

- 17) The goal of the firm should be
- A) maximization of profits (net income per share).
 - B) maximization of shareholder wealth.
 - C) maximization of market share.
 - D) maximization of sales.

Answer: B

Diff: 1 Page Ref: 31

Keywords: Goal of the Firm, Maximize Shareholder Wealth

Learning Obj.: L.O. 1.1

AACSB: Reflective Thinking

- 18) Which of the following goals of the firm are synonymous (equivalent) to the maximization of shareholder wealth?
- A) profit maximization
 - B) risk minimization
 - C) maximization of the total market value of the firm's common stock
 - D) none of the above

Answer: C

Diff: 1 Page Ref: 32

Keywords: Goal of the Firm, Maximize Shareholder Wealth

Learning Obj.: L.O. 1.1

AACSB: Reflective Thinking

- 19) Which of the following is the most important goal that a corporation should strive for?
- A) maximize current profits
 - B) maximize market share
 - C) maximize revenue
 - D) maximize shareholder wealth

Answer: D

Diff: 1 Page Ref: 31

Keywords: Goal of the Firm, Maximize Shareholder Wealth

Learning Obj.: L.O. 1.1

AACSB: Reflective Thinking

- 20) One of the causes of the recent financial crisis in the United States has been excessive risk taking due to underestimation of risk. How does this relate to shareholder wealth maximization and financial leverage? Can overestimation of risk also be detrimental?

Answer: Underestimation of risk can lead managers to borrow excessively to fund more and more projects.

High levels of debt require interest and principal payments which may become impossible to make if the company's cash flows are reduced, even for short periods of time. Overestimation of risk can also be problematic. Managers who take on too little risk may be passing up desirable projects that could increase shareholder wealth. The principle that risk requires a reward does not mean that all risk is bad, but rather that additional risk is ok if additional expected returns are high enough. If all risk was bad, companies would go out of business and all investors would buy U.S. Treasury bills.

Diff: 2 Page Ref: 32, 37

Keywords: Risk Requires a Reward, Goal of the Firm

Learning Obj.: L.O. 1.1

AACSB: Reflective Thinking

- 21) Documents uncovered after the Exxon Valdez oil spill in Alaska revealed that Exxon could have used double-hulled oil tankers that would have prevented the spill, but the cost of refitting their fleet of single-hulled tankers was considered too high. Exxon determined that the cost of cleaning up an oil spill would be less than the cost of refitting the ships, thus increasing shareholder value. Several years after the oil spill, however, Exxon was fined billions of dollars for the spill. How do the costs of the cleanup and the fines pertain to a discussion of maximizing shareholder value and ethical responsibility?

Answer: Managers are supposed to maximize shareholder value. Exxon's analysis of the costs of an oil spill versus the cost of improving their tankers seems to have been a reasonable one at the time it was undertaken. The social costs of killing birds and fish were expected to be low. The outrage at Exxon's conduct and the subsequent large fines will change the estimation of future costs for similar situations. Managers need to consider the impact of their decisions on their companies' cash flows. Socially undesirable activities may lead to boycotts, protests, lower sales, fines, etc. These costs must be included in their analyses. Society sets limits within which corporations must operate or the corporations, and their shareholders, will suffer. Therefore, acting in ethical and socially responsible ways is congruent with the goal of shareholder wealth maximization.

Diff: 2 Page Ref: 32, 37, 38

Keywords: Goal of the Firm, Maximizing Shareholder Value, Ethical Responsibility, Cash Flow

Learning Obj.: L.O. 1.1

AACSB: Reflective Thinking

Learning Objective 1.2

- 1) When making financial decisions, managers should always look at marginal, or incremental cash flows.

Answer: TRUE

Diff: 1 Page Ref: 33

Keywords: Marginal or Incremental Cash Flows

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

- 2) An investment project is acceptable if the total cash received over the life of the project exceeds the total cash spent over the life of the project.

Answer: FALSE

Diff: 2 Page Ref: 33

Keywords: Cash Flow, Time Value of Money

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking

- 3) If two companies have the same net income and the same level of risk, they must also have the same stock price or the market is not in equilibrium.

Answer: FALSE

Diff: 2 Page Ref: 32

Keywords: Net Income, Risk, Timing of Cash Flow

Learning Obj.: L.O. 1.2

AACSB: Analytical Thinking

- 4) Profits represent money that can be spent, and as such, form the basis for determining the value of financial decisions.

Answer: FALSE

Diff: 2 Page Ref: 32

Keywords: Profits, Cash Flow

Learning Obj.: L.O. 1.2

AACSB: Reflective Thinking