

Chapter One

Financial Economics

This chapter contains 48 multiple choice questions, 20 short problems and 5 longer problems.

Multiple Choice

1. The primary goal of corporate management is to _____ shareholder wealth.
- (a) minimize
 - (b) maximize
 - (c) leverage
 - (d) mitigate

Answer: (b)

2. A _____ stock market imposes _____ discipline on managers to take actions to maximize the market value of the firm's shares.
- (a) competitive, strong
 - (b) dispersed, weak
 - (c) mature, no
 - (d) dispersed, strong

Answer: (a)

3. The _____ form is especially well suited to the separation of ownership and management of firms because it allows relatively frequent changes in owners by share transfer without affecting the operations of the firm.
- (a) corporate
 - (b) sole proprietorship
 - (c) partnership
 - (d) household

Answer: (a)

4. _____ is anything that has economic value.
- (a) A partnership
 - (b) An asset
 - (c) A balance sheet
 - (d) An income statement

Answer: (b)

5. A household's wealth or net worth is measured by the value of its _____ minus its _____.

- (a) liabilities; assets
- (b) assets; liabilities
- (c) stocks; bonds
- (d) bonds; liabilities

Answer: (b)

6. The branch of finance dealing with financial decisions of firms is called _____ or _____.

- (a) investments; international finance
- (b) markets; institutions
- (c) business finance; institutions
- (d) business finance; corporate finance

Answer: (d)

7. Bonds promise _____ cash payments, while stocks pay the _____ value left over after all other claimants have been paid.

- (a) variable; residual
- (b) residual; fixed
- (c) fixed; residual
- (d) fixed; variable

Answer: (c)

8. The day-to-day financial affairs of the firm are usually referred to as _____.

- (a) working capital management
- (b) capital structure
- (c) capital budgeting
- (d) strategic planning

Answer: (a)

9. A disadvantage of the sole proprietorship is the fact that the sole proprietor has _____.

- (a) limited liability for the debts of the firm
- (b) unlimited liability for the debts of the firm
- (c) expensive costs to establish the firm
- (d) limited authority over the day-to-day business decisions of the firm

Answer: (b)

10. In the U.S. corporations with concentrated ownership are called _____ and corporations with broadly dispersed ownership are called _____.

- (a) private corporations; public corporations
- (b) public corporations; private corporations
- (c) public corporations; monopolies
- (d) private corporations; state owned corporations

Answer: (a)

11. Billy owns a house worth \$350,000 and has a \$55,000 bank account. Billy owes \$270,000 to the bank on a home mortgage loan and has a \$12,000 credit card debt outstanding. Calculate Billy's net worth.

- (a) \$135,000
- (b) \$123,000
- (c) \$497,000
- (d) \$37,000

Answer: (b)

12. Marlowe owns a house worth \$150,000, a car worth \$25,000 and has an \$18,000 bank account. Marlowe owes \$135,000 to the bank on a home mortgage loan, \$18,000 on the car loan and has an \$18,000 credit card debt outstanding. Calculate Marlowe's net worth.

- (a) \$58,000
- (b) \$123,000
- (c) \$22,000
- (d) \$37,000

Answer: (c)

13. An advantage of the corporate form of ownership is _____.

- (a) no liability
- (b) unlimited liability
- (c) limited liability
- (d) CEO liability

Answer: (c)

14. In the corporate form, the separated structure creates the potential for _____ between owners and managers.

- (a) a conflict of interest
- (b) increased transactional costs
- (c) stability in relations
- (d) none of the above

Answer: (a)

15. All of the following are reasons for having a separation of management and ownership of the firm except:

- (a) the going concern effect favors the separated structure
- (b) professional managers may be found who possess a superior ability to run the business
- (c) it prevents the possibility of a conflict of interest between the owners and management
- (d) it allows for savings in the cost of information gathering

Answer: (c)

16. _____ involves the evaluation of costs and benefits spread out over time, and it is largely a financial decision-making process.

- (a) Stock valuation
- (b) Bond valuation
- (c) Inventory costing
- (d) Strategic planning

Answer: (d)

17. Shareholder wealth maximization depends on all of the following except:

- (a) production technology
- (b) market interest rates
- (c) risk aversion
- (d) market risk premiums

Answer: (c)

18. A problem with using the profit maximization criterion is _____.

- (a) deciding which period's profit is to be maximized
- (b) the definition of "maximize profits" is ambiguous
- (c) the failure to consider risk
- (d) all of the above

Answer: (d)

19. The existence of a well functioning stock market facilitates the efficient separation of the ownership and management of firms, since stock prices can be substituted for external information about _____.

- (a) the firm's production technology
- (b) the wealth, preferences, and other investment opportunities of the owners
- (c) the historic costs of the firm's infrastructure
- (d) the firm's ability to meet its projected goals

Answer: (b)

20. One place to look for a statement of the goals of a corporation's top managers is the _____.

- (a) balance sheet
- (b) income statement
- (c) annual report
- (d) bankruptcy filing

Answer: (c)

21. In the absence of a stock market, managers would require information that is _____ to obtain.

- (a) costly if not impossible
- (b) costless
- (c) readily available
- (d) time-consuming but inexpensive

Answer: (a)

22. Management's task is made much easier when it can observe the _____ of its own and other firms' shares.

- (a) book prices
- (b) market prices
- (c) historical prices
- (d) security prices

Answer: (b)

23. _____ are entitled to a share of any of the distributions from the corporation such as cash dividends.

- (a) Sole proprietors
- (b) General partners
- (c) Professional managers
- (d) Shareholders

Answer: (d)

24. _____ is the founder of modern portfolio theory.

- (a) Harry Markowitz
- (b) Merton Miller
- (c) William Sharpe
- (d) Bill Gates

Answer: (a)

25. In Germany, public corporations are identifiable by _____ after the company name, whereas private companies are denoted by _____.

- (a) PLC, Inc.
- (b) GmbH, AG
- (c) AG, GmbH
- (d) SpA, GmbH

Answer: (c)

26. In the United Kingdom, public corporations are identifiable by _____ after the company name, whereas private companies are denoted by _____.

- (a) Inc, PLC
- (b) LTD, PLC
- (c) AG, GmbH
- (d) PLC, LTD

Answer: (d)

27. Shareholders elect _____ who in turn select _____ to run the business.

- (a) a board of directors; a treasurer
- (b) a board of directors; managers
- (c) managers; a board of directors
- (d) a board of directors; accountants

Answer: (b)

28. In a competitive stock market, _____ offer(s) another important mechanism for aligning the incentives of managers with those of shareholders.

- (a) takeovers
- (b) increased taxes
- (c) liquidation
- (d) increased liability

Answer: (a)

29. If a raider is interested in making a profit through the takeover of a prospective firm, the only expenses that need be incurred are _____.

- (a) the cost of identifying a mismanaged firm
- (b) the cost of acquiring the firm's shares
- (c) physical capital
- (d) both (a) and (b)

Answer: (d)

30. The cost of identifying a mismanaged firm can be low if the raider is which of the following:

- (a) a supplier
- (b) a customer
- (c) a competitor
- (d) all of the above

Answer: (d)

31. Takeover mechanisms can most effectively be reduced by _____.

- (a) directives from the board of directors
- (b) media intervention
- (c) government policies
- (d) public disapproval

Answer: (c)

32. The chief financial officer (CFO) of a corporation normally reports to the _____ of the company.

- (a) controller
- (b) treasurer
- (c) chief executive officer
- (d) chairman of the board of directors

Answer: (c)

33. All of the following departments typically report to the chief financial officer (CFO) except:

- (a) marketing
- (b) financial planning
- (c) treasury
- (d) control

Answer: (a)

34. The treasurer's job includes managing all of the following except:

- (a) the firm's exposure to currency and interest rate risks
- (b) the tax department
- (c) relations with the external investment community
- (d) the analysis of proposed mergers and acquisitions

Answer: (d)

35. The activities of the vice president for financial planning include all of the following except:

- (a) analyzing proposed mergers
- (b) analyzing proposed spin-offs
- (c) preparing internal reports comparing planned and actual costs
- (d) analyzing major capital expenditures

Answer: (c)

36. Which of the following statements is most correct?

- (a) The shareholders of a corporation elect managers who in turn select a board of directors to run the business.
- (b) Partnerships do not pay corporate tax.
- (c) A disadvantage of the corporation is unlimited liability.
- (d) The government is powerless to discourage corporate takeovers.

Answer: (b)

37. For a typical firm, which of the following statements is most correct?

- (a) The CFO has three departments reporting to him: financial planning, treasury and control.
- (b) The treasurer oversees the accounting and auditing activities of the firm.
- (c) The controller has responsibility for managing the financing activities of the firm and for working capital management.
- (d) The CEO is a senior vice president with responsibility for all the financial functions in the firm.

Answer: (a)

38. Which of the following are financial decisions a firm has to make?

- (a) financing decisions
- (b) capital budgeting decisions
- (c) working capital decisions
- (d) all of the above

Answer: (d)

39. The controller's job includes responsibility for _____.

- (a) relations with the external investment community
- (b) preparation of financial statements for use by shareholders, creditors and regulatory authorities
- (c) analysis of proposed mergers, acquisitions and spin-offs
- (d) all of the above

Answer: (b)

40. The basic unit of analysis in capital budgeting is the _____.

- (a) financing project
- (b) investment project
- (c) strategic project
- (d) variable project

Answer: (b)

41. The steps involved in any capital budgeting process include:

- (a) evaluating projects
- (b) deciding which projects to undertake
- (c) identifying ideas for new investment projects
- (d) all of the above

Answer: (d)

42. Preferred stock, bonds, and convertible securities are also known as _____.

- (a) nonmarketable claims
- (b) standardized securities
- (c) variable securities
- (d) covenants

Answer: (b)

43. The basic unit of analysis in capital structure decisions is the _____.

- (a) firm as a whole
- (b) investment project
- (c) firm's personnel
- (d) financial system

Answer: (a)

44. Which one of the following correctly orders the steps involved in capital structure decisions?

- (a) determining a feasible financing plan; identifying new ideas for investment projects
- (b) determining the optimal financing mix; determining a feasible financing plan
- (c) identifying ideas for investment projects; determining the optimal financing mix
- (d) determining a feasible financing plan; determining the optimal financing mix

Answer: (d)

45. Which of the following is not a financial function of a corporation?

- (a) investor relations
- (b) tax administration
- (c) provision of capital
- (d) regulatory legislation

Answer: (d)

46. Which of the following functions may be categorized as administration of funds?

- (a) custodial responsibilities
- (b) tax administration
- (c) internal auditing
- (d) all of the above

Answer: (a)