

## CHAPTER 1—OVERVIEW OF FINANCIAL MANAGEMENT AND THE FINANCIAL ENVIRONMENT

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### TRUE/FALSE

1. While skillful workers and adequate capital support good businesses, outside connection and networking play no role.

ANS: F

**LO: (1.1) Successful Companies**

PTS: 1 DIF: EASY

2. The form of organizing a business is unimportant issue, as this decision has very little effect on the income and wealth of the firm's owners.

ANS: F

**LO: (1.2) Firm organization**

PTS: 1 DIF: EASY

3. There are three primary disadvantages of a regular partnership: (1) unlimited liability, (2) limited life of the organization, and (3) difficulty of transferring ownership. These combine to make it difficult for partnerships to attract large amounts of capital and thus to grow to a very large size.

ANS: F

**LO: (1.2) Partnership**

PTS: 1 DIF: EASY

4. Two disadvantages of a proprietorship are (1) the relative difficulty of raising new capital and (2) the owner's unlimited personal liability for the business's debts.

ANS: T

**LO: (1.2) Proprietorship**

PTS: 1 DIF: EASY

5. By being too involved in the business operation, limited partners can lose their limited liability status.

ANS: T

**LO: (1.2) Limited partnership**

PTS: 1 DIF: EASY

6. An income trust essentially pays no corporate taxes.

ANS: T

**LO: (1.2) Income trust**

PTS: 1 DIF: EASY

7. The best way to maximize the intrinsic value of a company and thus shareholders' wealth is to maximize its earnings per share.

ANS: F

**LO: (1.3) Value maximization**

PTS: 1 DIF: EASY

8. If Firm A's business is to obtain savings from individuals and then invest them in financial assets issued by other firms or individuals, Firm A is a financial intermediary.

ANS: T

**LO: (1.4) Financial intermediaries**

PTS: 1 DIF: EASY

9. Today, trustee services can be arranged only with trust companies.

ANS: F

**LO: (1.6) Financial institution**

PTS: 1 DIF: EASY

10. If an individual investor trades currently outstanding common shares through a broker, this is a secondary market transaction.

ANS: T

**LO: (1.7) Financial markets**

PTS: 1 DIF: EASY

11. Recently, Hale Corporation announced the sale of 2.5 million newly issued shares of its stock at a price of \$21 per share. Hale sold the stock to an investment banker, which in turn sold it to individual and institutional investors. This is a primary market transaction.

ANS: T

**LO: (1.7) Financial markets**

PTS: 1 DIF: EASY

12. With the more formal nature of the partnership agreement and the commitment of all partners' personal assets, partnerships have no difficulty raising large amounts of capital as do proprietorships.

ANS: F

**LO: (1.2) Partnership**

PTS: 1 DIF: MEDIUM

13. Two key advantages to proprietorship are that, as a business, it pays no corporate income tax and is easily and inexpensively formed.

ANS: T

**LO: (1.2) Proprietorship**

PTS: 1

DIF: MEDIUM

14. Fighting recession with low interest rates is technically impossible when we have large trade deficits and huge national debt.

ANS: T

**LO: (1.5) Trade deficit**

PTS: 1

DIF: MEDIUM

### **MULTIPLE CHOICE**

1. Which of the following statements best describes firm organization?
- One of the disadvantages of incorporating a business is that the owners have personal liabilities when firm goes bankrupt.
  - Sole proprietorships are subject to more regulations than corporations.
  - In any type of partnership, every partner has the same rights, privileges, and liability exposure as every other partner.
  - Sole proprietorships and partnerships generally have a tax advantage over corporations, especially large ones.

ANS: D

Sole proprietorships and partnerships pay personal income tax, but they avoid the corporate income tax.

**LO: (1.2) Firm organization**

PTS: 1

DIF: EASY

2. Which of the following statements best describes firm organization?
- One of the disadvantages of a sole proprietorship is that the proprietor is exposed to unlimited liability.
  - It is generally easier to transfer one's ownership interest in a partnership than in a corporation.
  - One of the advantages of the corporate form of organization is that it avoids double taxation.
  - One of the advantages of a corporation from a social standpoint is that every shareholder has equal voting rights, i.e., "one person, one vote."

ANS: A

**LO: (1.2) Firm organization**

PTS: 1

DIF: EASY

3. Which of the following statements best describes firm organization?
- a. It is generally more expensive to form a proprietorship than a corporation because, with a proprietorship, extensive legal documents are required.
  - b. One disadvantage of operating a business as a sole proprietorship is that the firm is subject to double taxation, at both the firm level and the owner level.
  - c. One advantage of forming a corporation is that equity investors are usually exposed to less liability than in a regular partnership.
  - d. If a regular partnership goes bankrupt, each partner is exposed to liabilities only up to the amount of his or her investment in the business.

ANS: C

Corporations have limited liability; however, they face more regulations than the other forms of organization.

**LO: (1.2) Firm organization**

PTS: 1

DIF: EASY

4. Cheers Inc. operates as a partnership. Now the partners have decided to convert the business into a regular corporation. Which of the following statements best describes firm organization?
- a. Assuming Cheers is profitable, less of its income will be subject to taxes.
  - b. Cheers will now be subject to fewer regulations.
  - c. Cheers' shareholders (the ex-partners) will now be exposed to less liability.
  - d. Cheers will find it more difficult to raise additional capital.

ANS: C

**LO: (1.2) Firm organization**

PTS: 1

DIF: EASY

5. Which of the following statements best describes firm organization?
- a. It is usually easier to transfer ownership in a corporation than it is to transfer ownership in a sole proprietorship.
  - b. Corporate shareholders are exposed to unlimited liability.
  - c. Corporations generally face fewer regulations than sole proprietorships.
  - d. Corporate shareholders are exposed to unlimited liability, and this factor may be compounded by the tax disadvantages of incorporation.

ANS: A

If ownership in a proprietorship or partnership is transferred, the basic documents under which the firm operates must be rewritten, whereas for a corporation the seller simply sells shares to a buyer, and the corporation records the transfer on its books.

**LO: (1.2) Firm organization**

PTS: 1

DIF: EASY

6. Which of the following could explain why a business might choose to operate as a corporation rather than as a sole proprietorship or a partnership?
- a. Less of a corporation's income is generally subjected to taxes than would be true if the firm were a partnership.
  - b. Corporate shareholders escape liability for the firm's debts, but this factor may be offset by the tax disadvantages of the corporate form of organization.
  - c. Corporate investors are exposed to limited growth potential.
  - d. Corporations generally face relatively few regulations.

ANS: B

**LO: (1.2) Corporate form of organization**

PTS: 1

DIF: EASY

7. What should be done to maximize shareholder wealth and thus the value of the firm?
- a. Decrease the size of expected cash flow of the company.
  - b. Slow down the cash receipt of the organization.
  - c. Increase the risk level of the firm.
  - d. Raise the free cash flows of the business.

ANS: D

**LO: (1.3) Value maximization**

PTS: 1

DIF: EASY

8. You recently sold 100 shares of your new company, XYZ Corporation, to your brother at a family reunion. At the reunion your brother gave you a cheque for the shares and you gave your brother the share certificates. Which of the following statements best describes this transaction?
- a. This is an example of an exchange of physical assets.
  - b. This is an example of a primary market transaction.
  - c. This is an example of a direct transfer of capital.
  - d. This is an example of a money market transaction.

ANS: C

**LO: (1.4) Financial transactions**

PTS: 1

DIF: EASY

9. Which of the following statements best describes interest rates?
- a. The cost of money to fund users is basically determined by the rate of return required by fund providers.
  - b. If individuals in general increase the percentage of their income that they save, interest rates are likely to increase.
  - c. If companies have fewer good investment opportunities, interest rates are likely to increase.
  - d. If expected inflation increases, interest rates are likely to decrease.

ANS: A

**LO: (1.5) Interest rates**

PTS: 1

DIF: EASY

10. Which of the following statements best describes hedge funds?
- a. Hedge funds are risky, although they may be market-neutral.
  - b. Hedge funds open to everyone.
  - c. Hedge funds have low risk because they hedge their investments.
  - d. Hedge funds are legal only in Canada, but they are not permitted to operate in Europe or Asia.

ANS: A

**LO: (1.6) Hedge funds**

PTS: 1 DIF: EASY

11. Money markets are markets for which of the following?
- a. foreign stocks
  - b. consumer automobile loans
  - c. short-term debt securities
  - d. long-term bonds

ANS: C

**LO: (1.7) Money markets**

PTS: 1 DIF: EASY

12. Which of the following is a primary market transaction?
- a. You sell 200 shares of IBM stock on the TSX through your broker.
  - b. IBM issues 2,000,000 shares of new stock and sells them to the public through an investment banker.
  - c. One financial institution buys 200,000 shares of IBM share from another institution with help of an investment banker.
  - d. You invest \$10,000 in a mutual fund, which then uses the money to buy \$10,000 of IBM shares on the TSX.

ANS: B

(b) is a primary market transaction, since the money and the security pass directly between the issuing firm and the investor.

**LO: (1.7) Financial markets**

PTS: 1 DIF: EASY

13. Which of the following statements best describes financial markets?
- a. If Disney issues additional shares of common stock through an investment banker, this would be a secondary market transaction.
  - b. The IPO market is a major part of the secondary market.
  - c. Only institutions, not individuals, can participate in derivatives market transactions.
  - d. Money market transactions involve debt securities with maturities of less than one year.

ANS: D

**LO: (1.7) Financial markets**

PTS: 1 DIF: EASY

14. You recently sold to your brother 200 shares of Disney stock; the transfer was made through a broker, and the trade occurred on the TSX. This is an example of which of the following?
- a. a futures market transaction
  - b. a primary market transaction
  - c. a secondary market transaction
  - d. a money market transaction

ANS: C

It is a secondary market transaction because the share is transferred from one investor to another.

**LO: (1.7) Financial markets**

PTS: 1

DIF: EASY

15. Which of the following statements best describes financial markets?
- a. Capital market transactions involve only the purchase and sale of equity securities, i.e., common stocks.
  - b. If an investor sells shares of stock through a broker, then this would be an indirect finance transaction.
  - c. Money market mutual funds have high degree of default risk.
  - d. Commercial papers have maturities longer than one year.

ANS: B

**LO: (Comp: 1.5-1.7) Financial markets**

PTS: 1

DIF: EASY

16. Which of the following statements best describes financial markets?
- a. Capital market instruments include both long-term debt and common stocks.
  - b. Banker's acceptance has no default risk.
  - c. Foreign banks are more restricted from operating in Canada.
  - d. The original maturity of a commercial loan can go up to ten years.

ANS: A

**LO: (Comp: 1.5-1.7) Financial markets**

PTS: 1

DIF: EASY

17. Which of the following statements best describes financial markets?
- a. Rates of return on T-bill are the highest among all major financial securities.
  - b. Money market mutual funds are illiquid.
  - c. Money markets are markets for long-term debt and common stocks.
  - d. EuroCanadian market time deposits are instruments issued by banks outside Canada.

ANS: D

**LO: (Comp: 1.5-1.7) Financial markets**

PTS: 1

DIF: EASY

18. One drawback of switching from a partnership to the corporate form of organization is the following:
- It subjects the firm to additional regulations.
  - It makes it more difficult for the firm to raise additional capital.
  - It makes the firm's investors subject to greater potential personal liabilities.
  - It makes it more difficult for the firm's investors to transfer their ownership interests.

ANS: A

**LO: (1.2) Corporate form of organization**

PTS: 1

DIF: MEDIUM

19. For businesses with cash-producing assets and no need of large capital expenditures, which of the following forms of organization is the best?
- sole proprietorship
  - limited partnership
  - corporation
  - income trust

ANS: D

**LO: (1.2) Corporate form of organization**

PTS: 1

DIF: MEDIUM

20. Which of the following statements best describes partnerships?
- In a regular partnership, liability for other partners' misdeeds is limited to the amount of a particular partner's investment in the business.
  - Partnerships have trouble attracting large capital due to such facts as unlimited liability, and the illiquidity of partnership interests.
  - A slow-growth company, with little need for new capital, would be more likely to organize as a corporation than would a faster-growing company.
  - A major disadvantage of all partnerships relative to all corporations is the fact that taxes must be paid by the partners rather than by the firm itself.

ANS: B

**LO: (1.2) Partnership form of organization**

PTS: 1

DIF: MEDIUM

21. Which of the following statements best describes partnerships?
- Corporations are at a disadvantage relative to partnerships because they have to file more reports to regulatory agencies, even if they are not publicly owned.
  - In a regular partnership, liability for the firm's debts is limited to the amount a particular partner has invested in the business.
  - A fast-growth company would be more likely to set up as a partnership for its business organization than would a slow-growth company.
  - There must be at least one person acting as a general partner in a limited partnership.

ANS: D

**LO: (1.2) Partnership form of organization**

PTS: 1

DIF: MEDIUM



22. Which of the following statements best describes income trusts?
- a. Income trust investors do not need to pay personal taxes on cash distribution received.
  - b. Income trusts face the same issue of double taxation as corporations.
  - c. Up to 2011, existing income trusts are allowed to treat their equity as debt for tax purposes.
  - d. Income trusts usually require significant capital reinvestment in the businesses.

ANS: C

**LO: (1.2) Income trust form of organization**

PTS: 1

DIF: MEDIUM

23. What is the main perceived attraction of income trusts?
- a. reducing double taxation
  - b. unregulated business environment
  - c. fewer layers in the organizational structure
  - d. maintenance-free business assets

ANS: A

**LO: (1.2) Income trust form of organization**

PTS: 1

DIF: MEDIUM

24. Which of the following statements is most accurate in regarding corporations?
- a. Due to limited liability, unlimited lives, and ease of ownership transfer, the vast majority of businesses are organized as corporations.
  - b. Due to legal considerations related to ownership transfers and limited liability, most business is conducted by corporations in spite of large corporations' often less favourable tax treatment.
  - c. Large corporations are taxed more favourably than sole proprietorships.
  - d. Corporate stockholders are exposed to unlimited liability.

ANS: B

**LO: (1.2) Firm organization**

PTS: 1

DIF: MEDIUM

25. Jane Doe, who has substantial personal wealth and income, is considering the possibility of starting a new business in the chemical waste management field. She will be the sole owner, and she has enough funds to finance the operation. The business will have a relatively high degree of risk, and it is expected that the firm will incur losses for the first few years. However, the prospects for growth and positive future income look good, and Jane plans to have the firm pay out all of its income as dividends to her once it is well established. Which of the legal forms of business organization would probably best suit her needs?
- a. proprietorship, because of ease of entry
  - b. income trust, to gain some tax advantages and also to obtain limited liability
  - c. partnership, but only if she needs additional capital
  - d. regular corporation, because of the limited liability

ANS: B

The income trust organization would allow her to take early losses as deductions against operating income and, hence, save some taxes. Then, when the firm became profitable, she would receive dividends and pay taxes on them, but the firm itself would avoid corporate taxes and double taxation by distributing all the free cash flows to investors.

**LO: (1.2) Firm organization**

PTS: 1

DIF: MEDIUM

26. Which of the following statements best describes articles of incorporation and bylaws?
- a. The corporate bylaws are a standard set of rules established by the state of incorporation. These rules are identical for all corporations, and their purpose is to ensure that the firm's managers run the firm in accordance with government laws.
  - b. Companies must establish a home office in a particular province, and that province must be the one in which most of their business is conducted.
  - c. Attorney fees are generally involved when a company develops its articles of incorporation and bylaws, but since these documents are voluntary, a new corporation can avoid these costs by deciding not to have any.
  - d. The articles of incorporation are concerned with things like what business the company will engage in, whereas the bylaws are concerned with things like procedures for electing the board of directors.

ANS: D

**LO: (1.2) Articles of incorporation and bylaws**

PTS: 1

DIF: MEDIUM

27. With which of the following statements would most people in business agree?
- a. Firms should not be punished because they have unintentionally built incentive schemes that induce unethical behaviour.
  - b. Firms and government agencies almost always agree with one another regarding the restrictions that should be placed on hiring and firing employees.
  - c. Although moral characters are developed differently, it is useful to educate people about the adverse consequences of unethical behaviour to themselves, their firms, and the nation.
  - d. Because of the courage it takes to blow the whistle, “whistle blowers” are generally promoted more rapidly than other employees.

ANS: C

It is important to have a specific set of rules that all employees are expected to follow. This helps constrain actions, and it is also important to “prove” that the company is trying to do right if some employee does something wrong.

**LO: (1.3) Business ethics**

PTS: 1

DIF: MEDIUM

28. The primary operating goal of a publicly owned firm interested in serving its shareholders should be to do which of the following?
- a. maximize the stock price per share over the long run, which is the stock’s intrinsic value
  - b. maximize the firm’s expected EPS
  - c. maximize the firm’s expected total income
  - d. maximize the stock price on a specific target date

ANS: A

**LO: (1.3) Goal of firm**

PTS: 1

DIF: MEDIUM

29. Which of the following statements best describes corporate goals?
- a. The proper goal of the financial manager should be to attempt to maximize the firm’s expected cash flows, because this will add the most to the wealth of the individual shareholders.
  - b. The financial manager should seek that combination of assets, liabilities, and capital that will generate the largest expected projected after-tax income over the relevant time horizon, generally the coming year.
  - c. The riskiness inherent in a firm’s earnings per share (EPS) depends on the characteristics of the projects the firm selects, and thus on the firm’s assets. However, EPS is not affected by the manner in which those assets are financed.
  - d. Potential agency problems can arise between shareholders and managers, because managers hired as agents to act on behalf of the owners may instead make decisions favourable to themselves rather than the shareholders.

ANS: D

**LO: (1.3) Corporate goals and control**

PTS: 1

DIF: MEDIUM

30. Suppose the Bank of Canada announces plans to issue \$50 billion of new bonds. Assuming the announcement was not expected, what effect, other things held constant, would that have on bond prices and interest rates?
- Prices and interest rates would both rise.
  - Prices would decline and interest rates would rise.
  - Prices and interest rates would both decline.
  - Prices would rise and interest rates would decline.

ANS: B

**LO: (1.5) Security prices and interest rates**

PTS: 1

DIF: MEDIUM

31. Which of the following would be most likely to lead to higher interest rates on all debt securities in the economy?
- Households start saving a larger percentage of their income.
  - The economy moves from a boom to a recession.
  - The level of inflation begins to decline.
  - With expansion plans, corporate increase their demand for capital.

ANS: D

**LO: (1.5) Interest rates**

PTS: 1

DIF: MEDIUM

32. Which of the following factors would be most likely to lead to an increase in interest rates in the economy?
- Households reduce their consumption and increase their savings.
  - The federal government decides to try to stimulate the economy.
  - There is an increase in expected inflation.
  - The economy falls into a recession.

ANS: C

To protect the purchasing power, interest rates are driven by the expected inflation. Moreover, an increase in the demand for capital by businesses will increase interest rates in the economy.

**LO: (1.5) Interest rates**

PTS: 1

DIF: MEDIUM

33. Which of the following financial intermediaries is not a depository institution?
- commercial bank
  - investment bank
  - trust company
  - credit union

ANS: B

**LO: (1.6) Financial institutions**

PTS: 1

DIF: MEDIUM

34. Which of the following services will not be offered by insurance companies?
- a. taking deposits
  - b. selling policies with saving features
  - c. administering pension funds
  - d. making payments to beneficiaries

ANS: A

**LO: (1.6) Financial institutions**

PTS: 1 DIF: MEDIUM

35. Which of the following statements is correct?
- a. A good goal for a firm's management is maximization of expected EPS.
  - b. Like corporations, the board of directors for an income trust supervises the operating entity on behalf of unitholders.
  - c. There is legal obligation to pay cash distributions for income trusts.
  - d. Agency conflicts easily arise between shareholders and managers.

ANS: D

**LO: (Comp: 1.2,1.3) Miscellaneous concepts**

PTS: 1 DIF: MEDIUM

36. Which of the following statements best describes income trusts?
- a. As income trust cash distributions are taxed at each unitholder's full tax rate, a higher tax liability results.
  - b. The administrative costs can be higher with an income trust structure relative to a corporate counterpart.
  - c. Income trust units cannot be held as equity securities.
  - d. Cash flows distributed to unitholders are paid after the corporate taxes.

ANS: B

**LO: (Comp: 1.2,1.3) Miscellaneous concepts**

PTS: 1 DIF: MEDIUM

37. Which of the following statements is **INCORRECT**?
- a. When a corporation's shares are owned by a few individuals and are not traded on public markets, we say that the firm is "closely, or privately, held."
  - b. "Going public" establishes a firm's true intrinsic value, and it also ensures that a highly liquid market will always exist for the firm's shares.
  - c. When stock in a closely held corporation is offered to the public for the first time, the transaction is called "going public," and the market for such stock is called the new issue market.
  - d. Publicly owned companies have shares owned by investors who are not associated with management, and public companies must register with and report to a regulatory agency such as the SEC.

ANS: B

**LO: (1.7) Ownership and going public**

PTS: 1 DIF: MEDIUM/HARD