Chapter 2: Business (Corporate) Finance

**MULTIPLE CHOICE QUESTIONS**

1) Which of the following is *not* a reason for incorporating a business?

a) Limited liability

b) Ownership is relatively easy to transfer

c) It is easier to form than a proprietorship

d) Corporate tax laws may allow tax deferral or avoidance

Answer: c

Type: Concept

Level of Difficulty: Easy

Learning Objective: List the four forms of business organizations and describe the advantages and disadvantages of each.

Section Reference: Types of Business Organizations

2) Which of the following is *not* a form of business organization?

a) Corporation

b) Sole partnership

c) General partnership

d) Sole proprietorship

Answer: b

Type: Definition

Level of Difficulty: Easy

Learning Objective: List the four forms of business organizations and describe the advantages and disadvantages of each.

Section Reference: Types of Business Organizations

3) If you are in a business that is faced with enormous risks of failure, what type of ownership would you avoid?

a) Corporation

b) Sole partnership

c) General partnership

d) Sole proprietorship

Answer: d

Type: Concept

Level of Difficulty: Easy

Learning Objective: List the four forms of business organizations and describe the advantages and disadvantages of each.

Section Reference: Types of Business Organizations

4) Which of the following is an advantage of a corporation over a sole proprietorship?

a) A corporation is easy to set up

b) Corporate tax laws are often less attractive than personal tax laws

c) Shareholders’ liability is limited to their investment in the corporation

d) In a sole proprietorship, it is easier to transfer ownership

Answer: c

Type: Concept

Level of Difficulty: Easy

Learning Objective: List the four forms of business organizations and describe the advantages and disadvantages of each.

Section Reference: Types of Business Organizations

5) What was the reason for the increase in the number of income trusts in Canada?

a) Limited liability

b) Unlimited liability

c) Tax advantage

d) Transfer of ownership

Answer: c

Type: Concept

Level of Difficulty: Easy

Learning Objective: List the four forms of business organizations and describe the advantages and disadvantages of each.

Section Reference: Types of Business Organizations

6) Which of the following is the **most** correct? \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ know their exposure is limited to the amount of capital they invest in the company.

a) Employees

b) Sole proprietors

c) General partners

d) Limited partners and shareholders

Answer: d

Type: Concept

Level of Difficulty: Medium

Learning Objective: List the four forms of business organizations and describe the advantages and disadvantages of each.

Section Reference: Types of Business Organizations

7) Which of the following is (are) true about a general partnership?

I. Some of the partners have limited liability.

II. Some of the partners may not be involved in the day-to-day operations.

III. Some partners may receive a different percentage of the profits.

a) III only

b) I and III

c) II and III

d) I and II

Answer: c

Type: Concept

Level of Difficulty: Medium

Learning Objective: List the four forms of business organizations and describe the advantages and disadvantages of each.

Section Reference: Types of Business Organizations

8) Beginning in 2013, in Canada, what would be the most appropriate type of organization for a business with large assets and revenue?

a) Trust

b) Corporation

c) General partnership

d) Sole proprietorship

Answer: b

Type: Concept

Level of Difficulty: Medium

Learning Objective: List the four forms of business organizations and describe the advantages and disadvantages of each.

Section Reference: Types of Business Organizations

9) Which of the following businesses is **most likely** to be operated as a corporation?

a) A law firm

b) A mining company

c) An accounting firm

d) All of these are likely to be operated as a corporation.

Answer: b

Type: Concept

Level of Difficulty: Easy

Learning Objective: List the four forms of business organizations and describe the advantages and disadvantages of each.

Section Reference: Types of Business Organizations

10) The main purpose of creating a trust is to:

I. Separate ownership from control

II. Avoid legal liability

III. Avoid taxes

IV. Improve a firm’s reputation

a) I, II, and III

b) I and IV

c) I and III

d) III and IV

Answer: c

Type: Concept

Level of Difficulty: Easy

Learning Objective: List the four forms of business organizations and describe the advantages and disadvantages of each.

Section Reference: Types of Business Organizations

11) Which of the following is *not* an example of a trust?

a) A mutual fund

b) An estate

c) A royalty trust

d) A bank

Answer: d

Type: Concept

Level of Difficulty: Easy

Learning Objective: List the four forms of business organizations and describe the advantages and disadvantages of each.

Section Reference: Types of Business Organizations

12) After 20 years of being the sole proprietor of Montere Lawn Care, Denis Seville is considering making a change. His business has grown substantially over the years and he now has approximately 100 extremely loyal clients. Denis wants to retire and move to Florida. Unfortunately, Denis has no children to carry on his business and thus he is thinking of selling it to someone else. What is the main consideration Denis should have about selling his lawn care business?

a) He will face some difficulty in selling because all the client relationships are personal and belong to him; he will have to explain the new situation to each client.

b) Lawn care is seasonal and not many people would want to purchase his business.

c) It is difficult to learn lawn care skills for potential buyers.

d) The new owner may not retain the same business name.

Answer: a

Type: Concept

Level of Difficulty: Medium

Learning Objective: List the four forms of business organizations and describe the advantages and disadvantages of each.

Section Reference: Types of Business Organizations

13) Lucy Vale and Bob Fama, both accountants, have opened an accounting firm in Calgary together and business has been steadily increasing. Since they each have the same number of clients, Lucy and Bob decided to simply split any income equally between them. However, Lucy has recently made a grievous error in the financial statements of one of her clients, and that client is now considering suing Lucy and the firm. If Lucy and Bob had never created a formal partnership agreement since the inception of their firm, should Bob be at all concerned about the potential lawsuit? Choose the best answer from the following:

a) No. Since there was no formal partnership agreement made, Bob cannot be held responsible for Lucy’s error.

b) Yes. A legal agreement is not always required for someone to be considered a partner of a partnership. Thus, Bob may be held partially responsible for Lucy’s error in the event the client sues the firm.

c) No. It was Lucy’s client and she made the error. Bob was not involved.

d) Yes. Bob has just incurred substantial debt by purchasing a new home which was partially financed by his share of the firm’s earnings.

Answer: b

Type: Concept

Level of Difficulty: Medium

Learning Objective: List the four forms of business organizations and describe the advantages and disadvantages of each.

Section Reference: Types of Business Organizations

14) Which of the following should be the primary goal of a CEO in a publicly traded company?

a) Maximize the profit margin

b) Avoid bankruptcy

c) Increase market share

d) Maximize the company’s share price

Answer: d

Type: Concept

Level of Difficulty: Easy

Learning Objective: Describe the goals of the firm and the pressures exerted on corporations by various stakeholders.

Section Reference: The Goals of the Corporation

15) How is wealth different from profits?

a) Wealth is a personal issue, while profits are related to a business.

b) Profits include a deduction for expenses, and expenses are not relevant for wealth calculations.

c) Wealth reflects the value of all profits, both short- and long-term, while profits refer to economic profits only.

d) All of the above.

Answer: c

Type: Concept

Level of Difficulty: Medium

Learning Objective: Describe the goals of the firm and the pressures exerted on corporations by various stakeholders.

Section Reference: The Goals of the Corporation

16) What are externalities?

a) Valuable resources to a company that the firm does not pay or charge for.

b) Issues in the surrounding business environment of a firm that have no impact on the firm’s operations or policies.

c) Members of the board of directors who are not employed by the firm.

d) None of the above.

Answer: a

Type: Definition

Level of Difficulty: Easy

Learning Objective: Describe the goals of the firm and the pressures exerted on corporations by various stakeholders.

Section Reference: The Goals of the Corporation

17) Why are externalities a necessary consideration when conducting business, especially for large corporations?

a) Externalities always cost money, and those costs hurt a firm’s bottom line.

b) Forgetting to account for externalities is against tax laws in Canada

c) The actions a large firm makes can have a significant impact on other firms, and those actions may not necessarily be in Canada’s best interests.

d) All of the above.

Answer: c

Type: Concept

Level of Difficulty: Medium

Learning Objective: Describe the goals of the firm and the pressures exerted on corporations by various stakeholders.

Section Reference: The Goals of the Corporation

18) Which of the following is/are considered a stakeholder in the Toronto Stock Exchange?

a) Shareholders

b) Listing companies

c) Provincial government

d) All of the above

Answer: d

Type: Concept

Level of Difficulty: Easy

Learning Objective: Describe the goals of the firm and the pressures exerted on corporations by various stakeholders.

Section Reference: The Goals of the Corporation

19) Which one of the following is *not* part of externalities?

a) Union pension costs and regulations

b) High borrowing rate

c) Labour regulations

d) Cost of carbon emissions

Answer: b

Type: Concept

Level of Difficulty: Medium

Learning Objective: Describe the goals of the firm and the pressures exerted on corporations by various stakeholders.

Section Reference: The Goals of the Corporation

20) Who, of the following, does not have a contractual claim on a company?

a) Employees

b) Shareholders

c) Local community

d) Customers

Answer: c

Type: Concept

Level of Difficulty: Medium

Learning Objective: Describe the goals of the firm and the pressures exerted on corporations by various stakeholders.

Section Reference: The Goals of the Corporation

21) What is the risk-return tradeoff?

a) A firm will only have returns when it takes on risk.

b) A firm can either have risk, or it can have returns, but not both.

c) The balancing of gain with risk.

d) A risky return is always preferred to a risk-free return.

Answer: c

Type: Definition

Level of Difficulty: Easy

Learning Objective: Describe the goals of the firm and the pressures exerted on corporations by various stakeholders.

Section Reference: The Goals of the Corporation

22) Which one of the following is *not* true about the board of directors?

a) It represents shareholders’ interests

b) It cannot ignore its stakeholders

c) It is involved with guiding the management of the company

d) Board of directors may include members of the company’s management team.

Answer: b

Type: Concept

Level of Difficulty: Medium

Learning Objective: Describe the goals of the firm and the pressures exerted on corporations by various stakeholders.

Section Reference: The Goals of the Corporation

23) What is the main implication of the 1994 Dey Report?

a) Firms should pay attention to special interests or other stakeholders, not just shareholders.

b) Boards of directors are responsible only for ensuring management is maximizing revenue.

c) Boards of directors can ignore stakeholders and focus solely on shareholders while maintaining their contractual responsibilities.

d) Considerations for social welfare should be of utmost importance to firms.

Answer: c

Type: Concept

Level of Difficulty: Medium

Learning Objective: Describe the goals of the firm and the pressures exerted on corporations by various stakeholders.

Section Reference: The Goals of the Corporation

24) Which of the following is an example of an indirect agency cost?

a) A company buys the latest computer equipment for its employees.

b) Senior management use company money to pay their children’s education.

c) Managers can use the company float plane to fly to their cottages on weekends.

d) Managers may take risky projects when the company is not doing well.

Answer: d

Type: Concept

Level of Difficulty: Easy

Learning Objective: Explain the importance of aligning the interests of management with the interests of shareholders in a corporation.

Section Reference: The Role of Management and Agency Issues

25) Agency problems are best defined as:

a) difficulties arising in dealings with real estate agencies.

b) problems arising due to potential misalignment between the interests of owners, creditors, and managers.

c) problems arising due to the complete alignment of the interests of owners, creditors, and managers.

d) issues surrounding whether or not to outsource production to an external agency.

Answer: b

Type: Definition

Level of Difficulty: Easy

Learning Objective: Explain what agency costs are and how they affect the interests of management and shareholders.

Section Reference: Corporate Finance

26) Which one of the following is*not* an example of the agency problem?

a) Management refusing a merger because of the possibility of major changes in management

b) Taking a high risk project to increase the value of the stock options held by management.

c) Increasing the level of debt of the company to increase the return on equity value.

d) Distributing a low level of dividends to have enough cash for bonuses.

Answer: c

Type: Concept

Level of Difficulty: Difficult

Learning Objective: Explain what agency costs are and how they affect the interests of management and shareholders.

Section Reference: Corporate Finance

27) Which of the following will help shareholders mitigate agency problems? Shareholders can:

I. Elect directors

II. Challenge management through proxy fights

III. Tender their shares to outsiders in a hostile takeover

IV. Sell their shares on the stock market

a) I, II, and IV

b) II, III, and IV

c) I, II, and III

d) I, II, III, and IV

Answer: d

Type: Concept

Level of Difficulty: Medium

Learning Objective: Explain the importance of aligning the interests of management with the interests of shareholders in a corporation.

Section Reference: The Role of Management and Agency Issues

28) Which of the following is true?

a) Managers can ignore the objective of shareholder wealth in the short-run in favour of other stakeholders’ interests, but not in the long run.

b) In 2000, BCE spun off its ownership in Nortel, making this an example of a firm’s agency costs diminishing shareholder value.

c) A 1997 Canadian survey of Shareholder Value Measurement showed that a minority of companies with listed shares state maximizing firm value is a key corporate objective.

d) Without adequate financial performance, a firm can survive in a competitive environment.

Answer: a

Type: Concept

Level of Difficulty: Medium

Learning Objective: Explain what agency costs are and how they affect the interests of management and shareholders.

Section Reference: Corporate Finance

29) You are asked to watch over your brother and sister in exchange for a fee. You invited your friends over and you watched TV all night without paying attention to your siblings. What type of agency problem is this?

a) Indirect

b) Direct

c) Moral hazard

d) None of the above

Answer: c

Type: Concept

Level of Difficulty: Medium

Learning Objective: Explain what agency costs are and how they affect the interests of management and shareholders.

Section Reference: Corporate Finance

30) Which of the following is true?

a) Management buying another business at a premium may be an example of an agency cost.

b) Corporations are not vulnerable to agency costs.

c) Stock options are an example of an agency cost.

d) Agency costs do not include expenses of monitoring and controlling the actions of management.

Answer: c

Type: Concept

Level of Difficulty: Hard

Learning Objective: Explain what agency costs are and how they affect the interests of management and shareholders.

Section Reference: Corporate Finance

31) A merger between Bank of Montreal and TD Bank would be a potential

a) Agency problem

b) Too big to fail problem

c) Moral hazard

d) None of the above

Answer: b

Type: Concept

Level of Difficulty: Easy

Learning Objective: Explain what agency costs are and how they affect the interests of management and shareholders.

Section Reference: Corporate Finance

32) Of the following list, which represents a potential implication for agency issues when shareholders are dispersed?

a) More shareholders have a controlling say in what happens in the firm.

b) The likelihood of management pleasing all shareholders is greatly improved

c) A firm’s chief executive officer (CEO) is better able to choose his or her friends to sit on the board of directors.

d) None of the above.

Answer: c

Type: Concept

Level of Difficulty: Medium

Learning Objective: Explain what agency costs are and how they affect the interests of management and shareholders.

Section Reference: Corporate Finance

33) Which one of the following is *not* a criterion that managers prefer to be judged upon?

a) Return on assets

b) Return on equity

c) Share price

d) Market share

Answer: c

Type: Concept

Level of Difficulty: Easy

Learning Objective: Explain the importance of aligning the interests of management with the interests of shareholders in a corporation.

Section Reference: The Role of Management and Agency Issues

34) Why do shareholders have a greater preference for risk than do managers?

a) Shareholders are always richer than managers, and can afford to take more risk.

b) Shareholders can diversify risk by holding many securities, while a manager’s career is tied up with the firm.

c) Because they are investing in the stock market, shareholders must naturally prefer taking more risk than managers.

d) Managers do not like risk because it hurts the value of the company.

Answer: b

Type: Concept

Level of Difficulty: Medium

Learning Objective: Explain the importance of aligning the interests of management with the interests of shareholders in a corporation.

Section Reference: The Role of Management and Agency Issues

35) What is the main purpose behind share incentive plans?

a) The plans encourage managers to invest in the stock market.

b) The plans are meant to align the interests of management and shareholders.

c) The plans encourage managers to give shares as incentives for employees.

d) All of the above.

Answer: b

Type: Concept

Level of Difficulty: Easy

Learning Objective: Explain the importance of aligning the interests of management with the interests of shareholders in a corporation.

Section Reference: The Role of Management and Agency Issues

36) Which one of the following is true?

a) Managers have the mandate to increase the market value of the company.

b) Managers always look after shareholders’ interests.

c) The Board of directors is legally responsible for all the company’s decisions.

d) All of the above

Answer: a

Type: Concept

Level of Difficulty: Medium

Learning Objective: Explain the importance of aligning the interests of management with the interests of shareholders in a corporation.

Section Reference: The Role of Management and Agency Issues

37) Share incentive plans may not produce the desired results. Why?

a) The retooling of option grants and share incentive schemes

b) Compensation schemes are generally designed to reward management, not to provide incentives

c) Fraud

d) All of the above

Answer: d

Type: Concept

Level of Difficulty: Medium

Learning Objective: Explain the importance of aligning the interests of management with the interests of shareholders in a corporation.

Section Reference: The Role of Management and Agency Issues

38) Which one of the following is *not* a way to improve the efficiency in Canadian wealth management?

a) Encourage takeovers

b) Expand management’s defence mechanisms with regards to takeovers

c) Hold managers personally accountable

d) Increase measures of corporate governance

Answer: b

Type: Concept

Level of Difficulty: Medium

Learning Objective: Explain the importance of aligning the interests of management with the interests of shareholders in a corporation.

Section Reference: The Role of Management and Agency Issues

39) Which of the following is **not** a reason why the market for corporate control is the most effective mechanism to give managers the incentive to act like shareholders?

a) The government imposes significant lawsuits and penalties for managers not acting in the best interests of shareholders.

b) The threat of acquisition keeps managers focused on achieving good performance and a high stock price.

c) A low stock price makes a firm a good target for acquisition.

d) It allows the best managers the chance to manage assets.

Answer: a

Type: Concept

Level of Difficulty: Medium

Learning Objective: Explain the importance of aligning the interests of management with the interests of shareholders in a corporation.

Section Reference: The Role of Management and Agency Issues

40) Which of the following is an example of a capital structure decision?

a) Issuing new shares

b) Buying a new factory

c) Reducing inventory levels

d) Increasing purchases on credit

Answer: a

Type: Definition

Level of Difficulty: Easy

Learning Objective: Identify the main corporate finance decisions involving the financial management of a firm’s assets and its liabilities (corporate financing).

Section Reference: Finance Careers and the Organization of the Finance Function

41) The framework for analyzing investment or asset decisions is known as:

a) income management analysis

b) capital budgeting analysis

c) capital aligning analysis

d) asset allocation analysis

Answer: b

Type: Definition

Level of Difficulty: Easy

Learning Objective: Identify the main corporate finance decisions involving the financial management of a firm’s assets and its liabilities (corporate financing).

Section Reference: Finance Careers and the Organization of the Finance Function

42) Capital budgeting refers to:

a) The decision to raise capital from the market

b) The decision to invest

c) The decision to budget the administrative expenses of the firm

d) The decision to budget compensation within the firm

Answer: b

Type: Definition

Level of Difficulty: Medium

Learning Objective: Identify the main corporate finance decisions involving the financial management of a firm’s assets and its liabilities (corporate financing).

Section Reference: Finance Careers and the Organization of the Finance Function

43) What does it mean to “go public”?

a) To sell goods and services to the public

b) To raise money from the stock market

c) To borrow money from the debt market

d) To do business with governmental firms

Answer: b

Type: Definition

Level of Difficulty: Medium

Learning Objective: Identify the main corporate finance decisions involving the financial management of a firm’s assets and its liabilities (corporate financing).

Section Reference: Finance Careers and the Organization of the Finance Function

44) If a controller is responsible for liquidity management, which of the following accounts is she *not* interested in?

a) Long-term debt

b) Cash

c) Accounts payable

d) Inventory

Answer: a

Type: Concept

Level of Difficulty: Medium

Learning Objective: Identify the main corporate finance decisions involving the financial management of a firm’s assets and its liabilities (corporate financing).

Section Reference: Finance Careers and the Organization of the Finance Function

45) Another term for the “paper” market is:

a) debt market

b) equity market

c) money market

d) options market

Answer: c

Type: Definition

Level of Difficulty: Easy

Learning Objective: Identify the main corporate finance decisions involving the financial management of a firm’s assets and its liabilities (corporate financing).

Section Reference: Finance Careers and the Organization of the Finance Function

46) Which of the following statements is *not* true?

a) Cash and cash equivalents are defined as: deposits in banks plus short-term investments.

b) A firm’s accounts receivable is debt owed to them by other firms.

c) Another term for accounts receivable is trade credit.

d) A firm’s mortgages would appear on the asset side of its balance sheet.

Answer: d

Type: Definition

Level of Difficulty: Easy

Learning Objective: Identify the main corporate finance decisions involving the financial management of a firm’s assets and its liabilities (corporate financing).

Section Reference: Finance Careers and the Organization of the Finance Function

47) Which one of the following is *not* part of financial management?

a) Deciding on sources of capital financing

b) Deciding on debt versus equity

c) Deciding on buying property

d) Deciding on changing company image

Answer: d

Type: Concept

Level of Difficulty: Easy

Learning Objective: Identify the main corporate finance decisions involving the financial management of a firm’s assets and its liabilities (corporate financing).

Section Reference: Finance Careers and the Organization of the Finance Function

48) Which of the following is *not* a source of corporate financing?

a) Equity

b) Retained earnings

c) Bonds

d) Increase in inventory

Answer: d

Type: Definition

Level of Difficulty: Medium

Learning Objective: Identify the main corporate finance decisions involving the financial management of a firm’s assets and its liabilities (corporate financing).

Section Reference: Finance Careers and the Organization of the Finance Function

49) Typical duties of the financial manager include:

I. Raising funds

II. Product line evaluation

III. Controlling the disbursement of funds

IV. Dividend policy

V. Auditing financial statements

VI. Shareholder relations

VII. Setting personnel policy

VIII. Pricing of the company’s products

a) I, III, IV, V, and VI

b) I, III, IV, and VI

c) III, IV, VI, and VII

d) II, III, VI, and VIII

Answer: b

Type: Concept

Level of Difficulty: Hard

Learning Objective: List some finance jobs available with financial and non-financial companies.

Section Reference: Finance Careers and the Organization of the Finance Function.

50) Which of the following is the least important of the financial manager’s responsibilities?

a) Keep an up-to-date record on past operations

b) Contain costs and foster productivity improvements

c) Raise funds to support the ongoing operations and planned investments

d) Control the disbursement of funds to ensure efficiency and adequate returns

Answer: a

Type: Concept

Level of Difficulty: Medium

Learning Objective: List some finance jobs available with financial and non-financial companies.

Section Reference: Finance Careers and the Organization of the Finance Function.

51) All of the following are the responsibility of the controller except:

a) financial planning

b) liquidity management

c) mergers and acquisitions

d) dividend policy

Answer: d

Type: Definition

Level of Difficulty: Medium

Learning Objective: List some finance jobs available with financial and non-financial companies.

Section Reference: Finance Careers and the Organization of the Finance Function.

52) The primary objective of the financial manager is to:

a) maximize earnings

b) maximize dividend payments

c) maximize shareholder wealth

d) minimize expenses

Answer: c

Type: Concept

Level of Difficulty: Easy

Learning Objective: List some finance jobs available with financial and non-financial companies.

Section Reference: Finance Careers and the Organization of the Finance Function.

53) If you are working for a company and your job description includes accounting, budgeting, internal audit, systems management/MIS, and tax management, you are most likely a(n):

a) treasurer

b) tax accountant

c) auditor

d) controller

Answer: d

Type: Concept

Level of Difficulty: Easy

Learning Objective: List some finance jobs available with financial and non-financial companies.

Section Reference: Finance Careers and the Organization of the Finance Function.

54) In major financial institutions, people generally start out their careers as:

a) Consultants

b) Analysts

c) Account managers

d) Banking associates

Answer: b

Type: Definition

Level of Difficulty: Medium

Learning Objective: List some finance jobs available with financial and non-financial companies.

Section Reference: Finance Careers and the Organization of the Finance Function.

**PRACTICE PROBLEMS**

55) Define the term finance. What are the three broad functional categories associated with finance?

Answer: Finance is the study of the management of funds. The three broad functional categories associated with finance are:

1. Making long-term investment decisions, also called capital budgeting decisions

2. Making long-term financing decisions, also called capital structure decisions

3. Managing day-to-day activities, also called working capital (or liquidity) management

Type: Definition

Level of Difficulty: Easy

Learning Objective: Identify the main corporate finance decisions involving the financial management of a firm’s assets and its liabilities (corporate financing).

Section Reference: Finance Careers and the Organization of the Finance Function

56) Give three potential advantages that explain why corporations represent a small percentage of the total number of businesses in Canada, but dominate in terms of assets and dollar volumes of sales.

Answer: i) Limited liability: investors know that their exposure to loss is limited

ii) Transfer of ownership is relatively easy; investors can cash out at any time if they need cash or are unhappy with the direction in which the company is headed

iii) Corporate tax laws may be more attractive in some circumstances, allowing tax deferral or avoidance

In principle, the separation of ownership from control allows corporations to obtain the best available management team.

Type: Concept

Level of Difficulty: Medium

Learning Objective: List the four forms of business organizations and describe the advantages and disadvantages of each.

Section Reference: Types of Business Organizations

57) Give two reasons for the importance and scope of finance.

Answer: First, the scale of operations of business firms has expanded greatly in recent years. The growing significance of large corporations and the increasing size of investments highlight the importance of long-range financial planning.

Second, the widespread diversification of products and the global nature of today’s business environment have increased the complexity of managing a business. We now have multiproduct, multidivisional, and multinational corporations.

Type: Concept

Level of Difficulty: Medium

Learning Objective: Identify the main corporate finance decisions involving the financial management of a firm’s assets and its liabilities (corporate financing).

Section Reference: Finance Careers and the Organization of the Finance Function

58) Which is a better economic objective for financial managers: maximizing profit or maximizing share price? Why? Give three reasons.

Answer: Maximizing share price is a better economic objective for financial managers because simple profit maximization does not address the following three issues:

Profits versus Return on Capital – Profits have to be viewed in relation to the amount of capital invested. The wealth position of shareholders can suffer even when total profits increase.

Timing of cash flows – The time value of money has to be considered when comparing profits across different time periods. Identical dollar amounts received at two different points in time do not have the same economic value.

Risk – Any stream of anticipated profits is subject to risk. Given the same potential return, investors will prefer less risk, as they are risk adverse. Investors will demand a higher return, or a risk premium, in order to invest in risky securities.

The objective of share price maximization overcomes the shortcomings of profit maximization.

Type: Concept

Level of Difficulty: Medium

Learning Objective: Describe the goals of the firm and the pressures exerted on corporations by various stakeholders.

Section Reference: The Goals of the Corporation

59) Explain the concept of “too big to fail” and how it relates to the latest financial crisis.

Answer: The “too big to fail” argument relates to firms that employ a high number of people or are involved in a vital sector of the economy. The argument refers to the inability of society to lose firms that are so important, and society must do whatever is in its power to protect these large businesses. However, the issue becomes: how can we control the management of businesses that are important in the economy? The saving of AIG and other financial institutions during the latest crisis shows the cost that society pays as a result.

Type: Concept

Level of Difficulty: Medium

Learning Objective: Explain what agency costs are and how they affect the interests of management and shareholders.

Section Reference: Corporate Finance

60) Describe what is meant by agency relationships, and outline the potential conflicts of interest that may arise.

Answer: One type of agency relationship arises when there is a separation of management from ownership, which results in management being hired to act as an agent on behalf of the owner. Potential conflicts of interest arise when actions that are in the best interests of shareholders do not coincide with those that are in management’s best interests.

Another type of agency relationship arises when a corporation finances its activities with both equity and debt. At times, shareholders (who control the decisions of the firm) have an incentive to invest in projects that are detrimental to bondholders. To eliminate the potential for such actions, bondholders put restrictive covenants in the debt contracts restricting the actions of management. These covenants may impair management’s ability to make value-maximizing decisions.

Type: Definition

Level of Difficulty: Medium

Learning Objective: Explain what agency costs are and how they affect the interests of management and shareholders.

Section Reference: Corporate Finance

61) Do agency costs only occur in a corporation, or can you have agency costs in a sole proprietorship?

Answer: Agency costs primarily occur in corporations, but can also occur in other forms of business. Whenever an owner of a business hires another person to act on their behalf, there exists an agency relationship. Whenever there exists an agency relationship, there is a potential for conflicts of interest to arise, and therefore agency costs may be incurred.

Type: Concept

Level of Difficulty: Hard

Learning Objective: Explain what agency costs are and how they affect the interests of management and shareholders.

Section Reference: Corporate Finance

62) Frank Wood, the owner of Cozy Corner Cabinets (CCC) has just hired Joe Boss to manage his company. Instead of using a flat salary, the two men have agreed that Joe will be paid 15 percent of the profits at the end of each year. CCC currently has three project opportunities to choose from, and can only choose one of them. Project A will generate profits of $75,000 per year, and will increase the value of CCC by $145,000. Project B will generate profits of $63,000 per year, and will increase the value of CCC by $153,000. Project C will generate profits of $68,000 per year, and will increase the value of CCC by $138,000. Which project is Joe Boss likely to choose and why? As the owner of CCC, which project would Frank prefer?

Answer: Under Project A, Joe would receive 0.15 \* $75,000 = $11,250 per year. Under Project B, Joe would receive 0.15 \* $63,000 = $9,450. Under Project C, Joe would receive 0.15 \* $68,000 = $10,200. Thus, since $11,250 > $10,200 > $9,450, Joe would choose Project A to maximize his income.

However, Frank would prefer that Project B be chosen as it results in the greatest increase in firm value for CCC ($153,000 > $145,000 > $138,000).

Type: Calculation

Level of Difficulty: Hard

Learning Objective: Identify the main corporate finance decisions involving the financial management of a firm’s assets and its liabilities (corporate financing).

Section Reference: Finance Careers and the Organization of the Finance Function

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