



Pearson

Titman, Financial Management: Principles and Applications, 8th edition

Chapter 1: Getting started—Principles of finance

Multiple choice: Choose the one alternative that best completes the statement or answers the question

1. Which of the following statements best represents what finance is about?
 - A. The study of how political, social and economic forces affect corporations
 - B. Maximising profits
 - C. The study of how people and businesses make investment decisions and how to finance those decisions
 - D. Reducing risk

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.1 Understand the importance of finance in your personal and professional lives, and identify the three primary business decisions that financial managers make

Answer: C

2. From a financial point of view, a company that decides to develop a new product is making [blank].
 - A. a financing decision
 - B. an investment decision
 - C. a capital structure decision
 - D. a cash flow decision

Difficulty: Basic

AACSB: 6. Reflective thinking

Learning Objective: 1.1 Understand the importance of finance in your personal and professional lives, and identify the three primary business decisions that financial managers make

Answer: B

3. Working capital management refers to [blank].

- A. long-term financing decisions
- B. the management of cash flows
- C. investing in product development
- D. capital structure

Difficulty: Basic

AACSB: 7. Application of knowledge

Learning Objective: 1.1 Understand the importance of finance in your personal and professional lives, and identify the three primary business decisions that financial managers make

Answer: B

4. A key component of finance is the management and interpretation of [blank].

- A. marketing managers
- B. accounting staff
- C. entrepreneurship
- D. information

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.1 Understand the importance of finance in your personal and professional lives, and identify the three primary business decisions that financial managers make

Answer: D

5. According to the authors, the personal decision to take a year off from work to obtain a graduate degree in business is primarily a(n) [blank] decision.

- A. social
- B. financial
- C. ethical
- D. investment

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.1 Understand the importance of finance in your personal and professional lives, and identify the three primary business decisions that financial managers make

Answer: D

6. The area of finance that deals with long-term investment decisions is known as [blank].
- A. capital structure
 - B. working capital management
 - C. financial strategy
 - D. capital budgeting

Difficulty: Basic

AACSB: 6. Reflective thinking

Learning Objective: 1.1 Understand the importance of finance in your personal and professional lives, and identify the three primary business decisions that financial managers make

Answer: D

7. Capital structure refers to the financing of long-term investments.
- A. True
 - B. False

Difficulty: Basic

AACSB: 6. Reflective thinking

Learning Objective: 1.1 Understand the importance of finance in your personal and professional lives, and identify the three primary business decisions that financial managers make

Answer: A

8. Financial decisions can be difficult because the cost of investments can be estimated with greater confidence than future payoffs.
- A. True
 - B. False

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.1 Understand the importance of finance in your personal and professional lives, and identify the three primary business decisions that financial managers make

Answer: A

Short answer: Write the word or phrase that best completes each statement or answers the question

9. What are the three basic questions addressed by the study of investments?

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.1 Understand the importance of finance in your personal and professional lives and identify the three primary business decisions that financial managers make

Answer:

1. What investments should the firm undertake?
2. How should the firm fund these investments?
3. How can the firm best manage cash flows in its day-to-day operations?

Multiple choice: Choose the one alternative that best completes the statement or answers the question

10. Sole proprietorships are often used at which stage of a firm's life?

- A. After a partnership
- B. At the early stages
- C. As the number of employees increases
- D. When the company goes public

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.2 Identify the key differences between the three major legal forms of business

Answer: B

11. What is the chief disadvantage of the sole proprietorship as a form of business organisation when compared to the corporate form?

- A. Sole proprietorships are subject to double taxation of profits
- B. The cost of formation
- C. Inadequate profit sharing
- D. Owners have unlimited liability

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.2 Identify the key differences between the three major legal forms of business

Answer: D

12. Which of the following is true for limited partnerships?

- A. Only limited partners can manage the business.
- B. All partners must have limited liability.
- C. General and limited partners can appear in the name of the firm.
- D. Limited partners may sell their interest in the company.

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.2 Identify the key differences between the three major legal forms of business

Answer: D

13. The true owners of the corporation are the [blank].

- A. holders of debt issues of the firm
- B. preferred stockholders
- C. board of directors of the firm
- D. common stockholders

Difficulty: Basic

AACSB: 6. Reflective thinking

Learning Objective: 1.2 Identify the key differences between the three major legal forms of business

Answer: D

14. In terms of organisational costs, which of the following sequences is generally correct, moving from lowest to highest cost?

- A. General partnership, sole proprietorship, limited partnership, corporation
- B. Sole proprietorship, general partnership, limited partnership, corporation
- C. Corporation, limited partnership, general partnership, sole proprietorship
- D. Sole proprietorship, general partnership, corporation, limited partnership

Difficulty: Complex

AACSB: 6. Reflective thinking

Learning Objective: 1.2 Identify the key differences between the three major legal forms of business

Answer: B

15. Assume that you are starting a business. Further, assume that the business is expected to grow very quickly and a great deal of capital will be needed soon. After reading the chapter, which type of business organisation would you choose?

- A. Corporation
- B. General partnership
- C. Limited liability company
- D. Limited partnership

Difficulty: Complex

AACSB: 6. Reflective thinking

Learning Objective: 1.2 Identify the key differences between the three major legal forms of business

Answer: A

16. One advantage of a corporation is [blank].

- A. unlimited liability
- B. the life of the business is tied to the status of the investors

- C. the classical tax system
- D. ease of raising capital

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.2 Identify the key differences between the three major legal forms of business

Answer: D

17. Which of the following is a characteristic of a corporation?

- A. It allows one or more partners to have limited liability.
- B. It requires one or more of the partners to be a general partner to whom the privilege of limited liability does not apply.
- C. It prohibits the limited partners from participating in the management of the partnership.
- D. It is legally owned by its current set of shareholders.

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.2 Identify the key differences between the three major legal forms of business

Answer: D

18. Limited liability companies (LLCs) differ from limited partnerships in that [blank].

- A. owners of the LLC are subject to double taxation
- B. owners of the LLC have unlimited liability for the firm's debt
- C. owners of the LLC are not liable for the firm's debt
- D. owners of the LLC may not exceed 12 in number

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.2 Identify the key differences between the three major legal forms of business

Answer: C

19. Which of the following types of business forms is least risky to investors?

- A. Sole proprietorship
- B. Limited partnership
- C. General partnership
- D. A public company

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.2 Identify the key differences between the three major legal forms of business

Answer: D

20. Which form of organisation is free of initial legal requirements?

- A. Sole proprietorship
- B. Private company
- C. Corporation
- D. Public company

Difficulty: Basic

AACSB: 6. Reflective thinking

Learning Objective: 1.2 Identify the key differences between the three major legal forms of business

Answer: D

21. In a [blank], the life of the partnership is tied to the life of the general partner.

- A. private company
- B. general partnership
- C. public company
- D. limited partnership

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.2 Identify the key differences between the three major legal forms of business

Answer: D

22. Which of the following is a significant disadvantage of a general partnership?

- A. The cost of forming it is high.
- B. Each partner is fully responsible for the liabilities incurred by the partnership.
- C. There is a risk associated with the industry in which it operates.
- D. Forming the business is very complex.

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.2 Identify the key differences between the three major legal forms of business

Answer: B

23. Which legal form of businesses will be examined most frequently in this book?

- A. The sole proprietorship
- B. The general partnership
- C. The limited partnership
- D. The corporation

Difficulty: Basic

AACSB: 6. Reflective thinking

Learning Objective: 1.2 Identify the key differences between the three major legal forms of business

Answer: D

24. A limited partner is liable [blank].

- A. for only his or her own share of the partnership's debts
- B. for his or her own share of the partnership's debts and contingently liable for the other partners shares
- C. only up to the amount invested by that partner
- D. for none of the partnership's debts

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.2 Identify the key differences between the three major legal forms of business

Answer: C

25. A corporation is owned by [blank].

- A. its Chief Operations Officer
- B. the shareholders
- C. the Board of Directors
- D. its Chief Executive Officer (CEO)

Difficulty: Basic

AACSB: 6. Reflective thinking

Learning Objective: 1.2 Identify the key differences between the three major legal forms of business

Answer: B

26. The major sources of financing for corporations are [blank].

- A. partners contributions
- B. exchanges between shareholders
- C. interest and dividends
- D. debt and equity

Difficulty: Basic

AACSB: 6. Reflective thinking

Learning Objective: 1.2 Identify the key differences between the three major legal forms of business

Answer: D

27. A firm's Treasurer is typically responsible for [blank].

- A. data processing
- B. capital expenditures
- C. cost accounting
- D. financial statements

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.2 Identify the key differences between the three major legal forms of business

Answer: B

28. The sole proprietorship is the same as the individual for liability purposes.

- A. True
- B. False

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.2 Identify the key differences between the three major legal forms of business

Answer: A

29. In a general partnership, all partners have unlimited liability for the actions of any one partner when that partner is conducting business for the firm.

- A. True
- B. False

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.2 Identify the key differences between the three major legal forms of business

Answer: A

30. There is no legal distinction made between the assets of the business and the personal assets of the owners in the limited partnership.

- A. True
- B. False

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.2 Identify the key differences between the three major legal forms of business

Answer: B

31. The owners of a corporation are liable for the corporation's obligations up to the amount of their investment.

- A. True
- B. False

Difficulty: Basic

AACSB: 6. Reflective thinking

Learning Objective: 1.2 Identify the key differences between the three major legal forms of business

Answer: A

32. General partners have unrestricted transferability of ownership, while limited partners must have the consent of all partners to transfer their ownership.

- A. True
- B. False

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.2 Identify the key differences between the three major legal forms of business

Answer: B

33. Ultimate control in a corporation is vested in the board of directors.

- A. True
- B. False

Difficulty: Basic

AACSB: 6. Reflective thinking

Learning Objective: 1.2 Identify the key differences between the three major legal forms of business

Answer: B

34. Owners must register and pay yearly fees to their State of residence when establishing a sole proprietorship.

- A. True
- B. False

Difficulty: Basic

AACSB: 6. Reflective thinking

Learning Objective: 1.2 Identify the key differences between the three major legal forms of business

Answer: B

35. Limited partners may actively manage the business.

- A. True
- B. False

Difficulty: Basic

AACSB: 6. Reflective thinking

Learning Objective: 1.2 Identify the key differences between the three major legal forms of business

Answer: B

36. The life of a corporation is not dependent upon the status of the investors.

- A. True

B. False

Difficulty: Basic

AACSB: 6. Reflective thinking

Learning Objective: 1.2 Identify the key differences between the three major legal forms of business

Answer: A

37. If a limited partner dies or leaves the business, the partnership is dissolved and a new partnership must be formed.

A. True

B. False

Difficulty: Basic

AACSB: 6. Reflective thinking

Learning Objective: 1.2 Identify the key differences between the three major legal forms of business

Answer: B

38. In a sole proprietorship, the owner is personally responsible without limitation for the liabilities incurred.

A. True

B. False

Difficulty: Basic

AACSB: 6. Reflective thinking

Learning Objective: 1.2 Identify the key differences between the three major legal forms of business

Answer: A

39. In a limited partnership, at least one general partner must remain in the association; the privilege of limited liability still applies to this partner.

A. True

B. False

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.2 Identify the key differences between the three major legal forms of business

Answer: B

Essay: Write your answer in the space provided or on a separate sheet of paper

40. Compare and contrast the duties of a corporate Treasurer and a Financial Controller.

Difficulty: Complex

AACSB: 6. Reflective thinking

Learning Objective: 1.2 Identify the key differences between the three major legal forms of business

Answer: Both typically serve under the firm's Chief Financial Officer (CFO); however, in a small firm, the same person may fulfil both roles. The Treasurer handles financing activities such as managing its cash and credit, exercising control over the firm's major spending, decisions, raising money, developing financial plans and managing any foreign currency the firm receives. The firm's Financial Controller is responsible for managing the firm's accounting duties, which include producing financial statements, paying tax and gathering and monitoring data that the firm's executives need to oversee its financial well-being.

Multiple choice: Choose the one alternative that best completes the statement or answers the question

41. Which of the following is central to all five priorities at Woolworths Ltd?

- A. Shareholders
- B. Strategy
- C. Culture
- D. Customers

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.3 Understand the role of the financial manager within the firm and the goal for making financial choices

Answer: D

42. The authors believe that [blank].

- A. most businesses act out of greed to get rich quickly
- B. successful companies must choose between maximising return to shareholders and looking after the interests of their customers
- C. maximising the wealth of shareholders and doing the right thing for other stakeholders in the company go hand in hand
- D. companies that achieve their goals have competing objectives

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.3 Understand the role of the financial manager within the firm and the goal for making financial choices

Answer: C

43. Managing funding for the company's day-to-day operations is known as [blank].

- A. capital budgeting decisions

- B. working capital management
- C. capital structure decisions
- D. generating sustainable portfolios

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.3 Understand the role of the financial manager within the firm and the goal for making financial choices

Answer: B

44. Business dealings between people and firms ultimately depend on the [blank].

- A. willingness of parties to trust one another
- B. perfectly crafted contract
- C. ability of all parties to not make errors
- D. maximising wealth of shareholders

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.3 Understand the role of the financial manager within the firm and the goal for making financial choices

Answer: A

45. Profit maximisation is not an adequate goal of the firm when making financial decisions because [blank].

- A. it reflects shareholder wealth maximisation
- B. it reflects the risk inherent in different projects that will generate the profits
- C. it ignores the timing of a project's returns
- D. it minimises the share price

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.3 Understand the role of the financial manager within the firm and the goal for making financial choices

Answer: C

46. Which of the following goals is in the best long-term interest of shareholders?

- A. Profit maximisation
- B. Risk minimisation
- C. Maximising of the market value of the existing shareholders' common stock
- D. Maximising sales revenues

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.3 Understand the role of the financial manager within the firm and the goal for making financial choices

Answer: C

47. If managers do not pursue the goal of maximising shareholder wealth [blank].

- A. they concentrate on more important matters like growing market share
- B. they can focus more on social responsibilities
- C. they are likely to lose their jobs
- D. they can focus more on long-term profitability

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.3 Understand the role of the financial manager within the firm and the goal for making financial choices

Answer: C

48. The case of Tony Faddell and the MP3 player is an illustration of how [blank].

- A. a management team's investment decision can positively affect a firm's total value
- B. becoming a lean retailer through end-to-end process and systems excellence
- C. maximising wealth of shareholders is more important than doing the right thing for stakeholders
- D. lack of financial ethics can cost investors billions of dollars

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.3 Understand the role of the financial manager within the firm and the goal for making financial choices

Answer: A

49. Managers of corporations need to act in an ethical manner [blank].

- A. because ethics violations will be punished by the law
- B. because a business must be trusted by investors, customer and the public if it is to succeed
- C. because business managers must answer to a higher authority
- D. because ethical behaviour is its own justification

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.3 Understand the role of the financial manager within the firm and the goal for making financial choices

Answer: B

50. [blank] are the principal owners of a corporation.

- A. Shareholders
- B. Managers
- C. Employees
- D. Suppliers

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.3 Understand the role of the financial manager within the firm and the goal for making financial choices

Answer: A

51. In 2002, following serious ethical violations by corporations such as Enron, the United States Congress passed the [blank].

- A. Dodd–Frank Act
- B. Insider Trading Act of 1988
- C. Sarbanes–Oxley Act
- D. Bank Integration Act of 1901

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.3 Understand the role of the financial manager within the firm and the goal for making financial choices

Answer: C

52. Most criticism of legislation aimed at preventing corporate collapses and scandals has focused on [blank].

- A. the excessive cost of compliance
- B. inadequate penalties for violations
- C. diminished competitiveness of US corporations in international markets
- D. decreased confidence in financial reporting

Difficulty: Moderate

AACSB: 2. Ethical understanding and reasoning

Learning Objective: 1.3 Understand the role of the financial manager within the firm and the goal for making financial choices

Answer: A

53. Which act mandates that Australian CEOs and CFOs must affirm in writing that company financial statements are 'true and fair'?

- A. The Corporate Law Economic Reform Program Act 2004
- B. The Insider Trading Act of 1988
- C. The Sarbanes–Oxley Act
- D. The Bank Integration Act of 1901

Difficulty: Moderate

AACSB: 2. Ethical understanding and reasoning

Learning Objective: 1.3 Understand the role of the financial manager within the firm and the goal for making financial choices

Answer: A

54. The Sarbanes–Oxley Act of 2002 [blank].

- A. protects managers of publicly held corporations from frivolous lawsuits for unethical behaviour

- B. prohibits managers of publicly held corporations from personally profiting from non-public information
- C. holds those who influence corporate decisions legally accountable for unethical conduct
- D. allows corporate accountants greater latitude in the application of generally accepted accounting principles

Difficulty: Moderate

AACSB: 2. Ethical understanding and reasoning

Learning Objective: 1.3 Understand the role of the financial manager within the firm and the goal for making financial choices

Answer: C

55. It is impossible to write a perfect contract.

- A. True
- B. False

AACSB: 6. Reflective thinking

Learning Objective: 1.3 Understand the role of the financial manager within the firm and the goal for making financial choices

Answer: A

56. The goal of the firm should be the maximisation of profit.

- A. True
- B. False

Difficulty: Basic

AACSB: 6. Reflective thinking

Learning Objective: 1.3 Understand the role of the financial manager within the firm and the goal for making financial choices

Answer: B

57. One of the problems associated with profit maximisation is that it ignores the timing of a project's return.

- A. True
- B. False

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.3 Understand the role of the financial manager within the firm and the goal for making financial choices

Answer: A

58. The goal of profit maximisation is equivalent to the goal of maximisation of share value.

- A. True
- B. False

Difficulty: Basic

AACSB: 6. Reflective thinking

Learning Objective: 1.3 Understand the role of the financial manager within the firm and the goal for making financial choices

Answer: B

59. The goal of profit maximisation ignores the timing of profit.

- A. True
- B. False

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.3 Understand the role of the financial manager within the firm and the goal for making financial choices

Answer: A

60. The goal of maximising shareholder wealth inevitably conflicts with socially responsible behaviour on the part of corporations.

- A. True
- B. False

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.3 Understand the role of the financial manager within the firm and the goal for making financial choices

Answer: B

61. Unethical insider trading by government officials inspired both the Sarbanes–Oxley Act and CLERP 9.

- A. True
- B. False

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.3 Understand the role of the financial manager within the firm and the goal for making financial choices

Answer: B

62. A reputation for unethical behaviour can negatively affect the value of a company's shares.

- A. True
- B. False

Difficulty: Basic

AACSB: 6. Reflective thinking

Learning Objective: 1.3 Understand the role of the financial manager within the firm and the goal for making financial choices

Answer: A

Essay: Write your answer in the space provided or on a separate sheet of paper

63. Who was Alan Bond? What lessons does his story offer business entrepreneurs?

Difficulty: Complex

AACSB: 6. Reflective thinking

Learning Objective: 1.3 Understand the role of the financial manager within the firm and the goal for making financial choices

Answer: Bond was best known as the bankroller of Australia's victory in the 1983 America's Cup. He is the founder of Bond University. He built a multi-billion dollar fortune and headed a network of complex businesses and financial relationships. As a result of the mountain of debt instigated by the stock-market crash of 1987, Bond resorted to more and more questionable actions to keep his ship afloat. His business career should serve as a salient lesson to high-flying business entrepreneurs the world over, in three important respects: (1) business empires based on debt-funded acquisitions during times of rapidly rising asset prices tend to be highly vulnerable when prices start to fall; (2) it is at times of greatest stress, pressure and desperation that many of us are most at risk of immoral, unethical or even criminal behaviour; and (3) as soon as one feels compelled to hide the truth about a business transaction from colleagues, shareholders and regulators, that should serve as a warning that even tougher times lie ahead.

64. Briefly discuss the incentives for financial managers to conduct their business in an ethical manner.

Difficulty: Moderate

AACSB: 6. Reflective thinking

Learning Objective: 1.3 Understand the role of the financial manager within the firm and the goal for making financial choices

Answer: Unethical behaviour destroys trust, and businesses cannot function without a certain degree of trust. Extreme ethical lapses such as those evident in the Madoff Ponzi scheme may also break laws and result in fines or imprisonment. In less extreme cases, deceptive accounting practices or sales techniques once exposed lead to a loss of trust. Because individuals and firms are reluctant to do business with those they mistrust, a reputation for unethical behaviour over the long run leads to adversarial relations with business partners, a loss of customers and destruction of the firm's value.

Multiple choice: Choose the one alternative that best completes the statement or answers the question

65. Consider the following equally likely project outcomes:

	Profit	
	X	Y
Pessimistic prediction	\$ 0	\$500
Expected outcome	\$ 500	\$500
Optimistic prediction	\$1000	\$500

- A. Investors will prefer project X because it potentially offers a higher profit.
- B. Investors will reject both projects because the profit is too low.
- C. Investors will prefer project Y because the expected return is the same as for project X but the outcome is certain.
- D. Since projects X and Y have the same expected outcomes of \$500, investors will view them as identical in value.

Answer: C

Difficulty: Moderate

AACSB: 3. Analytical thinking

Learning Objective: 1.4 Explain the five principles of finance that form the basis of financial management for both businesses and individuals

Answer: C

66. Consider the timing of the profits of the following certain investment projects:

	Profit	
	L	S
Year 1	\$0	\$3000
Year 2	\$3000	

- A. Project S is preferred to project L.
- B. Project L is preferred to project S.
- C. Projects S and L are equally desirable.
- D. A goal of profit maximisation would favour project S only.

Difficulty: Moderate

AACSB: 3. Analytical thinking

Learning Objective: 1.4 Explain the five principles of finance that form the basis of financial management for both businesses and individuals

Answer: A

67. In finance, we assume that investors are generally [blank].

- A. tolerant of risk
- B. averse to risk
- C. expecting risk
- D. natural risk-takers

Difficulty: Basic

AACSB: 3. Analytical thinking

Learning Objective: 1.4 Explain the five principles of finance that form the basis of financial management for both businesses and individuals

Answer: B

68. Consider cash flows for projects X and Y such as:

	Project X	Project Y
Year 1	\$3000	\$0
Year 2	\$0	\$3000

A rational person would prefer receiving cash flows sooner because [blank].

- A. the money can be reinvested
- B. the money is nice to have around
- C. the investor may be tired of a particular investment
- D. the investor is indifferent to either proposal

Difficulty: Moderate

AACSB: 3. Analytical thinking

Learning Objective: 1.4 Explain the five principles of finance that form the basis of financial management for both businesses and individuals

Answer: A

69. Which of the following should be considered when assessing the financial impact of business decisions?

- A. The amount of projected earnings
- B. The risk-return trade-off
- C. The timing of projected earnings—that is, when they are expected to occur
- D. All of the above

Difficulty: Basic

AACSB: 3. Analytical thinking

Learning Objective: 1.4 Explain the five principles of finance that form the basis of financial management for both businesses and individuals

Answer: D

70. Which of the following is most likely to motivate executives to maximise shareholder wealth?

- A. Tying bonuses to cost reductions and meeting budget goals
- B. Offering them relatively high salaries
- C. Tying annual bonuses to increases in annual profits
- D. Compensating them with stock options that can only be exercised after five years

Difficulty: Basic

AACSB: 3. Analytical thinking

Learning Objective: 1.4 Explain the five principles of finance that form the basis of financial management for both businesses and individuals

Answer: D

71. If one security has a greater risk than another security, investors will most likely require a [blank] rate of return for the investment that has the [blank] risk.

- A. lower; greater
- B. higher; lower
- C. higher; greater
- D. lower; lesser

Difficulty: Moderate

AACSB: 3. Analytical thinking

Learning Objective: 1.4 Explain the five principles of finance that form the basis of financial management for both businesses and individuals

Answer: C

72. How could you compensate an investor for taking on a significant amount of risk?

- A. Increase the expected rate of return
- B. Raise more debt capital
- C. Offer stock at a higher price
- D. Increase sales

Difficulty: Moderate

AACSB: 3. Analytical thinking

Learning Objective: 1.4 Explain the five principles of finance that form the basis of financial management for both businesses and individuals

Answer: A

73. If an investor had a choice of receiving \$1000 today, or \$1000 in five years, which would the average investor prefer?

- A. \$1000 in five years because they are not good at saving money
- B. \$1000 today because it will be worth more than \$1000 received in five years

- C. \$1000 in five years because it will be worth more than \$1000 received today
- D. Investors would be indifferent to when they would receive the \$1000

Difficulty: Moderate

AACSB: 3. Analytical thinking

Learning Objective: 1.4 Explain the five principles of finance that form the basis of financial management for both businesses and individuals

Answer: B

74. Why do investors prefer receiving cash sooner rather than later, according to finance theory?

- A. Incremental profits are greater than accounting profits.
- B. Money received earlier can be reinvested and returns can be increased.
- C. Tax considerations are important when investing.
- D. Diversification leads to increased value.

Difficulty: Moderate

AACSB: 3. Analytical thinking

Learning Objective: 1.4 Explain the five principles of finance that form the basis of financial management for both businesses and individuals

Answer: B

75. Investors choose to invest in higher risk investments because these investments offer higher [blank].

- A. expected returns
- B. inflation
- C. actual returns
- D. future consumption

Difficulty: Moderate

AACSB: 3. Analytical thinking

Learning Objective: 1.4 Explain the five principles of finance that form the basis of financial management for both businesses and individuals

Answer: A

76. Foregoing the earning potential of a dollar today is referred to as the [blank].

- A. time value of money
- B. opportunity cost concept
- C. risk–return trade-off
- D. creation of wealth

Difficulty: Moderate

AACSB: 3. Analytical thinking

Learning Objective: 1.4 Explain the five principles of finance that form the basis of financial management for both businesses and individuals

Answer: B

77. In measuring value, the focus should be on [blank].

- A. cash flow
- B. accounting profits
- C. time value of money
- D. earnings per share

Difficulty: Moderate

AACSB: 3. Analytical thinking

Learning Objective: 1.4 Explain the five principles of finance that form the basis of financial management for both businesses and individuals

Answer: A

78. Which of the following is a characteristic of an efficient market?

- A. Small number of individuals
- B. Opportunities exist for investors to profit from publicly available information
- C. Security prices reflect fair value of the firm
- D. Immediate response occurs for new public information

Difficulty: Moderate

AACSB: 3. Analytical thinking

Learning Objective: 1.4 Explain the five principles of finance that form the basis of financial management for both businesses and individuals

Answer: C

79. Which of the following factors is most important in investment decisions?

- A. The change in earnings before taxes
- B. The change in gross sales revenue
- C. The change in net income
- D. The change in after-tax cash flow

Difficulty: Moderate

AACSB: 3. Analytical thinking

Learning Objective: 1.4 Explain the five principles of finance that form the basis of financial management for both businesses and individuals

Answer: D

80. In November 2005, traders on the ground sold off a significant amount of Nike's shares while Nike's CEO was flying aboard the company's Gulfstream jet. The jet was malfunctioning and traders were watching television coverage of the event. This scenario illustrates which principle?

- A. Market prices reflect information
- B. Individuals respond to incentives
- C. Cash flows are the source of value
- D. The time value of money

Difficulty: Moderate

AACSB: 3. Analytical thinking

Learning Objective: 1.4 Explain the five principles of finance that form the basis of financial management for both businesses and individuals

Answer: A

81. The two worst performers on the ASX in 2016 were healthcare companies.

- A. True
- B. False

Difficulty: Moderate

AACSB: 3. Analytical thinking

Learning Objective: 1.4 Explain the five principles of finance that form the basis of financial management for both businesses and individuals

Answer: A

82. The risk–return principle implies that the more risky a given course of action, the higher the expected return must be.

- A. True
- B. False

Difficulty: Moderate

AACSB: 3. Analytical thinking

Learning Objective: 1.4 Explain the five principles of finance that form the basis of financial management for both businesses and individuals

Answer: A

83. The financial manager should examine available risk–return trade-offs and make his decision based upon the greatest expected return.

- A. True
- B. False

Difficulty: Moderate

AACSB: 3. Analytical thinking

Learning Objective: 1.4 Explain the five principles of finance that form the basis of financial management for both businesses and individuals

Answer: B

84. Only a few financial decisions involve some sort of risk–return trade-off.

- A. True
- B. False

Difficulty: Basic

AACSB: 3. Analytical thinking

Learning Objective: 1.4 Explain the five principles of finance that form the basis of financial management for both businesses and individuals

Answer: B

85. In efficient markets, prices rapidly adjust to new information.

- A. True
- B. False

Difficulty: Moderate

AACSB: 3. Analytical thinking

Learning Objective: 1.4 Explain the five principles of finance that form the basis of financial management for both businesses and individuals

Answer: A

86. Rewarding executives for increasing quarterly earnings will motivate them to act in the long-term best interests of shareholders.

- A. True
- B. False

Difficulty: Basic

AACSB: 3. Analytical thinking

Learning Objective: 1.4 Explain the five principles of finance that form the basis of financial management for both businesses and individuals

Answer: B

Essay: Write your answer in the space provided or on a separate sheet of paper

87. Briefly discuss why financial decision makers must focus on incremental cash flows when evaluating new projects.

Difficulty: Complex

AACSB: 3. Analytical thinking

Learning Objective: 1.4 Explain the five principles of finance that form the basis of financial management for both businesses and individuals

Answer: Incremental cash flows describe the total cash effect on the company, looking at the difference between total cash flow to the company, with the cash flow and without the cash flow. The company can then value these cash flows and see if the company is worth more with the project or without the project.

88. Discuss the risk–return trade-off and how it relates to finance.

Difficulty: Moderate

AACSB: 3. Analytical thinking

Learning Objective: 1.4 Explain the five principles of finance that form the basis of financial management for both businesses and individuals

Answer: As people are risk averse, they need a higher return as the risk gets higher. This means that investors will need a higher return on bonds that they do not consider to be as

safe as other bonds, and they will need a higher return on stock when the company in question's stock seems to be riskier than the stock of other companies.

89. Why do you think many companies compensate executives with options based on long-term increases in the value of the company's stock?

Difficulty: Moderate

AACSB: 3. Analytical thinking

Learning Objective: 1.4 Explain the five principles of finance that form the basis of financial management for both businesses and individuals

Answer: Tying executive compensation to long-term increases in the stock price makes sense because they are supposed to be working to maximise shareholder wealth. Stock-based compensation plans imply that decisions made to benefit shareholders will also benefit themselves.