?      |  |  | | --- | --- | | A. | $18,000 |  |  |  | | --- | --- | | B. | $30,000 |  |  |  | | --- | --- | | C. | $60,000 |  |  |  | | --- | --- | | D. | $70,000 | |

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| 36. | The line that connects the maximum that one can consume this year (now, on the horizontal axis) and the maximum one can consume next year:      |  |  | | --- | --- | | A. | has a slope of (1 + *r*). |  |  |  | | --- | --- | | B. | has a slope of - (1 + *r*). |  |  |  | | --- | --- | | C. | has a slope of *r*. |  |  |  | | --- | --- | | D. | has a slope of 1/*r*. | |

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| 37. | Ms. Newcastle has $60,000 income this year and $40,000 next year. The market interest rate is 10% per year. Suppose Ms. Newcastle wishes to consume $62,000 next year. What will be her consumption this year?      |  |  | | --- | --- | | A. | $19,000 |  |  |  | | --- | --- | | B. | $40,000 |  |  |  | | --- | --- | | C. | $60,000 |  |  |  | | --- | --- | | D. | $70,000 | |

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| 38. | Mr. Smith has an income of $40,000 this year and $60,000 next year. He can invest in a project that costs $30,000 this year, which generates an income of $36,000 next year. The market interest rate is 10%. What will be his consumption next year if Mr. Smith invests in the project and consumes $50,000 this year?      |  |  | | --- | --- | | A. | $40,000 |  |  |  | | --- | --- | | B. | $52,000 |  |  |  | | --- | --- | | C. | $60,000 |  |  |  | | --- | --- | | D. | $62,000 | |

**True / False Questions**

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| 39. | The board of directors is ultimately responsible for all large investment decisions.    True    False |

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| 40. | A corporation has a legal existence of its own and is based on "articles of incorporation".    True    False |

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| 41. | Real assets of a corporation are claims on their financial assets.    True    False |

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| 42. | The treasurer's responsibilities include preparation of financial statements.    True    False |

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| 43. | In large firms, there is usually a chief financial officer (CFO) who oversees both the treasurer's and the controller's work.    True    False |

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| 44. | The controller's responsibilities typically include banking relations and cash management.    True    False |

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| 45. | A firm's total asset value belongs entirely to the shareholders.    True    False |

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| 46. | Managers, shareholders, and the firm's debtholders have identical information about the value of the firm.    True    False |

**Short Answer Questions**

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| 47. | Explain the term *corporation*. |

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| 48. | Briefly explain the term *limited liability.* |

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| 49. | Briefly explain the advantages of a corporation as a form of business organization. |

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| 50. | Briefly explain the sequence of cash flows between financial markets and the firm. |

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| 51. | Briefly explain the functions of financial markets. |

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| 52. | Briefly discuss the role of financial managers. |

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| 53. | Briefly explain the term *agency* costs as related to a corporation. |

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| 54. | Briefly discuss principal-agent problems as related to a corporation. |

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| 55. | Explain why "maximization of shareholders' wealth" is the appropriate ultimate, long-term goal of the firm. |

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| 56. | Briefly explain some of the institutional arrangements that ensure that managers work toward increasing the value of a firm. |

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| 57. | Briefly explain how individuals can adjust their current and future consumption according to their preferences. |

Chapter 01 Introduction to Corporate Finance Answer Key

**Multiple Choice Questions**

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| 1. | This book is mainly about:      |  |  | | --- | --- | | **A.** | financial decisions made by corporations. |  |  |  | | --- | --- | | B. | financial decisions made by households. |  |  |  | | --- | --- | | C. | financial decisions made by governments. |  |  |  | | --- | --- | | D. | financial decisions made by employees. | |

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| *Type: Easy* |

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| 2. | Shareholders of a corporation may be, among others: I) individuals; II) pension funds; III) insurance companies      |  |  | | --- | --- | | A. | I only |  |  |  | | --- | --- | | B. | I and II only |  |  |  | | --- | --- | | C. | II only |  |  |  | | --- | --- | | **D.** | I, II, and III | |

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| 3. | Generally, a corporation is owned by its: I) managers; II) board of directors; III) shareholders      |  |  | | --- | --- | | A. | I only |  |  |  | | --- | --- | | B. | II and III |  |  |  | | --- | --- | | **C.** | III only |  |  |  | | --- | --- | | D. | I, II, and III | |

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| 4. | A corporation, potentially, has infinite life because it:      |  |  | | --- | --- | | **A.** | is a legal entity. |  |  |  | | --- | --- | | B. | has the same ownership and management. |  |  |  | | --- | --- | | C. | has limited liability. |  |  |  | | --- | --- | | D. | is closely regulated. | |

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| 5. | Limited liability is an important feature of:      |  |  | | --- | --- | | A. | sole proprietorships. |  |  |  | | --- | --- | | B. | partnerships. |  |  |  | | --- | --- | | **C.** | corporations. |  |  |  | | --- | --- | | D. | both partnerships and corporations. | |

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| 6. | As a legal entity a corporation can perform the following functions EXCEPT: I) borrow money; II) lend money; III) sue and be sued; IV) vote      |  |  | | --- | --- | | A. | I and II only |  |  |  | | --- | --- | | B. | I, II, and III only |  |  |  | | --- | --- | | **C.** | IV only |  |  |  | | --- | --- | | D. | I, II, III, and IV | |

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| 7. | Which of the following assets is tangible?      |  |  | | --- | --- | | **A.** | Exxon-Mobil's corporate headquarters building |  |  |  | | --- | --- | | B. | Apple Computer's trademark |  |  |  | | --- | --- | | C. | Hewlett-Packard's most recent printer patent |  |  |  | | --- | --- | | D. | Microsoft's technical expertise | |

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| 8. | Which of the following types of assets are intangible?      |  |  | | --- | --- | | A. | production machinery |  |  |  | | --- | --- | | B. | factories |  |  |  | | --- | --- | | **C.** | trademarks |  |  |  | | --- | --- | | D. | office equipment | |

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| 9. | A firm's investment decision is also called its:      |  |  | | --- | --- | | A. | financing decision. |  |  |  | | --- | --- | | B. | liquidity decision. |  |  |  | | --- | --- | | **C.** | capital budgeting decision. |  |  |  | | --- | --- | | D. | leasing decision. | |

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| 10. | Which of the following is not a financial asset?      |  |  | | --- | --- | | A. | common stock |  |  |  | | --- | --- | | B. | bank loans |  |  |  | | --- | --- | | C. | preferred stock |  |  |  | | --- | --- | | **D.** | buildings | |

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| 11. | The treasurer usually oversees the following functions of a corporation: I) preparation of financial statements; II) currency trading; III) cash management; IV) raising new capital      |  |  | | --- | --- | | A. | I and III only |  |  |  | | --- | --- | | B. | I, II, and III only |  |  |  | | --- | --- | | C. | III and IV only |  |  |  | | --- | --- | | **D.** | II, III, and IV only | |

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| 12. | The treasurer is usually responsible for the following functions of a corporation: I) tax obligations; II) investor relationships; III) cash management; IV) raising new capital      |  |  | | --- | --- | | A. | I only |  |  |  | | --- | --- | | B. | I and II only |  |  |  | | --- | --- | | **C.** | II, III, and IV only |  |  |  | | --- | --- | | D. | I, II, III, and IV | |

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| 13. | The controller usually oversees the following functions of a corporation: I) preparation of financial statements; II) internal accounting; III) cash management; and IV) taxes      |  |  | | --- | --- | | **A.** | I, II, and IV only |  |  |  | | --- | --- | | B. | III only |  |  |  | | --- | --- | | C. | I and II only |  |  |  | | --- | --- | | D. | II and III | |

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| 14. | The controller is usually responsible for the following functions of a corporation **EXCEPT**: I) preparation of financial statements; II) internal accounting; III) cash management; IV) taxes      |  |  | | --- | --- | | A. | I only |  |  |  | | --- | --- | | **B.** | III only |  |  |  | | --- | --- | | C. | I and II only |  |  |  | | --- | --- | | D. | IV only | |

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| 15. | Which of the following is an important function of financial markets? I) providing financing; II) providing liquidity; III) reducing risk; IV) providing information      |  |  | | --- | --- | | A. | I only |  |  |  | | --- | --- | | B. | I and II only |  |  |  | | --- | --- | | **C.** | I, II, III, and IV |  |  |  | | --- | --- | | D. | IV only | |

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| 16. | The chief financial officer (CFO) of a corporation oversees:      |  |  | | --- | --- | | A. | treasurer's functions. |  |  |  | | --- | --- | | B. | controller's functions. |  |  |  | | --- | --- | | **C.** | the chief operating officer's functions. |  |  |  | | --- | --- | | D. | both the treasurer and the controller's functions. | |

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| 17. | In the principal-agent framework:      |  |  | | --- | --- | | A. | shareholders are the principals. |  |  |  | | --- | --- | | B. | managers are the principals. |  |  |  | | --- | --- | | C. | managers are the agents. |  |  |  | | --- | --- | | **D.** | A and C. | |

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| 18. | Costs associated with the conflicts of interest between the bondholders and the shareholders of a corporation are called:      |  |  | | --- | --- | | A. | legal costs. |  |  |  | | --- | --- | | B. | bankruptcy costs. |  |  |  | | --- | --- | | C. | administrative costs. |  |  |  | | --- | --- | | **D.** | agency costs. | |

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| 19. | A corporation may incur agency costs because:      |  |  | | --- | --- | | A. | managers may not attempt to maximize the value of the firm to shareholders. |  |  |  | | --- | --- | | B. | shareholders incur monitoring costs. |  |  |  | | --- | --- | | C. | of the separation of ownership and management. |  |  |  | | --- | --- | | **D.** | all of the options. | |

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| 20. | The following groups are some of the claimants to a firm's income stream: I) shareholders; II) bondholders; III) employees; IV) management; V) government      |  |  | | --- | --- | | A. | I and II only |  |  |  | | --- | --- | | B. | I, II, and III only |  |  |  | | --- | --- | | C. | I, II, III, and IV only |  |  |  | | --- | --- | | **D.** | I, II, III, IV, and V | |

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| 21. | The financial goal of a corporation is to:      |  |  | | --- | --- | | A. | maximize profits. |  |  |  | | --- | --- | | B. | maximize sales. |  |  |  | | --- | --- | | **C.** | maximize the value of the firm for the shareholders. |  |  |  | | --- | --- | | D. | maximize managers' benefits. | |

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| 22. | The firm's purchase of real assets is also referred to as the:      |  |  | | --- | --- | | A. | capital structure decision. |  |  |  | | --- | --- | | B. | CFO decision. |  |  |  | | --- | --- | | C. | financing decision. |  |  |  | | --- | --- | | **D.** | investment decision. | |

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| 23. | The sale of financial assets by a corporation is also referred to as the:      |  |  | | --- | --- | | A. | capital budgeting decision. |  |  |  | | --- | --- | | B. | CFO decision. |  |  |  | | --- | --- | | **C.** | financing decision. |  |  |  | | --- | --- | | D. | investment decision. | |

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| 24. | The choice of the proper mixture of debt and equity, used to finance a corporation, is also referred to as the:      |  |  | | --- | --- | | A. | capital budgeting decision. |  |  |  | | --- | --- | | **B.** | capital structure decision. |  |  |  | | --- | --- | | C. | investment decision. |  |  |  | | --- | --- | | D. | liquidity decision. | |

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| 25. | Which of the following is not a common function of the firm's chief financial officer?      |  |  | | --- | --- | | **A.** | Hiring the firm's CEO |  |  |  | | --- | --- | | B. | Hiring the firm's controller |  |  |  | | --- | --- | | C. | Capital investment decisions |  |  |  | | --- | --- | | D. | Discussing earnings with investors | |

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| 26. | Which of the following groups are referred to as stakeholders? I) employees; II) customers; III) shareholders; IV) suppliers      |  |  | | --- | --- | | A. | I, II, and IV only |  |  |  | | --- | --- | | B. | III only |  |  |  | | --- | --- | | C. | I and II only |  |  |  | | --- | --- | | **D.** | I, II, III, and IV | |

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| 27. | The following are examples of real assets: I) machinery; II) office buildings; III) warehouses; IV) common stock      |  |  | | --- | --- | | **A.** | I, II, and III only |  |  |  | | --- | --- | | B. | I and II only |  |  |  | | --- | --- | | C. | IV only |  |  |  | | --- | --- | | D. | I only | |

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| 28. | The following are examples of tangible assets except: I) machinery; II) office buildings; III) warehouses; IV) training courses for employees      |  |  | | --- | --- | | A. | I only |  |  |  | | --- | --- | | B. | I and II only |  |  |  | | --- | --- | | **C.** | IV only |  |  |  | | --- | --- | | D. | I, II, and III only | |

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| 29. | The ultimate financial goal of a corporation is to:      |  |  | | --- | --- | | A. | minimize stockholder risk. |  |  |  | | --- | --- | | B. | maximize profit. |  |  |  | | --- | --- | | **C.** | maximize value of the corporation to the stockholders. |  |  |  | | --- | --- | | D. | increase size of the firm. | |

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| 30. | Mr. Free has $100 dollars income this year and zero income next year. The market interest rate is 10% per year. If Mr. Free consumes $30 this year and invests the rest in the market, what will be his consumption next year?      |  |  | | --- | --- | | A. | $50 |  |  |  | | --- | --- | | B. | $55 |  |  |  | | --- | --- | | **C.** | $77 |  |  |  | | --- | --- | | D. | $100 |   Consumption next year = (100 - 30) × (1.1) = 77. |

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| 31. | Mr. Bird has $100 income this year and zero income next year. The market interest rate is 10% per year. Mr. Bird also has an investment opportunity in which he can invest $50 today and receive $80 next year. Suppose Mr. Bird consumes $30 this year and invests in the project. What will be his consumption next year?      |  |  | | --- | --- | | A. | $80 |  |  |  | | --- | --- | | B. | $82 |  |  |  | | --- | --- | | C. | $100 |  |  |  | | --- | --- | | **D.** | $102 |   Consumption next year = (100 - 30 - 50) × 1.1 + 80 = 102. |

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| 32. | Ms. Venus has $100 income this year and $110 next year. The market interest rate is 10% per year. Suppose Ms. Venus consumes $60 this year. What will be her consumption next year?      |  |  | | --- | --- | | A. | $120 |  |  |  | | --- | --- | | **B.** | $154 |  |  |  | | --- | --- | | C. | $170 |  |  |  | | --- | --- | | D. | 210 |   Consumption next year = (100 - 60) × 1.1 + 110 = 154. |

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| 33. | Mr. Thomas has $100 income this year and zero income next year. The market interest rate is 10% per year. Mr. Thomas also has an investment opportunity in which he can invest $50 this year and receive $80 next year. Suppose Mr. Thomas consumes $50 this year and invests in the project. What will be his consumption next year?      |  |  | | --- | --- | | A. | $50 |  |  |  | | --- | --- | | B. | $55 |  |  |  | | --- | --- | | **C.** | $80 |  |  |  | | --- | --- | | D. | $110 |   Mr. Thomas' investment this year = 100 - 50 = 50. His income next year by taking the investment opportunity is equal to 80. |

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| 34. | Mr. Dell has $100 income this year and zero income next year. The market interest rate is 10% per year. Mr. Dell also has an investment opportunity—having the same risk as the market in which he can invest $50 this year and receive $80 next year. Suppose Mr. Dell consumes $50 this year and invests in the project. What is the NPV of the investment opportunity?      |  |  | | --- | --- | | A. | $0 |  |  |  | | --- | --- | | B. | $5 |  |  |  | | --- | --- | | **C.** | $22.73 |  |  |  | | --- | --- | | D. | none of the options |   NPV = (80/1.1) - 50 = + 22.73. |

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| 35. | Ms. Anderson has $60,000 income this year and $40,000 next year. The market interest rate is 10% per year. Suppose Ms. Anderson consumes $80,000 this year. What will be her consumption next year?      |  |  | | --- | --- | | **A.** | $18,000 |  |  |  | | --- | --- | | B. | $30,000 |  |  |  | | --- | --- | | C. | $60,000 |  |  |  | | --- | --- | | D. | $70,000 |   Borrow $20,000 this year to consume 60,000 + 20,000 = 80,000. Consumption next year = 40,000 - (20,000 × 1.1) = 18,000. |

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| 36. | The line that connects the maximum that one can consume this year (now, on the horizontal axis) and the maximum one can consume next year:      |  |  | | --- | --- | | A. | has a slope of (1 + *r*). |  |  |  | | --- | --- | | **B.** | has a slope of - (1 + *r*). |  |  |  | | --- | --- | | C. | has a slope of *r*. |  |  |  | | --- | --- | | D. | has a slope of 1/*r*. | |

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| 37. | Ms. Newcastle has $60,000 income this year and $40,000 next year. The market interest rate is 10% per year. Suppose Ms. Newcastle wishes to consume $62,000 next year. What will be her consumption this year?      |  |  | | --- | --- | | A. | $19,000 |  |  |  | | --- | --- | | **B.** | $40,000 |  |  |  | | --- | --- | | C. | $60,000 |  |  |  | | --- | --- | | D. | $70,000 |   Consumption this year = 60,000 - (22,000/1.1) = 40,000. |

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| 38. | Mr. Smith has an income of $40,000 this year and $60,000 next year. He can invest in a project that costs $30,000 this year, which generates an income of $36,000 next year. The market interest rate is 10%. What will be his consumption next year if Mr. Smith invests in the project and consumes $50,000 this year?      |  |  | | --- | --- | | A. | $40,000 |  |  |  | | --- | --- | | **B.** | $52,000 |  |  |  | | --- | --- | | C. | $60,000 |  |  |  | | --- | --- | | D. | $62,000 |   Consumption next year = [40,000 - 30,000 - 50,000] × 1.1 + (60,000 + 36,000) = 52,000. |

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**True / False Questions**

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| 39. | The board of directors is ultimately responsible for all large investment decisions.    **TRUE** |

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| 40. | A corporation has a legal existence of its own and is based on "articles of incorporation".    **TRUE** |

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| 41. | Real assets of a corporation are claims on their financial assets.    **FALSE** |

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| 42. | The treasurer's responsibilities include preparation of financial statements.    **FALSE** |

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| 43. | In large firms, there is usually a chief financial officer (CFO) who oversees both the treasurer's and the controller's work.    **TRUE** |

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| 44. | The controller's responsibilities typically include banking relations and cash management.    **FALSE** |

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| 45. | A firm's total asset value belongs entirely to the shareholders.    **FALSE** |

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| 46. | Managers, shareholders, and the firm's debtholders have identical information about the value of the firm.    **FALSE** |

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**Short Answer Questions**

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| 47. | Explain the term *corporation*.     A corporation is a legal entity and has an existence of its own. Generally, large businesses are organized as corporations. |

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| 48. | Briefly explain the term *limited liability.*     The shareholders of a corporation cannot be held personally responsible for the debts of the corporation. This is called *limited liability.* Hence, a shareholder's loss is limited to the amount he or she has invested in a corporation. This is an attractive feature for investors. |

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| 49. | Briefly explain the advantages of a corporation as a form of business organization.     • Corporations have infinite life. • Corporations have very many owners called shareholders and therefore corporations can raise funds more easily than other forms of business. • There is a separation of ownership and management that is helpful in running the corporation on a day-to-day basis. • It is relatively easy to transfer ownership in a corporation. • Corporations have limited liability. |

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| 50. | Briefly explain the sequence of cash flows between financial markets and the firm.     • Cash is raised by selling financial assets to investors. • Cash is invested in the firm's operation and used to purchase real assets. • Cash is generated by the firm's operations. • Cash is reinvested or returned to investors. |

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| 51. | Briefly explain the functions of financial markets.     There are five important functions of financial markets. They are:  • providing financing for corporations • providing liquidity for investors • reducing risk for investors • providing information • monitoring firms' financial performance |

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| 52. | Briefly discuss the role of financial managers.     Chief financial officer (CFO): Supervises the treasurer and the controller in a large corporation. CFO is involved in corporate planning and financial policy. Treasurer: Is responsible for obtaining funds and managing cash, banking relationships and investor relationships. Controller: Is responsible for accounting functions, payroll, and taxes. |

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| 53. | Briefly explain the term *agency* costs as related to a corporation.     Agency costs arise in a corporation as a result of principal-agent problems. For example, managers may not act in the best interests of shareholders while making decisions. Hence, shareholders incur monitoring costs that are called agency costs. It also arises as a result of informational asymmetry between managers and other stakeholders of a firm. Agency costs tend to reduce the value of a firm. |

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| 54. | Briefly discuss principal-agent problems as related to a corporation.     Principal-agent problems arise in a corporation as a result of the separation of ownership and management. Managers may not act in the best interests of the shareholders while making decisions. Hence, shareholders incur monitoring and bonding costs, which are a part of agency costs. It also arises as result of informational asymmetry between managers and other stakeholders of a firm. Agency costs tend to reduce the value of a firm. |

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| 55. | Explain why "maximization of shareholders' wealth" is the appropriate ultimate, long-term goal of the firm.     Under perfect market conditions, everyone can borrow or lend at the same interest rate. This implies that differences in consumption patterns can be adjusted in the capital markets. Given this, all investors will agree that they are better off if the firm maximizes their current wealth, i.e., maximizing shareholders' wealth. |

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| 56. | Briefly explain some of the institutional arrangements that ensure that managers work toward increasing the value of a firm.     • the board of directors, elected by shareholders, which scrutinizes managers' actions • competition among managers • the threat of takeover that brings a new management team • incentive schemes that are closely tied to the value of the firm like stock options |

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| 57. | Briefly explain how individuals can adjust their current and future consumption according to their preferences.     Individuals can adjust their preferences for consumption by borrowing or lending in the financial market. The appropriate balance between present and future consumption that each individual will choose depends on personal preferences. Nevertheless, individuals with different preferences can adjust their preferences using the financial market. Individuals desiring current consumption can borrow from future income. Meanwhile, individuals favoring future consumption can refrain from current consumption and invest in the same financial market. |

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