

Testbank

to accompany

Fundamentals of Corporate Finance 2nd edition

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Chapter 1 – The financial manager and the company

True/False

1. The financial manager is responsible for making decisions that are in the best interest of the company's owners.

*a. True
b. False

Correct answer: a

2. The local Liberal Party is a stakeholder in a local company that makes no political donations to either party.

a. True
*b. False

Correct answer: b

3. A patent is a productive asset for a technology-based company.

*a. True
b. False

Correct answer: a

4. Intangible assets generate most of a company's cash flows.

a. True
*b. False

Correct answer: b

5. The most fundamental way that a business can grow in size is from the reinvestment of cash flows or earnings.

*a. True
b. False

Correct answer: a

6. When insolvency occurs, the company will always be liquidated.

- a. True
- *b. False

Correct answer: b

7. Capital assets are generally short term in nature.

- a. True
- *b. False

Correct answer: b

8. A good capital budgeting decision is one in which the benefits are worth more to the company than the cost of the asset.

- *a. True
- b. False

Correct answer: a

9. The financing decision determines how companies raise cash to pay for their investments.

- *a. True
- b. False

Correct answer: a

10. The dollar difference between current assets and liabilities is called working capital.

- a. True
- *b. False

Correct answer: b

11. A sole proprietorship is an owner's only business.

- a. True
- *b. False

Correct answer: b

12. The greatest number of businesses in Australia are companies.
- a. True
 - *b. False

Correct answer: b

13. Unlimited liability means that the owner of a company is responsible for paying all the company's bills.
- *a. True
 - b. False

Correct answer: a

14. The process of transferring ownership of a sole proprietorship is relatively easy.
- a. True
 - *b. False

Correct answer: b

15. General partners in a business have limited liability with regard to their company's obligations.
- a. True
 - *b. False

Correct answer: b

16. Most large companies are incorporated in New South Wales because of its favourable tax treatment of corporate income and its laws protecting the rights of its owners.
- a. True
 - *b. False

Correct answer: b

17. Companies do not have their income subject to double taxation.

- a. True
- *b. False

Correct answer: b

18. Privately held companies are allowed to have shareholders.

- *a. True
- b. False

Correct answer: a

19. The treasurer of a company usually reports to the CFO of the company.

- *a. True
- b. False

Correct answer: a

20. The external auditors of the company report their findings directly to the CFO of the company.

- a. True
- *b. False

Correct answer: b

21. Maximising revenue should be the goal of the company.

- a. True
- *b. False

Correct answer: b

22. An agency problem can arise when the agent of the company is the sole owner of the company.
- a. True
 - *b. False

Correct answer: b

23. The owners of a company are unaffected by agency costs.
- a. True
 - *b. False

Correct answer: b

24. Corruption in business does not affect the functioning of the financial markets.
- a. True
 - *b. False

Correct answer: b

25. An ethical business culture is the most effective way to protect the public:
- *a. True
 - b. False

Correct answer: a

Multiple Choice – Rate of difficulty noted after learning objective (basic, moderate, challenging)

26. Financial managers make decisions that:
- a. maximise the owners' wealth.
 - b. accord with the owners' decisions.
 - c. maximise the owners' share values.
 - *d. all of the above.

Correct answer: d

Learning Objective 1.1 ~ identify the key financial decisions facing the financial manager of any company (Moderate)

27. If you have loaned capital to a company, then you could be:
- a. a shareholder.
 - *b. a stakeholder.
 - c. a partner.
 - d. all of the above.

Correct answer: b

Learning Objective 1.1 ~ identify the key financial decisions facing the financial manager of any company (Basic)

28. Which of the following are stakeholders?
- a. a shareholder
 - b. a lender
 - c. the tax department
 - *d. all of the above

Correct answer: d

Learning Objective 1.1 ~ identify the key financial decisions facing the financial manager of any company (Basic)

29. A draftsman is an example of:
- a. a productive asset.
 - *b. an intangible asset.
 - c. a nebulous asset.
 - d. none of the above.

Correct answer: b

Learning Objective 1.1 ~ identify the key financial decisions facing the financial manager of any company (Challenging)

30. Which of the following asset purchase decisions are the most important to the company?
- a. an intangible asset
 - *b. a tangible asset
 - c. a financing decision
 - d. all of the above

Correct answer: b

Learning Objective 1.1 ~ identify the key financial decisions facing the financial manager of any company (Moderate)

31. The cash remaining after the company has met its operating expenses, payments to creditors, and tax is called:
- a. earnings per share.
 - b. capital contributed in excess of par.
 - *c. residual cash.
 - d. dividends.

Correct answer: c

Learning Objective 1.1 ~ identify the key financial decisions facing the financial manager of any company (Moderate)

32. Cash dividends are paid out of:

- *a. residual cash.
- b. liquidated assets.
- c. long-term debt.
- d. operating expenses.

Correct answer: a

Learning Objective 1.1 ~ identify the key financial decisions facing the financial manager of any company (Moderate)

33. Where liquidation follows insolvency, the _____ is/are always paid first.

- a. employees
- b. government
- *c. creditors
- d. owners

Correct answer: c

Learning Objective 1.1 ~ identify the key financial decisions facing the financial manager of any company (Challenging)

34. Current liabilities are liabilities that:

- a. will be converted to cash within a year.
- *b. must be paid within a year.
- c. will be converted to equity within a year.
- d. none of the above

Correct answer: b

Learning Objective 1.1 ~ identify the key financial decisions facing the financial manager of any company (Basic)

35. Capital budgeting involves:

- a. how a company's day-to-day financial matters should be managed.
- b. how the company should finance its assets.
- *c. which productive assets the company should employ.
- d. all of the above.

Correct answer: c

Learning Objective 1.1 ~ identify the key financial decisions facing the financial manager of any company (Basic)

36. Working capital management decisions involve:

- *a. how a company's day-to-day financial matters should be managed.
- b. how the company should finance its assets.
- c. which productive assets the company should employ.
- d. all of the above.

Correct answer: a

Learning Objective 1.1 ~ identify the key financial decisions facing the financial manager of any company (Basic)

37. Capital budgeting decisions generally involve:

- *a. the fixed asset portion of the balance sheet.
- b. the short-term portion of the balance sheet.
- c. the current liability portion of the balance sheet.
- d. all of the above.

Correct answer: a

Learning Objective 1.1 ~ identify the key financial decisions facing the financial manager of any company (Basic)

38. Financing decisions involve:

- a. raising cash to pay for investments.
- b. trade-offs between advantages and disadvantages.
- c. long-term borrowing for productive assets.
- *d. all of the above.

Correct answer: d

Learning Objective 1.1 ~ identify the key financial decisions facing the financial manager of any company (Moderate)

39. A good capital budgeting decision is:

- a. one in which the benefits of the project are equal to the cost of the asset.
- b. one in which the benefits of the project are less than the cost of the asset.
- *c. one in which the benefits of the project are more than the cost of the asset.
- d. all of the above.

Correct answer: c

Learning Objective 1.1 ~ identify the key financial decisions facing the financial manager of any company (Moderate)

40. Financial markets in which equity and debt instruments with maturities greater than one year are traded are called:
- a. money markets.
 - *b. capital markets.
 - c. share markets.
 - d. none of the above.

Correct answer: b

Learning Objective 1.1 ~ identify the key financial decisions facing the financial manager of any company (Moderate)

41. About 75 per cent of all businesses in Australia are:
- *a. sole traders.
 - b. partnerships.
 - c. companies.
 - d. limited liability partnerships.

Correct answer: a

Learning Objective 1.2 ~ identify the basic forms of business organisation used in Australia, and review their respective strengths and weaknesses (Moderate)

42. Which of the following business organisational forms subjects the owner(s) to unlimited liability?
- *a. sole trader
 - b. limited partnership
 - c. company
 - d. public company

Correct answer: a

Learning Objective 1.2 ~ identify the basic forms of business organisation used in Australia, and review their respective strengths and weaknesses (Moderate)

43. Which of the following cannot be engaged in managing the business?
- a. a sole trader
 - b. a general partner
 - *c. a limited partner
 - d. none of the above

Correct answer: c

Learning Objective 1.2 ~ identify the basic forms of business organisation used in Australia, and review their respective strengths and weaknesses (Basic)

44. What form of business organisation is described in a legal sense as a ‘person’?
- a. a sole trader
 - b. a partnership
 - *c. a company
 - d. none of the above

Correct answer: c

Learning Objective 1.2 ~ identify the basic forms of business organisation used in Australia, and review their respective strengths and weaknesses (Moderate)

45. Which organisational form(s) accounts for more than 75 per cent of the revenues of all businesses in Australia?
- a. sole trader
 - b. partnership
 - *c. company
 - d. a and b

Correct answer: c

Learning Objective 1.2 ~ identify the basic forms of business organisation used in Australia, and review their respective strengths and weaknesses (Moderate)

46. Which organisational form best enables a business to sell its securities to the market?
- a. sole trader
 - b. partnership
 - c. private company
 - *d. public company

Correct answer: d

Learning Objective 1.2 ~ identify the basic forms of business organisation used in Australia, and review their respective strengths and weaknesses (Basic)

47. Which of the following organisational forms is subject to the most legal regulations?
- a. sole trader
 - b. partnership
 - c. private company
 - *d. public company

Correct answer: d

Learning Objective 1.2 ~ identify the basic forms of business organisation used in Australia, and review their respective strengths and weaknesses (Moderate)

48. Which organisational form best enables the owners of the company to monitor the actions of other owners of the same company?

- a. sole trader
- *b. partnership
- c. private company
- d. public company

Correct answer: b

Learning Objective 1.2 ~ identify the basic forms of business organisation used in Australia, and review their respective strengths and weaknesses (Moderate)

49. Which of the following is considered a hybrid organisational form?
- a. sole trader
 - b. partnership
 - c. company
 - *d. limited liability partnership

Correct answer: d

Learning Objective 1.2 ~ identify the basic forms of business organisation used in Australia, and review their respective strengths and weaknesses (Basic)

50. Which of the following reports directly to the owners of the company (assume the company is a public company)
- a. CFO
 - b. CEO
 - *c. board of directors
 - d. audit committee

Correct answer: c

Learning Objective 1.3 ~ describe the typical organisation of the financial function in a large company (Moderate)

51. Which of the following is responsible for seeing that the best possible financial analysis is presented?
- *a. CFO
 - b. CEO
 - c. board of directors
 - d. audit committee

Correct answer: a

Learning Objective 1.3 ~ describe the typical organisation of the financial function in a large company (Basic)

52. Which of the following is responsible for performing an independent audit of the company's financial statements?
- a. CFO
 - b. CEO
 - *c. CPA company
 - d. audit committee

Correct answer: c

Learning Objective 1.3 ~ describe the typical organisation of the financial function in a large company (Challenging)

53. How is the CPA company insulated from being pressured by management?
- *a. The audit committee approves the external auditor's fees and assists with the auditor's report.
 - b. The chairman of the board approves the external auditor's fees and assists with the auditor's report.
 - c. The tax department approves the external auditor's fees and assists with the auditor's report.
 - d. The CPA company is not insulated from management.

Correct answer: a

Learning Objective 1.3 ~ describe the typical organisation of the financial function in a large company (Moderate)

54. Which of the following is an appropriate goal for the company?
- a. profit maximisation
 - b. revenue maximisation
 - *c. shareholder wealth maximisation
 - d. tax minimisation

Correct answer: c

Learning Objective 1.4 ~ explain why maximising the current value of the company's shares is the appropriate goal for management (Moderate)

55. When analysts and investors determine the value of a company's shares, they should consider:
- a. the size of the expected cash flows associated with owning the shares.
 - b. the timing of the cash flows.
 - c. the riskiness of the cash flows.
 - *d. all of the above.

Correct answer: d

Learning Objective 1.4 ~ explain why maximising the current value of the company's shares is the appropriate goal for management (Basic)

56. One reason for the existence of agency problems between managers and shareholders is that:
- *a. there is a separation of ownership and control of the company.
 - b. managers know how to manage the company better than shareholders.
 - c. shareholders have unreasonable expectations about managerial performance.
 - d. none of the above

Correct answer: a

Learning Objective 1.5 ~ discuss how agency conflicts affect the goal of maximising shareholder value (Moderate)

57. Which of the following is a principal within the agency relationship?
- a. a company engineer
 - b. the CEO of the company
 - *c. a shareholder
 - d. the board of directors

Correct answer: c

Learning Objective 1.5 ~ discuss how agency conflicts affect the goal of maximising shareholder value (Basic)

58. Shareholders elect _____ to represent their interest in the company.
- a. a chairman
 - b. a CEO
 - *c. a board of directors
 - d. a and c

Correct answer: c

Learning Objective 1.5 ~ discuss how agency conflicts affect the goal of maximising shareholder value (Basic)

59. An example of a direct agency cost is:
- a. a manager turning down a value-contributing project because of its risks.
 - *b. a manager expensing a large dinner on the company expense report.
 - c. a manager using too little debt within the company's capital structure because of the additional risk associated with debt.
 - d. all of the above.

Correct answer: b

Learning Objective 1.5 ~ discuss how agency conflicts affect the goal of maximising shareholder value (Basic)

60. Which of the following can help align the behaviour of managers with the goals of shareholders?
- a. management compensation
 - b. managerial labour markets
 - c. an independent board of directors
 - *d. all of the above

Correct answer: d

Learning Objective 1.5 ~ discuss how agency conflicts affect the goal of maximising shareholder value (Basic)

61. The point in time when ownership of a compensation-related option or sum of shares passes to the manager refers to:
- a. the agency date.
 - b. the compensation payment date.
 - c. granting.
 - *d. vesting.

Correct answer: d

Learning Objective 1.5 ~ discuss how agency conflicts affect the goal of maximising shareholder value (Challenging)

62. If a company has had an agency problem that is reflected in a poor performing share for a long period of time, then the company may become a target of _____.
- a. an ASIC investigation.
 - *b. a corporate raider.
 - c. a tax department investigation.
 - d. an insolvency lawyer.

Correct answer: b

Learning Objective 1.5 ~ discuss how agency conflicts affect the goal of maximising shareholder value (Moderate)

63. Executives that repeatedly put their own interests before that of the company may find that they have difficulty finding another job after their current one. This is an example of:
- a. the managerial labour market disciplining managers.
 - *b. the market for corporate control.
 - c. the board of directors affecting the prospects of a manager.
 - d. none of the above.

Correct answer: b

Learning Objective 1.5 ~ discuss how agency conflicts affect the goal of maximising shareholder value (Moderate)

64. Who or what is responsible for setting the agenda at meetings of the board of directors?
- *a. the chairman
 - b. the board of directors
 - c. nominating committee
 - d. audit committee

Correct answer: a

Learning Objective 1.5 ~ discuss how agency conflicts affect the goal of maximising shareholder value (Moderate)

65. A director who is not an employee of the company is called an:
- a. executive director.
 - b. internal director.
 - *c. independent director.
 - d. official director.

Correct answer: c

Learning Objective 1.5 ~ discuss how agency conflicts affect the goal of maximising shareholder value (Moderate)

66. Which of the following is **NOT** one of the strategies incorporated in the Sarbanes-Oxley Act of 2002?
- a. attain greater board independence
 - b. establish compliance programs
 - c. establish ethics programs
 - *d. dictate maximum compensation levels

Correct answer: d

Learning Objective 1.5 ~ discuss how agency conflicts affect the goal of maximising shareholder value (Challenging)

67. Which of the following powers does the audit committee have the authority to do?
- a. audit the personal bank account of the CEO
 - *b. question any person employed by the company
 - c. audit the compensation files of companies in the same industry
 - d. none of the above

Correct answer: b

Learning Objective 1.5 ~ discuss how agency conflicts affect the goal of maximising shareholder value (Basic)

68. What is the main purpose of the ASX Corporate Governance Council recommendations?
- a. to disclose the roles of the board.
 - b. to safeguard the integrity of all material matters.
 - *c. to promote and maintain investor confidence.
 - d. to facilitate internal control.

Correct answer: c

Learning Objective 1.5 ~ discuss how agency conflicts affect the goal of maximising shareholder value (Moderate)

69. A society's ideas about what actions are right and wrong are:
- a. morals.
 - *b. ethics.
 - c. laws.
 - d. unwritten laws.

Correct answer: b

Learning Objective 1.6 ~ explain why ethics is an appropriate topic in the study of corporate finance (Basic)

70. The golden rule is an example of:
- a. a current law.
 - b. a historical law.
 - c. an unworkable rule in financial markets.
 - *d. an ethical norm.

Correct answer: d

Learning Objective 1.6 ~ explain why ethics is an appropriate topic in the study of corporate finance (Basic)

71. An example of an economy that had trouble establishing a share market and attracting foreign investment is:
- *a. Russia.
 - b. China.
 - c. Greece.
 - d. Japan.

Correct answer: a

Learning Objective 1.6 ~ explain why ethics is an appropriate topic in the study of corporate finance (Basic)

72. Which corporate officer, when he or she is guilty of serious misconduct, can subject the company to the most serious losses in financial wealth?
- a. CEO
 - *b. CFO
 - c. Chief Technology Officer
 - d. Chief Risk Officer

Correct answer: b

Learning Objective 1.6 ~ explain why ethics is an appropriate topic in the study of corporate finance (Basic)

73. An officer of a company that is a majority owner in a competing company will probably be subject to:
- a. a tax audit.
 - *b. a conflict of interest with his shareholders.
 - c. arbitrage profit returns to ASIC.
 - d. a police investigation.

Correct answer: b

Learning Objective 1.6 ~ explain why ethics is an appropriate topic in the study of corporate finance (Moderate)

74. _____ occur(s) when one party in a business transaction has information that is unavailable to the other parties in the transaction.
- a. Profits
 - *b. Information asymmetry
 - c. Information efficiency
 - d. Financial advantage

Correct answer: b

Learning Objective 1.6 ~ explain why ethics is an appropriate topic in the study of corporate finance (Moderate)

75. Incentives for ethical behaviour are:
- a. market forces.
 - b. legislation.
 - c. insolvency.
 - *d. all of the above.

Correct answer: d

Learning Objective 1.6 ~ explain why ethics is an appropriate topic in the study of corporate finance (Basic)

Testbank to accompany Fundamentals of Corporate Finance 2e

Essay Questions

76. Explain what the goal of the company should be.

Answer: The goal of the company should be to maximise shareholder wealth, which in most cases is equivalent to maximising the price of the shares of the company. Note that this is not the same as maximising profits since maximising profits can occur while taking on too much risk (which can lower the value of the shareholders' investment). Maximising profits also does not take the timing of the profits into account. Profits, moreover, should not be confused with cash. Maximising shareholder wealth is also not the same as minimising risk, which can occur without taking any risks.

77. Explain how agency costs might be found within a company whose CEO owns no shares in the company, and whose compensation package is unaffected by the profits (cash or accounting profits) of the company.

Answer: Since the manager has no ownership interest in the company, she has no incentive to make the cash profits of the company as high as possible. In fact, she has a personal incentive to have the company pay for as many personal luxuries as possible since her compensation package will be completely unaffected by her decision to purchase the luxuries. In a company like the above, we might expect the company to expend a material amount of resources on items that the manager should probably pay for herself.

78. You have a friend who tells you that ethics are completely unimportant in business since a number of laws have been set up for us to know the rules of the game. Please discuss.

Answer: Despite heavy regulation, the financial sector has a long and rich history of financial scandals. While a good many of the scandals are due to laws that have been disregarded, many of the scandals began as ethical lapses. This suggests that laws are not enough to preclude behaviour that is detrimental to the well-functioning of the markets.