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Financial Management: Core Concepts, 5e (Brooks)
Chapter 1 Financial Management

1.1 The Cycle of Money

1) At its most basic level, the function of financial intermediaries is to _____.

- A) track and report interest rates
- B) move money from lenders to borrowers and back again
- C) report all financial transactions to the federal government
- D) effect a transfer of wealth in society

Answer: B

Diff: 1

Topic: 1.1 The Cycle of Money

AACSB: Analytical Thinking

LO: 1.1 Describe the cycle of money, the participants in the cycle, and the common objective of borrowing and lending.

2) Which of the following is NOT an example of a financial transaction?

- A) Your parents use their credit card to pay for your current term's college tuition.
- B) You use the ATM at Heathrow airport in London to withdraw British pounds.
- C) Your roommate lends you \$20 and you repay it in one week.
- D) All of the above are financial transactions.

Answer: D

Diff: 2

Topic: 1.1 The Cycle of Money

AACSB: Analytical Thinking

LO: 1.1 Describe the cycle of money, the participants in the cycle, and the common objective of borrowing and lending.

3) The movement of money from lender to borrower and back again is known as _____.

- A) the circle of life
- B) corporate finance
- C) the cycle of money
- D) money laundering

Answer: C

Diff: 1

Topic: 1.1 The Cycle of Money

AACSB: Analytical Thinking

LO: 1.1 Describe the cycle of money, the participants in the cycle, and the common objective of borrowing and lending.

Hmwrk Questions: * Taken from "Prepping for Exams" questions at the end of the chapter.

- 4) The common objective of borrowing and lending is to _____.
A) make all parties better off
B) gain a profit at the other's expense
C) make a firm or individual appear more liquid than is really the case
D) thwart regulatory authority

Answer: A

Diff: 1

Topic: 1.1 The Cycle of Money

AACSB: Analytical Thinking

LO: 1.1 Describe the cycle of money, the participants in the cycle, and the common objective of borrowing and lending.

- 5) Which of the following is NOT a function of a financial intermediary in the lending/borrowing process?

- A) To help establish terms of the lending/borrowing agreement
B) To match the borrower and the lender
C) To bear the risk that the lender will not repay
D) To bear the risk that the borrower will not repay

Answer: C

Diff: 1

Topic: 1.1 The Cycle of Money

AACSB: Analytical Thinking

LO: 1.1 Describe the cycle of money, the participants in the cycle, and the common objective of borrowing and lending.

- 6) Professor Gaston, your History teacher, borrows money at a rate of 6% per year from the Valley State Bank for a tuition loan for her son. You have \$1,200 deposited into your checking account at the same bank earning a rate of 0.5% per year. Which of the following statements is TRUE?

- A) The bank is criminally liable to you for paying an interest rate lower than the expected rate of inflation.
B) You and your professor have an obvious conflict of interest because you have accounts at the same financial institution.
C) You benefit from earning interest on your deposit, safety for your funds, and having a recognizable means for paying for your financial obligations without having to hold cash.
D) Your professor is the only party to be made worse off by this example because she is the only party paying net interest.

Answer: C

Explanation: Both you and your professor are using services typically provided by banks. There is no conflict of interest.

Diff: 2

Topic: 1.1 The Cycle of Money

AACSB: Analytical Thinking

LO: 1.1 Describe the cycle of money, the participants in the cycle, and the common objective of borrowing and lending.

7) The basic function of financial intermediaries is to move advice from lenders to borrowers and back to lenders.

Answer: FALSE

Explanation: The basic function of financial intermediaries is to move MONEY from lenders to borrowers and back to lenders.

Diff: 1

Topic: 1.1 The Cycle of Money

AACSB: Analytical Thinking

LO: 1.1 Describe the cycle of money, the participants in the cycle, and the common objective of borrowing and lending.

8) In the lending/borrowing process, a financial intermediary function is to bear the risk that the borrower will not repay.

Answer: TRUE

Diff: 1

Topic: 1.1 The Cycle of Money

AACSB: Analytical Thinking

LO: 1.1 Describe the cycle of money, the participants in the cycle, and the common objective of borrowing and lending.

9) All financial transactions have a buyer and a seller.

Answer: TRUE

Diff: 1

Topic: 1.1 The Cycle of Money

AACSB: Analytical Thinking

LO: 1.1 Describe the cycle of money, the participants in the cycle, and the common objective of borrowing and lending.

10) Give three examples of a financial transaction.

Answer:

(1) Your parents use their credit card to pay some of your college expenses.

(2) You use the ATM to withdraw funds so you can buy your best friend a birthday gift.

(3) Your roommate lends you \$20 and you repay it when you get your next pay check.

Diff: 2

Topic: 1.1 The Cycle of Money

AACSB: Analytical Thinking

LO: 1.1 Describe the cycle of money, the participants in the cycle, and the common objective of borrowing and lending.

1.2 Overview of Finance Areas

1) Which of the following best identifies the four main areas of finance?

- A) Exchange rate management, investments, financial institutions and markets, international finance
- B) Corporate finance, investments, capital structure, international finance
- C) Corporate finance, investments, financial institutions and markets, international finance
- D) Corporate finance, capital budgeting, financial institutions and markets, regulation

Answer: C

Explanation: Exchange rate management, capital structure, and capital budgeting are activities within the functional areas of finance.

Diff: 2

Topic: 1.2 Overview of Finance Areas

AACSB: Analytical Thinking

LO: 1.2 Distinguish the four main areas of finance and briefly explain the financial activities that each encompasses.

2) Of the following, which is NOT one of the four main areas of finance?

- A) International finance
- B) Corporate finance
- C) Investments
- D) Working capital management

Answer: D

Explanation: WCM is a primary function of corporate finance.

Diff: 1

Topic: 1.2 Overview of Finance Areas

AACSB: Analytical Thinking

LO: 1.2 Distinguish the four main areas of finance and briefly explain the financial activities that each encompasses.

3) The set of financial activities that support the OPERATIONS of a business is best described by which main area of finance?

- A) Corporate finance
- B) Investments
- C) Financial institutions and markets
- D) International finance

Answer: A

Diff: 1

Topic: 1.2 Overview of Finance Areas

AACSB: Analytical Thinking

LO: 1.2 Distinguish the four main areas of finance and briefly explain the financial activities that each encompasses.

4) _____ is the area of finance concerned with activities such as borrowing funds to finance long-term projects. For example, plant expansions or new product launches.

- A) Working capital management
- B) International finance
- C) Investments
- D) Corporate finance

Answer: D

Diff: 2

Topic: 1.2 Overview of Finance Areas

AACSB: Analytical Thinking

LO: 1.2 Distinguish the four main areas of finance and briefly explain the financial activities that each encompasses.

5) _____ is the area of finance concerned with activities such as repayment of borrowed funds through dividends or interest payments.

- A) Investments
- B) Corporate finance
- C) Capital budgeting
- D) International finance

Answer: B

Diff: 1

Topic: 1.2 Overview of Finance Areas

AACSB: Analytical Thinking

LO: 1.2 Distinguish the four main areas of finance and briefly explain the financial activities that each encompasses.

6) _____ is the area of finance concerned with the activities of buying and selling financial assets such as stocks and bonds.

- A) Investments
- B) Corporate finance
- C) International finance
- D) Financial markets and institutions

Answer: A

Diff: 1

Topic: 1.2 Overview of Finance Areas

AACSB: Analytical Thinking

LO: 1.2 Distinguish the four main areas of finance and briefly explain the financial activities that each encompasses.

Hmwrk Questions: * Taken from "Prepping for Exams" questions at the end of the chapter.

7) Which of the following is NOT typically thought of as an investment activity?

- A) Accurately pricing financial assets
- B) The process of buying and selling financial assets
- C) Repaying borrowed funds
- D) Negotiating the rules and regulations of financial transactions

Answer: C

Diff: 2

Topic: 1.2 Overview of Finance Areas

AACSB: Analytical Thinking

LO: 1.2 Distinguish the four main areas of finance and briefly explain the financial activities that each encompasses.

8) "The organized financial intermediaries and the forums that promote the cycle of money" is a good definition of which of the following main areas of finance?

- A) Corporate finance
- B) Investments
- C) Financial institutions and markets
- D) International finance

Answer: C

Diff: 1

Topic: 1.2 Overview of Finance Areas

AACSB: Analytical Thinking

LO: 1.2 Distinguish the four main areas of finance and briefly explain the financial activities that each encompasses.

9) Financial institutions and markets _____.

- A) are the organized financial intermediaries and the forums that promote the cycle of money
- B) compose the set of financial activities that support the operations of a business
- C) are the activities centered on the purchase and sale of financial assets
- D) are concerned only with the addition of a multinational element to all finance activities

Answer: A

Diff: 1

Topic: 1.2 Overview of Finance Areas

AACSB: Analytical Thinking

LO: 1.2 Distinguish the four main areas of finance and briefly explain the financial activities that each encompasses.

10) Of the following, which is NOT an example of a financial intermediary?

- A) Commercial bank
- B) Insurance company
- C) Investment bank
- D) All of the above are financial intermediaries.

Answer: D

Diff: 2

Topic: 1.2 Overview of Finance Areas

AACSB: Analytical Thinking

LO: 1.2 Distinguish the four main areas of finance and briefly explain the financial activities that each encompasses.

11) Of the following, which is NOT an activity engaged in by a financial intermediary?

- A) Matching borrowers and lenders
- B) Bearing risk
- C) Managing retirement portfolios for large classes of employees
- D) Enforcement of regulations including the application of fines for financial violations

Answer: D

Diff: 2

Topic: 1.2 Overview of Finance Areas

AACSB: Analytical Thinking

LO: 1.2 Distinguish the four main areas of finance and briefly explain the financial activities that each encompasses.

12) "Concern with the multinational elements of financial activities" best describes which of the four main areas of finance?

- A) Investments
- B) International finance
- C) Corporate finance
- D) Financial institutions and markets

Answer: B

Diff: 1

Topic: 1.2 Overview of Finance Areas

AACSB: Analytical Thinking

LO: 1.2 Distinguish the four main areas of finance and briefly explain the financial activities that each encompasses.

- 13) Which of the following is a reason why expertise in international finance is important?
- A) The process of assessing risk among many countries is more difficult than assessing risk for a single country.
 - B) Financial regulatory rules and requirements differ from country to country.
 - C) Changes in economic conditions impact the relative values of currency among countries.
 - D) All of the above are reasons for gaining expertise in international finance.

Answer: D

Diff: 1

Topic: 1.2 Overview of Finance Areas

AACSB: Analytical Thinking

LO: 1.2 Distinguish the four main areas of finance and briefly explain the financial activities that each encompasses.

- 14) Which of the following is NOT an activity of a financial institution or market?

- A) Bringing together buyers and sellers of financial assets
- B) Providing a market for the transaction of financial assets
- C) Providing information to buyers and/or sellers of financial assets
- D) All are activities of financial institutions.

Answer: D

Diff: 1

Topic: 1.2 Overview of Finance Areas

AACSB: Analytical Thinking

LO: 1.2 Distinguish the four main areas of finance and briefly explain the financial activities that each encompasses.

- 15) Financial markets and institutions is the set of activities generally concerned with the buying and selling of financial assets such as stocks and bonds.

Answer: FALSE

Explanation: Investments are the set of activities generally concerned with the buying and selling of financial assets such as stocks and bonds.

Diff: 1

Topic: 1.2 Overview of Finance Areas

AACSB: Analytical Thinking

LO: 1.2 Distinguish the four main areas of finance and briefly explain the financial activities that each encompasses.

- 16) Financial institutions and markets are the organized financial intermediaries and the forums that promote the cycle of money.

Answer: TRUE

Diff: 1

Topic: 1.2 Overview of Finance Areas

AACSB: Analytical Thinking

LO: 1.2 Distinguish the four main areas of finance and briefly explain the financial activities that each encompasses.

17) The four main areas of finance (corporate, investments, financial markets and institutions, and international finance) are mutually exclusive topics.

Answer: FALSE

Explanation: The four main areas of finance (corporate, investments, financial markets and institutions, and international finance) are NOT mutually exclusive topics.

Diff: 1

Topic: 1.2 Overview of Finance Areas

AACSB: Analytical Thinking

LO: 1.2 Distinguish the four main areas of finance and briefly explain the financial activities that each encompasses.

18) Gold and land are considered "real assets" because they are permanent, whereas a commodity such as rice is not a real asset because it is consumable.

Answer: FALSE

Diff: 1

Topic: 1.2 Overview of Finance Areas

AACSB: Analytical Thinking

LO: 1.2 Distinguish the four main areas of finance and briefly explain the financial activities that each encompasses.

19) What are the four main areas of finance? Give a brief definition of each.

Answer: The four main areas of finance are corporate finance, investments, financial institutions and markets, and international finance. Corporate finance deals with the financial operations of the firm and focuses on capital budgeting, capital structure, and working capital management. It is the primary focus of this text. Investments focuses on the activities associated with the buying, selling, pricing, and risk evaluation of financial assets. It is commonly the part of finance most interesting to students. Financial institutions and markets is the study of the firms and organizations that facilitate and regulate the trading of financial assets as well as the markets that make the trading possible. International finance deals with the multinational aspects of the other three areas of finance. Decision-making in the international arena is complicated by language differences, currency differences, taxation issues and differences in local and national laws. An expertise in international finance is a valuable asset to firms that have business dealings that span more than one country.

Diff: 3

Topic: 1.2 Overview of Finance Areas

AACSB: Analytical Thinking

LO: 1.2 Distinguish the four main areas of finance and briefly explain the financial activities that each encompasses.

1.3 Financial Markets

1) _____ are the forums where buyers and sellers of financial assets and commodities meet.

- A) Housing markets
- B) Federal Reserve banks
- C) Financial markets
- D) Automotive shows

Answer: C

Diff: 1

Topic: 1.3 Financial Markets

AACSB: Analytical Thinking

LO: 1.3 Explain the different ways of classifying financial markets.

2) Financial markets can be classified by which of the following?

- A) Type of asset traded
- B) Maturity of the financial asset
- C) Owner of the financial asset
- D) All of the above can be classifications of financial markets.

Answer: D

Diff: 2

Topic: 1.3 Financial Markets

AACSB: Analytical Thinking

LO: 1.3 Explain the different ways of classifying financial markets.

3) Stocks are bought and sold in _____ markets.

- A) equity
- B) debt
- C) derivatives
- D) foreign exchange

Answer: A

Diff: 1

Topic: 1.3 Financial Markets

AACSB: Analytical Thinking

LO: 1.3 Explain the different ways of classifying financial markets.

Hmwrk Questions: * Taken from "Prepping for Exams" questions at the end of the chapter.

4) Bonds are bought and sold in _____ markets.

- A) equity
- B) debt
- C) derivatives
- D) foreign exchange

Answer: B

Diff: 1

Topic: 1.3 Financial Markets

AACSB: Analytical Thinking

LO: 1.3 Explain the different ways of classifying financial markets.

5) Options are bought and sold in _____ markets.

- A) equity
- B) debt
- C) derivatives
- D) foreign exchange

Answer: C

Diff: 1

Topic: 1.3 Financial Markets

AACSB: Analytical Thinking

LO: 1.3 Explain the different ways of classifying financial markets.

6) Currencies are bought and sold in _____ markets.

- A) equity
- B) debt
- C) derivatives
- D) foreign exchange

Answer: D

Diff: 1

Topic: 1.3 Financial Markets

AACSB: Analytical Thinking

LO: 1.3 Explain the different ways of classifying financial markets.

7) Which of the following is NOT an example of an equity market transaction?

- A) Mark sells his shares of Apple stock.
- B) Grant contacts his broker and requests a purchase of IBM bonds.
- C) Pavlina buys shares of a small company stock traded on the NASDAQ.
- D) All of the above are equity market transactions.

Answer: B

Explanation: Mark contacts his broker and requests a purchase of IBM bonds—this is a debt market transaction.

Diff: 2

Topic: 1.3 Financial Markets

AACSB: Analytical Thinking

LO: 1.3 Explain the different ways of classifying financial markets.

8) Financial assets that will mature within a year are bought and sold in the _____ market.

- A) debt
- B) capital
- C) stock
- D) money

Answer: D

Explanation: Debt, capital, and the stock markets are longer term in nature.

Diff: 1

Topic: 1.3 Financial Markets

AACSB: Analytical Thinking

LO: 1.3 Explain the different ways of classifying financial markets.

9) The sale of "new" securities, where the financial asset is being traded for the very first time, is said to take place in the _____ market.

- A) primary
- B) money
- C) secondary
- D) capital

Answer: A

Diff: 1

Topic: 1.3 Financial Markets

AACSB: Analytical Thinking

LO: 1.3 Explain the different ways of classifying financial markets.

10) The sale of "used" securities, where the financial asset is being traded from one individual to another and the proceeds do not go to the original issuer of the security, is said to take place in the _____ market.

- A) primary
- B) money
- C) secondary
- D) capital

Answer: C

Diff: 1

Topic: 1.3 Financial Markets

AACSB: Analytical Thinking

LO: 1.3 Explain the different ways of classifying financial markets.

11) Sale of new common stock in the primary market is regulated by the _____, and a sale of used common on the secondary market is regulated by the _____.

- A) SEC; FDIC
- B) SEC; SEC
- C) FDIC; Federal Reserve
- D) Federal Reserve; SEC

Answer: B

Diff: 1

Topic: 1.3 Financial Markets

AACSB: Analytical Thinking

LO: 1.3 Explain the different ways of classifying financial markets.

12) Which of the following is TRUE of a dealer market?

- A) The dealer buys and sells assets out of his own inventory.
- B) The dealer acts as a broker, lining up the owners of assets with the purchasers of assets.
- C) The dealer acts as an auctioneer of securities and takes a percentage of the sale as compensation.
- D) None of the above is true of a dealer market.

Answer: A

Explanation: Broker markets are characterized by brokers bringing buyers and sellers together with the brokers earning a commission. Auction markets involve the purchase and sale of securities not currently held in the dealer's portfolio.

Diff: 1

Topic: 1.3 Financial Markets

AACSB: Analytical Thinking

LO: 1.3 Explain the different ways of classifying financial markets.

13) Which of the following is NOT a characteristic of a dealer market?

- A) Dealers make a profit on the spread between what they pay for financial assets and what they sell them for.
- B) Securities are auctioned off to the highest bidder.
- C) Dealers buy and sell from their own portfolio.
- D) All of the above are characteristics of the dealer market.

Answer: B

Explanation: Dealers buy and sell to customers; they do not auction to the highest bidder.

Diff: 2

Topic: 1.3 Financial Markets

AACSB: Analytical Thinking

LO: 1.3 Explain the different ways of classifying financial markets.

14) Financial markets are the forums where buyers and sellers of financial assets come together.

Answer: TRUE

Diff: 1

Topic: 1.3 Financial Markets

AACSB: Analytical Thinking

LO: 1.3 Explain the different ways of classifying financial markets.

15) If a company offers stock for sale for the first time and the proceeds go to the company, then this is a sale in the primary market.

Answer: TRUE

Diff: 1

Topic: 1.3 Financial Markets

AACSB: Analytical Thinking

LO: 1.3 Explain the different ways of classifying financial markets.

16) Auction markets consist of dealers buying and selling from their own portfolios.

Answer: FALSE

Explanation: DEALER markets consist of dealers buying and selling from their own portfolios.

Diff: 1

Topic: 1.3 Financial Markets

AACSB: Analytical Thinking

LO: 1.3 Explain the different ways of classifying financial markets.

17) Equity markets are where bonds are bought and sold.

Answer: FALSE

Explanation: Equity markets are where STOCKS are bought and sold.

Diff: 1

Topic: 1.3 Financial Markets

AACSB: Analytical Thinking

LO: 1.3 Explain the different ways of classifying financial markets.

18) Give an example of how a corporate manager might use the capital markets in the operation of his/her corporation. Be sure to define capital market in your answer.

Answer: There are several acceptable examples a student can list for this question, for example: The capital market is the market for longer-term financial assets such as stocks and bonds. The financial manager must finance the purchase of long-term assets and will often enter the capital market to raise sufficient funds by issuing new stock or bonds.

Diff: 3

Topic: 1.3 Financial Markets

AACSB: Analytical Thinking

LO: 1.3 Explain the different ways of classifying financial markets.

19) Define "money market" and "capital market" and give an example of a security that trades in each.

Answer: The money market is the term for the market for short-term, low-risk, highly liquid, homogeneous securities such as Treasury bills, negotiable certificates of deposit or commercial paper. The capital market consists of transactions in longer-term financial assets such as stocks and bonds.

Diff: 3

Topic: 1.3 Financial Markets

AACSB: Analytical Thinking

LO: 1.3 Explain the different ways of classifying financial markets.

1.4 The Finance Manager and Financial Management

1) _____ is the typical title of the corporate executive charged with determining the best repayment structure for borrowed funds to ensure timely repayment and sufficient cash for daily operations.

- A) Chief Executive Officer (CEO)
- B) Chief Financial Officer (CFO)
- C) Chairman
- D) Chief Operating Officer (COO)

Answer: B

Diff: 1

Topic: 1.4 The Finance Manager and Financial Management

AACSB: Analytical Thinking

LO: 1.4 Discuss the three main categories of financial management.

2) _____ is NOT a main category of financial management.

- A) Capital budgeting
- B) Capital structure
- C) Accounts payable management
- D) Working capital management

Answer: C

Diff: 2

Topic: 1.4 The Finance Manager and Financial Management

AACSB: Analytical Thinking

LO: 1.4 Discuss the three main categories of financial management.

3) The process of planning, evaluating, selecting, and managing the financing of long-term operating projects of the company is termed _____.

- A) capital budgeting
- B) capital structure
- C) accounts receivable management
- D) working capital management

Answer: A

Diff: 1

Topic: 1.4 The Finance Manager and Financial Management

AACSB: Analytical Thinking

LO: 1.4 Discuss the three main categories of financial management.

4) _____ addresses the question of what business a firm should be in over the long run.

- A) Capital budgeting
- B) Capital structure
- C) Working capital management
- D) Accounts receivable management

Answer: A

Diff: 1

Topic: 1.4 The Finance Manager and Financial Management

AACSB: Analytical Thinking

LO: 1.4 Discuss the three main categories of financial management.

5) The means by which a company is financed refers to the firm's _____.

- A) capital budgeting
- B) capital structure
- C) accounts receivable management
- D) working capital management

Answer: B

Diff: 2

Topic: 1.4 The Finance Manager and Financial Management

AACSB: Analytical Thinking

LO: 1.4 Discuss the three main categories of financial management.

Hmwrk Questions: * Taken from "Prepping for Exams" questions at the end of the chapter.

6) _____ addresses the question of where a firm raises money to finance its business activities.

- A) Capital budgeting
- B) Capital structure
- C) Working capital management
- D) Accounts receivable management

Answer: B

Diff: 1

Topic: 1.4 The Finance Manager and Financial Management

AACSB: Analytical Thinking

LO: 1.4 Discuss the three main categories of financial management.

7) Managing the firm's short-term financing activities is known as _____.

- A) capital budgeting
- B) capital structure
- C) accounts receivable management
- D) working capital management

Answer: D

Diff: 1

Topic: 1.4 The Finance Manager and Financial Management

AACSB: Analytical Thinking

LO: 1.4 Discuss the three main categories of financial management.

- 8) Which of the following is NOT a capital structure question?
- A) A delivery company chooses to buy more trucks.
 - B) A manufacturing firm chooses to take the discount for paying accounts payable early.
 - C) A retail firm chooses to use a new supplier.
 - D) None of the above are capital structure questions.

Answer: D

Diff: 2

Topic: 1.4 The Finance Manager and Financial Management

AACSB: Analytical Thinking

LO: 1.4 Discuss the three main categories of financial management.

- 9) Capital budgeting is best defined by which of the following questions?
- A) How will we fund our product and service choices?
 - B) What business are we in?
 - C) How will we manage our day-to-day financial needs?
 - D) What is our firm's best choice for corporate governance?

Answer: B

Diff: 1

Topic: 1.4 The Finance Manager and Financial Management

AACSB: Analytical Thinking

LO: 1.4 Discuss the three main categories of financial management.

- 10) Capital structure is best defined by which of the following questions?
- A) How will we finance our product and service choices?
 - B) What business are we in?
 - C) How will we manage our day-to-day financial needs?
 - D) What is our firm's best choice for corporate governance?

Answer: A

Diff: 1

Topic: 1.4 The Finance Manager and Financial Management

AACSB: Analytical Thinking

LO: 1.4 Discuss the three main categories of financial management.

- 11) Which of the following is NOT an activity of working capital management?
- A) Establishing the firm's receivable policies
 - B) Establishing the firm's payment policies
 - C) Choosing the appropriate level of inventory
 - D) Choosing the appropriate mix of long-term debt and equity

Answer: D

Explanation: This is a capital structure issue.

Diff: 1

Topic: 1.4 The Finance Manager and Financial Management

AACSB: Analytical Thinking

LO: 1.4 Discuss the three main categories of financial management.

12) Which of the following is NOT a capital budgeting question?

- A) The choice of which long-term assets to purchase to meet the firm's business goals
- B) The choice of what type of business a firm wants to operate
- C) The proper mix of stocks and bonds to issue for financing assets
- D) None of the above are capital budgeting questions.

Answer: C

Explanation: The proper mix of stocks and bonds to issue for financing assets is a capital structure question.

Diff: 2

Topic: 1.4 The Finance Manager and Financial Management

AACSB: Analytical Thinking

LO: 1.4 Discuss the three main categories of financial management.

Hmwrk Questions: * Taken from "Prepping for Exams" questions at the end of the chapter.

13) _____ addresses the question of how to handle our day-to-day business needs.

- A) Capital budgeting
- B) Capital structure
- C) Working capital management
- D) Accounts receivable management

Answer: C

Diff: 1

Topic: 1.4 The Finance Manager and Financial Management

AACSB: Analytical Thinking

LO: 1.4 Discuss the three main categories of financial management.

14) Capital budgeting is the means by which a company is financed.

Answer: FALSE

Explanation: Capital STRUCTURE is the means by which a company is financed.

Diff: 1

Topic: 1.4 The Finance Manager and Financial Management

AACSB: Analytical Thinking

LO: 1.4 Discuss the three main categories of financial management.

15) Capital structure is the process of planning, evaluating, selecting, and managing the long-term operating projects of the company.

Answer: FALSE

Explanation: Capital BUDGETING is the process of planning, evaluating, selecting, and managing the long-term operating projects of the company.

Diff: 1

Topic: 1.4 The Finance Manager and Financial Management

AACSB: Analytical Thinking

LO: 1.4 Discuss the three main categories of financial management.

16) Working capital management is the day-to-day management of the operating needs of the company via current assets and current liabilities.

Answer: TRUE

Diff: 1

Topic: 1.4 The Finance Manager and Financial Management

AACSB: Analytical Thinking

LO: 1.4 Discuss the three main categories of financial management.

17) Provide definitions for capital budgeting, capital structure, and working capital management. Give an example of a capital budgeting type decision and then do the same for capital structure and working capital management.

Answer: Capital budgeting is the process of choosing which long-term assets a firm should purchase to best meet the goal of maximizing shareholders' wealth. A firm might need to choose among several processes to produce a product for sale. The manager needs to choose the process that will be most valuable for the company.

Capital structure is choosing the optimal mix of long-term debt and equity to minimize the cost of capital. Here, a manager looking to finance a capital budgeting project might have to choose between a mixture of internal financing and external debt and equity.

Working capital management is the day-to-day management of short-term assets and liabilities, for example, what level of inventory to carry or what credit terms to extend to potential customers.

This question is very open ended in that there are many different examples a student can provide for each of the three categories.

Diff: 3

Topic: 1.4 The Finance Manager and Financial Management

AACSB: Analytical Thinking

LO: 1.4 Discuss the three main categories of financial management.

1.5 Objective of the Finance Manager

1) When there are conflicts among managerial goals in U.S. markets, the most important priority is to _____.

- A) increase the current market value of equity
- B) keep all of the company's customers happy
- C) foster good relationships with the community
- D) maintain a safe and happy work place

Answer: A

Explanation: Anglo-American markets emphasize that managers should maximize shareholders' wealth.

Diff: 2

Topic: 1.5 Objective of the Finance Manager

AACSB: Analytical Thinking

LO: 1.5 Identify the main objective of the finance manager and how he or she might meet that objective.

2) Maximizing the market value of firm equity and which of the following are mutually exclusive?

- A) Maximizing market value and a safe and happy work place are mutually exclusive.
- B) Maximizing market value and good relationships with the local community are mutually exclusive.
- C) Maximizing market value and customer satisfaction are mutually exclusive.
- D) None of the above is mutually exclusive with maximizing the value of market equity.

Answer: D

Diff: 1

Topic: 1.5 Objective of the Finance Manager

AACSB: Analytical Thinking

LO: 1.5 Identify the main objective of the finance manager and how he or she might meet that objective.

3) A firm's stock price most closely reflects which of the following?

- A) Current interest rates
- B) Expected risk, magnitude, and timing of future cash flows of the firm
- C) The amount and maturity of debt held by the firm
- D) Current federal tax codes

Answer: B

Diff: 1

Topic: 1.5 Objective of the Finance Manager

AACSB: Analytical Thinking

LO: 1.5 Identify the main objective of the finance manager and how he or she might meet that objective.

Hmwrk Questions: * Taken from "Prepping for Exams" questions at the end of the chapter.

4) Which of the following can lead to increased expected cash flow over time to the firm?

- A) Open and collaborative relations with the community
- B) Qualified and motivated employees
- C) Greater customer satisfaction
- D) All of the above

Answer: D

Diff: 2

Topic: 1.5 Objective of the Finance Manager

AACSB: Analytical Thinking

LO: 1.5 Identify the main objective of the finance manager and how he or she might meet that objective.

5) According to the textbook, a good manager treats shareholders, customers, creditors, and employees equally.

Answer: FALSE

Explanation: According to the author a good manager treats shareholders above all others.

Diff: 1

Topic: 1.5 Objective of the Finance Manager

AACSB: Analytical Thinking

LO: 1.5 Identify the main objective of the finance manager and how he or she might meet that objective.

6) The primary objective of the finance manager is to maximize the market value of equity of the company.

Answer: TRUE

Diff: 1

Topic: 1.5 Objective of the Finance Manager

AACSB: Analytical Thinking

LO: 1.5 Identify the main objective of the finance manager and how he or she might meet that objective.

7) Stock prices reflect the expected size, risk, and timing of future cash flow of the company.

Answer: TRUE

Diff: 1

Topic: 1.5 Objective of the Finance Manager

AACSB: Analytical Thinking

LO: 1.5 Identify the main objective of the finance manager and how he or she might meet that objective.

8) What is the primary goal of a financial manager? When you see firms like Enron imploding from the behavior of executive management, how can you justify your definition?

Answer: The primary goal of a financial manager is to maximize shareholders' wealth. In some ways, Enron is the exception that proves the rule. When management strays from its primary objective of maximizing shareholder wealth and resorts to deception in an effort to satisfy greed or ego, then that is a newsworthy event.

Diff: 3

Topic: 1.5 Objective of the Finance Manager

AACSB: Analytical Thinking

LO: 1.5 Identify the main objective of the finance manager and how he or she might meet that objective.

9) The author claims that the goals of keeping customers happy, employees happy, and shareholders happy are not mutually exclusive, even though the first two goals identified may be costly and come at the expense of shareholders. How can this be?

Answer: Simply put, the marginal benefits of providing a pleasing and productive work environment for qualified workers, keeping customers satisfied, and meeting customer expectations is greater than the marginal cost. The result of having unhappy workers and displeased customers could well cost the company in terms of shareholder value.

Diff: 3

Topic: 1.5 Objective of the Finance Manager

AACSB: Analytical Thinking

LO: 1.5 Identify the main objective of the finance manager and how he or she might meet that objective.

10) How does maximizing the long-run expected cash flows to the firm translate into maximizing shareholders' wealth?

Answer: Shareholders invest in firms to realize a return. The returns from investing in a firm result from cash flows such as dividends or capital gains on the resale of shares of stock. Increasing the amount of money a shareholder can expect to receive increases the value of the shares of stock, thus increasing shareholders' wealth through a larger stream of cash flows and a larger expected capital gain.

Diff: 3

Topic: 1.5 Objective of the Finance Manager

AACSB: Analytical Thinking

LO: 1.5 Identify the main objective of the finance manager and how he or she might meet that objective.

1.6 Internal and External Players

1) Of the following activities, which is MOST likely to be an interaction between the financial manager and the information systems manager?

- A) Developing a system to bill customers, pay suppliers, and track inventory
- B) Costing of products
- C) Setting credit policies
- D) Determining the appropriate pricing of products

Answer: A

Explanation: Costing of products is done in conjunction with the manufacturing manager. Determining the appropriate price for products and setting credit policies is a result of collaboration with the marketing department. IT works on billing, paying, and tracking.

Diff: 1

Topic: 1.6 Internal and External Players

AACSB: Analytical Thinking

LO: 1.6 Explain how the finance manager interacts with both internal and external players.

2) Of the following activities, which is NOT likely to be an interaction between the financial manager and the marketing manager?

- A) Costing of products
- B) Setting credit policies
- C) Determining that there are a sufficient number of trained workers to develop the product
- D) Setting advertising budgets

Answer: C

Diff: 1

Topic: 1.6 Internal and External Players

AACSB: Analytical Thinking

LO: 1.6 Explain how the finance manager interacts with both internal and external players.

Hmwrk Questions: * Taken from "Prepping for Exams" questions at the end of the chapter.

3) Of the following activities, which is MOST likely to be an interaction between the financial manager and the manufacturing manager?

- A) Setting of credit policies
- B) Developing a system to bill customers, pay suppliers, and track inventory
- C) Budgeting the timing and amount of cash needed for the production schedule
- D) Determining that there are a sufficient number of trained workers to develop the product

Answer: C

Diff: 1

Topic: 1.6 Internal and External Players

AACSB: Analytical Thinking

LO: 1.6 Explain how the finance manager interacts with both internal and external players.

4) Of the following, which group would be considered INTERNAL PLAYERS of the firm?

- A) The finance manager
- B) The shop foreman
- C) The human resources manager
- D) All of the above

Answer: D

Diff: 1

Topic: 1.6 Internal and External Players

AACSB: Analytical Thinking

LO: 1.6 Explain how the finance manager interacts with both internal and external players.

5) Of the following, which group would be considered EXTERNAL PLAYERS of the firm?

- A) The loan officer at the firm's commercial bank
- B) The shop foreman
- C) The human resources manager
- D) The head of payroll and accounts payable

Answer: A

Diff: 1

Topic: 1.6 Internal and External Players

AACSB: Analytical Thinking

LO: 1.6 Explain how the finance manager interacts with both internal and external players.

6) On a basic organizational chart for a company, the Finance Manager would be on the third line, where the first line is the CEO and the second line contains titles such as Marketing Manager and Human Resources Manager.

Answer: FALSE

Explanation: The Finance Manager would be on the second line with the other managers.

Diff: 1

Topic: 1.6 Internal and External Players

AACSB: Analytical Thinking

LO: 1.6 Explain how the finance manager interacts with both internal and external players.

7) The Finance Manager works with the Marketing Manager to set credit policies for targeted customers.

Answer: TRUE

Diff: 1

Topic: 1.6 Internal and External Players

AACSB: Analytical Thinking

LO: 1.6 Explain how the finance manager interacts with both internal and external players.

8) The Finance Manager works with the Marketing Manager to set annual sales targets.

Answer: TRUE

Diff: 1

Topic: 1.6 Internal and External Players

AACSB: Analytical Thinking

LO: 1.6 Explain how the finance manager interacts with both internal and external players.

9) What does the standard organizational chart show? In your answer, point out the functions needed for a successful business.

Answer: The standard organizational chart shows a bottom-up reporting relationship, but the reality is that the functions of marketing, finance, manufacturing, information systems, and human resources are all interconnected in a successful business.

Diff: 2

Topic: 1.6 Internal and External Players

AACSB: Analytical Thinking

LO: 1.6 Explain how the finance manager interacts with both internal and external players.

1.7 The Legal Forms of Business

1) A _____ is a business that is owned entirely by an individual.

A) sole proprietorship

B) partnership

C) subchapter S corporation

D) corporation

Answer: A

Diff: 1

Topic: 1.7 The Legal Forms of Business

AACSB: Analytical Thinking

LO: 1.7 Delineate the three main legal categories of business organizations and their respective advantages and disadvantages.

2) Which of the following is NOT an ADVANTAGE of a sole proprietorship?

A) The owner receiving all the after-tax profit

B) Limited liability

C) Quick decision making

D) It is the simplest and least complicated form of business organization.

Answer: B

Explanation: Sole proprietorships have UNLIMITED liability.

Diff: 1

Topic: 1.7 The Legal Forms of Business

AACSB: Analytical Thinking

LO: 1.7 Delineate the three main legal categories of business organizations and their respective advantages and disadvantages.

Hmwrk Questions: * Taken from "Prepping for Exams" questions at the end of the chapter.

3) Which of the following is an ADVANTAGE of a sole proprietorship?

- A) The owner's unlimited liability
- B) The lack of continuity upon death of the owner
- C) The ease of start up
- D) The ability to raise capital

Answer: C

Explanation: The owner's unlimited liability and the lack of continuity upon death of the owner are disadvantages. The ability to raise capital is an advantage of a corporation.

Diff: 1

Topic: 1.7 The Legal Forms of Business

AACSB: Analytical Thinking

LO: 1.7 Delineate the three main legal categories of business organizations and their respective advantages and disadvantages.

4) A _____ has limited liability, is a legal entity, and has the greatest potential to raise capital.

- A) sole proprietorship
- B) general partnership
- C) limited partnership
- D) corporation

Answer: D

Diff: 1

Topic: 1.7 The Legal Forms of Business

AACSB: Analytical Thinking

LO: 1.7 Delineate the three main legal categories of business organizations and their respective advantages and disadvantages.

5) A _____ is a business that is jointly owned by two or more individuals.

- A) partnership
- B) sole proprietorship
- C) subchapter S corporation
- D) corporation

Answer: A

Diff: 1

Topic: 1.7 The Legal Forms of Business

AACSB: Analytical Thinking

LO: 1.7 Delineate the three main legal categories of business organizations and their respective advantages and disadvantages.

6) Which of the following is NOT a DISADVANTAGE of a partnership?

- A) Unlimited liability to at least some of the owners
- B) The limited life of the business
- C) The potential difficulty in transferring ownership
- D) All are disadvantages of a partnership.

Answer: D

Diff: 1

Topic: 1.7 The Legal Forms of Business

AACSB: Analytical Thinking

LO: 1.7 Delineate the three main legal categories of business organizations and their respective advantages and disadvantages.

7) Which of the following is NOT an ADVANTAGE of a partnership?

- A) A potential increase in available capital over a sole proprietorship
- B) The commingling with the general partner's personal assets
- C) The potential for more talent and skills in the business
- D) All are advantages of a partnership.

Answer: B

Explanation: This is considered a disadvantage of a partnership.

Diff: 1

Topic: 1.7 The Legal Forms of Business

AACSB: Analytical Thinking

LO: 1.7 Delineate the three main legal categories of business organizations and their respective advantages and disadvantages.

8) Which of the following is NOT true of a sole proprietorship?

- A) Sole proprietorships are the least regulated form of business.
- B) Sole proprietorships are the easiest form of business to establish.
- C) Sole proprietorships are the most popular form of business organization (more sole proprietorships than other forms of business).
- D) Sole proprietors have limited liability.

Answer: D

Diff: 1

Topic: 1.7 The Legal Forms of Business

AACSB: Analytical Thinking

LO: 1.7 Delineate the three main legal categories of business organizations and their respective advantages and disadvantages.

9) _____ is a major disadvantage of the corporate form of business.

- A) Double taxation
- B) Unlimited liability
- C) Lack of ability to raise capital
- D) Transfer of ownership

Answer: A

Diff: 1

Topic: 1.7 The Legal Forms of Business

AACSB: Analytical Thinking

LO: 1.7 Delineate the three main legal categories of business organizations and their respective advantages and disadvantages.

10) The form of business organization in the United States that has the greatest amount of capital is _____.

- A) the sole proprietorship
- B) the partnership
- C) the subchapter S corporation
- D) the publicly traded corporation

Answer: D

Diff: 1

Topic: 1.7 The Legal Forms of Business

AACSB: Analytical Thinking

LO: 1.7 Delineate the three main legal categories of business organizations and their respective advantages and disadvantages.

11) Double taxation refers to which of the following scenarios?

- A) Both bondholders AND shareholders of a corporation must pay taxes on proceeds received.
- B) The corporation pays taxes on its earnings, and creditors pay taxes on interest received.
- C) The corporation pays taxes on its earnings, and shareholders pay taxes on dividends received.
- D) All of the above.

Answer: C

Diff: 1

Topic: 1.7 The Legal Forms of Business

AACSB: Analytical Thinking

LO: 1.7 Delineate the three main legal categories of business organizations and their respective advantages and disadvantages.

Hmwrk Questions: * Taken from "Prepping for Exams" questions at the end of the chapter.

12) In practice, _____.

- A) the structure of the corporation separates owners from managers
- B) the corporate board selects the main corporate officers
- C) the corporate board is elected by the shareholders
- D) all of the above are true

Answer: D

Diff: 1

Topic: 1.7 The Legal Forms of Business

AACSB: Analytical Thinking

LO: 1.7 Delineate the three main legal categories of business organizations and their respective advantages and disadvantages.

13) Limited liability is an advantage of the sole proprietorship.

Answer: FALSE

Explanation: UNLIMITED liability is a DISADVANTAGE of the sole proprietorship.

Diff: 1

Topic: 1.7 The Legal Forms of Business

AACSB: Analytical Thinking

LO: 1.7 Delineate the three main legal categories of business organizations and their respective advantages and disadvantages.

14) The ability to raise capital is an advantage of the corporate form of business organization.

Answer: TRUE

Diff: 1

Topic: 1.7 The Legal Forms of Business

AACSB: Analytical Thinking

LO: 1.7 Delineate the three main legal categories of business organizations and their respective advantages and disadvantages.

15) The sum of all the market value of publicly traded corporations in the United States exceeds the combined value of partnerships and sole proprietorships.

Answer: TRUE

Diff: 1

Topic: 1.7 The Legal Forms of Business

AACSB: Analytical Thinking

LO: 1.7 Delineate the three main legal categories of business organizations and their respective advantages and disadvantages.

16) Why are sole proprietorships so much more popular in terms of the number of firms than corporations? (This answer should identify the significant advantages to the sole proprietorship versus those of other forms of business organization.)

Answer: Sole proprietorships are popular because they are easy to start up, with fewer regulations and reporting requirements than other forms of business organization. Sole proprietorships are also popular because they give individuals the opportunity to be their own boss, to make all of the decisions, and to realize 100% of the after-tax proceeds of the business.

Diff: 3

Topic: 1.7 The Legal Forms of Business

AACSB: Analytical Thinking

LO: 1.7 Delineate the three main legal categories of business organizations and their respective advantages and disadvantages.

17) Define the term "limited liability" and state why you think it is an important feature of the corporate form of organization.

Answer: From a corporate standpoint, limited liability results from the corporation being defined as a legal entity with its own assets and liabilities. Limited liability thus occurs because the shareholders are responsible for no more than their investment in the corporation. Should the firm acquire greater debt than assets and declare bankruptcy, the shareholders do not have personal assets at risk for creditors to acquire.

Diff: 3

Topic: 1.7 The Legal Forms of Business

AACSB: Analytical Thinking

LO: 1.7 Delineate the three main legal categories of business organizations and their respective advantages and disadvantages.

1.8 The Financial Management Setting: The Agency Model

1) _____ is the name given to the processes surrounding recognition of the principal-agent problem and ways to align agents with the interests of the principals.

- A) Principal theory
- B) Interested party theory
- C) Agency theory
- D) Compensation process theory

Answer: C

Diff: 1

Topic: 1.8 The Financial Management Setting: The Agency Model

AACSB: Ethical Understanding and Reasoning

LO: 1.8 Illustrate agency theory and the principal-agent problem.

2) In agency theory, the owners of the business are referred to as _____, and the managers are referred to as _____.

- A) bondholders; principals
- B) stockholders; bondholders
- C) agents; principals
- D) principals; agents

Answer: D

Diff: 1

Topic: 1.8 The Financial Management Setting: The Agency Model

AACSB: Ethical Understanding and Reasoning

LO: 1.8 Illustrate agency theory and the principal-agent problem.

Hmwrk Questions: * Taken from "Prepping for Exams" questions at the end of the chapter.

3) Which of the following is NOT an example of an agency cost?

- A) Paying an accounting firm to audit your financial statements
- B) Paying an insurance company to assure that building codes have been met for new construction
- C) Paying a landscaping firm to maintain your firm's grounds
- D) The cost of designing contracts that satisfy creditors that their concerns will be met

Answer: C

Diff: 2

Topic: 1.8 The Financial Management Setting: The Agency Model

AACSB: Ethical Understanding and Reasoning

LO: 1.8 Illustrate agency theory and the principal-agent problem.

4) The problem of motivating one party to act in the best interest of another party is known as the _____.

- A) leadership directive
- B) management priority
- C) principal-agent problem
- D) sigma six structure

Answer: C

Diff: 1

Topic: 1.8 The Financial Management Setting: The Agency Model

AACSB: Analytical Thinking

LO: 1.8 Illustrate agency theory and the principal-agent problem.

5) Which of the following compensation packages is likely to work best for executive managers?

- A) Piecemeal
- B) Stock options
- C) Quarterly bonuses
- D) Commission

Answer: B

Diff: 2

Topic: 1.8 The Financial Management Setting: The Agency Model

AACSB: Analytical Thinking

LO: 1.8 Illustrate agency theory and the principal-agent problem.

6) According to the annual *Fortune Magazine* list of top paid executives in America, what percentage of annual compensation for the very highest paid managers comes in the form of performance bonuses or stock options?

- A) Less than 10%
- B) Between 10% and 40%
- C) Between 50% and 60%
- D) Nearly 70%

Answer: D

Diff: 2

Topic: 1.8 The Financial Management Setting: The Agency Model

AACSB: Ethical Understanding and Reasoning

LO: 1.8 Illustrate agency theory and the principal-agent problem.

7) In the agency model, the owners of corporations are the agents and the stockholders are the principals.

Answer: FALSE

Explanation: In the agency model, the owners of corporations are the PRINCIPALS and the AGENTS are the MANAGERS.

Diff: 1

Topic: 1.8 The Financial Management Setting: The Agency Model

AACSB: Ethical Understanding and Reasoning

LO: 1.8 Illustrate agency theory and the principal-agent problem.

8) The principal-agent problem is most severe for the sole proprietorship because there are fewer owners who can monitor the relationship.

Answer: FALSE

Diff: 1

Topic: 1.8 The Financial Management Setting: The Agency Model

AACSB: Ethical Understanding and Reasoning

LO: 1.8 Illustrate agency theory and the principal-agent problem.

9) The problem of motivating one party to act in the best interest of another party is known as the principal-agent problem.

Answer: TRUE

Diff: 1

Topic: 1.8 The Financial Management Setting: The Agency Model

AACSB: Ethical Understanding and Reasoning

LO: 1.8 Illustrate agency theory and the principal-agent problem.

10) Describe the principal-agent relationship. In your answer, give an example of how a principal-agent problem arises in the corporate world. Can such a problem become costly? Explain.

Answer: The principal-agent relationship is a relationship between one party (principal) who hires another party (agent) to perform a task. Problems with a principal-agent relationship arise when the agent has interests that conflict with those of the principal. Any problem becomes costly when the principal cannot always know for sure if an agent is behaving in a trustworthy manner. If a principal fears the agent is not properly fulfilling the assigned duties, then the principal has to decide what costs should be undertaken to monitor the agent. Costs might include hiring another party to watch the agent or offering the agent pay based on certain performance criteria. A common performance cost for large companies is the giving of stock options to employees so that their wealth is tied to how well they do their job.

Diff: 3

Topic: 1.8 The Financial Management Setting: The Agency Model

AACSB: Ethical Understanding and Reasoning

LO: 1.8 Illustrate agency theory and the principal-agent problem.

1.9 Corporate Governance and Business Ethics

1) _____ is the area of business that deals with how a company conducts its business and implements controls to ensure proper procedures and ethical behavior.

- A) Leadership
- B) Agency Relationship
- C) Corporate Governance
- D) Capital Budgeting

Answer: C

Diff: 1

Topic: 1.9 Corporate Governance and Business Ethics

AACSB: Ethical Understanding and Reasoning

LO: 1.9 Define issues in corporate governance and business ethics.

2) Of the following, which is the most recent example of legislation passed by the federal government to deal with a major economic or highly visible corporate event?

- A) The Federal Deposit Insurance Corporation Improvement Act
- B) The Securities and Exchange Act
- C) The Sarbanes-Oxley Act
- D) The Securities Act of 1933

Answer: C

Diff: 1

Topic: 1.9 Corporate Governance and Business Ethics

AACSB: Ethical Understanding and Reasoning

LO: 1.9 Define issues in corporate governance and business ethics.

3) Which of the following is NOT a feature of the Sarbanes-Oxley Act?

- A) The company and auditors must annually assess the effectiveness of financial controls.
- B) The company must maintain effective internal financial controls.
- C) The CEO and CFO must attest to the fairness of the financial reports.
- D) Each of the above are features of the Sarbanes-Oxley Act.

Answer: D

Diff: 1

Topic: 1.9 Corporate Governance and Business Ethics

AACSB: Ethical Understanding and Reasoning

LO: 1.9 Define issues in corporate governance and business ethics.

4) Which of the following is NOT a generally accepted way to remove ineffective management of a publicly traded firm?

- A) The Board of Directors can vote to remove management.
- B) The shareholders can vote out directors who won't discipline managers.
- C) Outside management teams can "take over" the company.
- D) Each of the above are recognized methods for the removal of ineffective management.

Answer: D

Diff: 2

Topic: 1.9 Corporate Governance and Business Ethics

AACSB: Analytical Thinking

LO: 1.9 Define issues in corporate governance and business ethics.

5) The _____ removed the last segments of Federal law that separated investment banking activities from commercial banking activities.

- A) Gramm-Leach-Bliley Act
- B) Sarbanes-Oxley Act
- C) Federal Deposit Insurance Corporation Improvement Act
- D) Glass-Steagall Act

Answer: A

Diff: 2

Topic: 1.9 Corporate Governance and Business Ethics

AACSB: Analytical Thinking

LO: 1.9 Define issues in corporate governance and business ethics.

6) The Sarbanes-Oxley Act (SOX) establishes requirements for documentation and procedures within a company, especially as they relate to financial reporting.

Answer: TRUE

Diff: 1

Topic: 1.9 Corporate Governance and Business Ethics

AACSB: Analytical Thinking

LO: 1.9 Define issues in corporate governance and business ethics.

7) The Sarbanes-Oxley Act (SOX) established the Securities and Exchange Commission (SEC).

Answer: FALSE

Diff: 1

Topic: 1.9 Corporate Governance and Business Ethics

AACSB: Analytical Thinking

LO: 1.9 Define issues in corporate governance and business ethics.

8) What three major requirements resulted from the Sarbanes-Oxley Act?

Answer:

- (1) The CEO and CFO attest to the fairness of the financial reports.
- (2) The company maintains an effective internal control structure around financial reporting.
- (3) The company and auditors assess the effectiveness of the controls over the most recent fiscal year.

Diff: 2

Topic: 1.9 Corporate Governance and Business Ethics

AACSB: Analytical Thinking

LO: 1.9 Define issues in corporate governance and business ethics.

1.10 Why Study Finance?

1) Your finance text and this course can help you hone your problem-solving skills in part by _____.

- A) learning that all factors in a decision are relevant and of equal importance
- B) helping weigh the importance of various decision-making factors
- C) assigning points to quantitative measures and grades to qualitative measures
- D) helping to maximize factors of lesser importance to the decision-making process

Answer: B

Diff: 1

Topic: 1.10 Why Study Finance?

AACSB: Ethical Understanding and Reasoning

LO: 1.10 Explain why studying finance improves your employability.

2) Perhaps the most important thing this course will help you develop is _____.

- A) your skill set as a contract negotiator
- B) your ability to manipulate a calculator
- C) your set of analytical skills
- D) your ability to distinguish among different types of financial statements

Answer: C

Diff: 1

Topic: 1.10 Why Study Finance?

AACSB: Ethical Understanding and Reasoning

LO: 1.10 Explain why studying finance improves your employability.

3) This course may harm your chances of employability because of an unreasonable reliance of technology for problem solving.

Answer: FALSE

Explanation: Enhancing your knowledge of technology will only make you more employable not less.

Diff: 1

Topic: 1.10 Why Study Finance?

AACSB: Ethical Understanding and Reasoning

LO: 1.10 Explain why studying finance improves your employability.

Chapter 15

Raising Capital

LEARNING OBJECTIVES

1. Describe the life cycle of a business.
2. Understand the different sources of capital available to a start-up business and to a growing business.
3. Explain the funding available to a stable or mature business.
4. Explain how companies sell bonds in a capital market.
5. Explain how companies sell stocks in a capital market.
6. Examine some special forms of financing: commercial paper and banker's acceptance.
7. Describe the options and regulations for closing a business.

IN A NUTSHELL...

This chapter is about how entrepreneurs and firms go about raising funds for growth and development. As a firm progresses through the various phases of its business cycle, its needs, focus, and conditions change requiring it to use different sources of capital. Firms typically sell bonds and stock to raise capital, and so the author explains the process followed by issuing companies. Besides bonds and stock, firms also borrow short-term funds by issuing commercial paper and bankers' acceptances. The chapter closes with a discussion of the options and regulations that come into play when a firm decides to cease operations and close permanently.

LECTURE OUTLINE

15.1 The Business Life Cycle

A firm typically goes through five stages in its life cycle: start-up, growth, maturity, decline, and closing.



FIGURE 15.1 The business life cycle.

Each stage presents unique problems, opportunities, and funding requirements.

Business life cycles vary considerably. Some firms go through the early stages fairly rapidly and then settle into maturity for a long time, while others skip to the closing stage in a few years.

The U.S. Census Bureau's Business Information Tracking System estimates that roughly 60% of businesses that employ others besides the owners will close within their first six years.

The life cycle approach is a useful way to discuss financing opportunities and sources for businesses.

15.2 Borrowing for a Start-up and Growing Business

Five sources of capital can generally be used to start and grow a business:

1. Personal funds
2. Borrowed funds from family and friends
3. Commercial bank loans
4. Borrowed funds through business start-up programs like the U.S. Small Business Administration (SBA)
5. Angel financing or venture capital

Personal funds and family loans, although limited in scope, are often good starting points for most entrepreneurs and sole proprietorships.

Professional lenders like commercial banks and venture capitalists view funding by family and friends as a sign that the business has potential.

After all, if you can't convince your family and friends that you have a good business idea, how can you convince a stranger?

Commercial bank loans constitute the first source that people often seek after they have run out of friends and in-laws to ask.

Banks tend to be very conservative lenders often requiring substantial collateral, income history, and evidence of stability.

Start-ups are rarely directly funded by commercial banks.

Commercial bank loans through the Small Business Administration (SBA) are available to qualified small business applicants via a variety of loan programs, the most common of which is the *7(a) Loan Program*.

The *7(a) Loan Program* administers business loans to individuals or businesses that might not be eligible for a loan through the normal lending agencies.

Loan proceeds can be used for working capital and fixed assets, with repayment schedules extending up to twenty-five years.

These loans are delivered through commercial lenders and guaranteed by the SBA.

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The interest rates tend to be quite competitive but the major advantage of this program accrues to the banks since the loans are backed by the SBA.

Angel financing and venture capital is generally sought by entrepreneurs and businesses that would not qualify for commercial bank or SBA-backed financing.

Angel investors are wealthy individuals and groups that are interested in providing initial funding for high-risk ideas. They typically have very short loan investment horizons (less than ten years) and upside limits of about \$2 million.

Venture capitalist firms or funds are also willing to fund high-risk projects but have longer time horizons and higher funding limits. They generally provide the funding in stages.

Table 15.1 presents some of the key differences between angel investors and venture capitalists.

TABLE 15.1 Differences between Angel Investors and Venture Capitalists

Angel Investors	Venture Capitalists
Individual or group of individuals	Corporate entities
Invest own money	Invest pooled money from range of investors
Focus on early stages of business	All stages of development
Investment may be tied to individual or group expertise	Investment may be tied to high-growth opportunities, with focus on technology and innovation

Source: Adapted from LBO Advisers, “Essential Differences between Angel Investors and Venture Capital,” www.lbo-advisers.com.

Table 15.2 provides an example of stages of financing provided by venture capital firms.

Table 15.2 Mobile Medical Device Targets and Funding Amounts

Phase	Funding Description	Funding Type	Length of Time for Stage
Phase 1	Design prototype	Seed money: \$800,000	Six months
Phase 2	Small-scale production	Production I phase money: \$1,600,000	Twelve months
Phase 3	Marketing and distribution in selected markets	Marketing and distribution money: \$1,600,000	Six months
Phase 4	Full-scale operations	Production II phase money: \$4,500,000	Twenty-four months

Entrepreneurs with strong, promising ideas could be in a position to choose from a group of angel investors and venture capitalists.

Factors to look for when picking a financier or group of financiers include the following:

Financial strength: Will the financier have the necessary funding ability to back the project until its completion?

Contacts: Can the financier provide valuable contacts to help the entrepreneur reach his or her goal?

Exit strategy: How much equity is the investor looking to acquire as a condition of providing the funding and how much of control is the entrepreneur willing to give up?

Given that there is a high probability of failure among start-ups, angel investors and financiers commonly look for 60% to 100% potential annual rates of return on their successful ventures in order to provide funding.

Example 1: Expected rate of return for a venture capitalist

Columbia Venture Capitalists (CVC) has a success rate of one out of every six ventures funded. The average funding for a new business venture is \$5 million, and the average length of time for recovery of funds is three years. What rate of return must CVC get on a successful new venture if the company wants to earn 15% on its invested capital?

Solution - If we assume that CVC disburses all the funds up front (that is, we are not sequencing the funding); we have an initial outlay of \$30 million for the six projects. At the end of three years, we will need a payoff that earns 15% annually on the \$30 million investment. So, in this case, we determine the future value as we did in Chapter 3 (Equation 3.2):

$$FV = \$30,000,000 \times (1.15)^3 = \$45,626,250$$

Statistically speaking, only one venture will be successful, so this one venture must be able to return \$45,626,250 to the venture capitalist in three years in return for its funding of \$5 million. Thus, the new venture must “borrow” the \$5 million at the following cost:

$$\text{cost of capital} = \left(\frac{\$45,626,250}{\$5,000,000} \right)^{1/3} - 1 = 108.97\%$$

This cost of capital is very expensive, but it may be the only capital an entrepreneur can get for starting up the business.

15.3 Borrowing for a Stable and Mature Business: Taking Out Bank Loans

Commercial banks provide much of the short-term financing required for the operating needs of a business via straight loans, discount loans, and lines of credit with or without compensating balances.

Straight loans represent the simplest of all types of bank loans and are offered with a quoted APR and preset payment amounts and intervals.

Example 2: Calculating payments and EAR of a straight loan

Madrical Manufacturing, a manufacturer of baseball equipment, is a stable business. The company has just signed a deal with Keen Sports to make baseball bats with the Keen insignia. To make the required number of bats, Madrical will need to expand its production facilities. The cost of such an expansion is \$2,500,000. The company applies for a loan from its local banker. The commercial loan officer approves the loan, quoting an annual percentage rate (APR) of 7% and required monthly repayments over the next five years. What are the monthly payments (principal and interest) and effective annual rate (EAR) on this bank loan?

Solution - For a calculator solution of the monthly payment,

Mode: P/Y = 12 and C/Y = 12

Input	60	7.0	−2,500,000	?	0
Key					
CPT				49,503	

The effective annual rate of this 7% APR loan is therefore

$$EAR = \left(1 + \frac{0.07}{12}\right)^{12} - 1 = \mathbf{0.0723 \text{ or } 7.23\%}$$

Discount loans are offered to firms with the interest amount being already subtracted at the start.

The difference between the amount the firm can use and the amount that has to be paid back at the end is the bank's interest or discount earned.

The loan amount is the amount due at maturity.

Example 3: Discount loan

Sunvold Systems makes shot clocks for basketball games. The state of Missouri has decided to use shot clocks for all high school games and has awarded the contract to Sunvold Systems. Sunvold Systems needs a loan of \$495,000 to buy all the additional materials to make the shot clocks. The company applies for a loan from Doone County Bank, and the bank says that Sunvold can borrow under a discount loan with a 10% discount rate, payable at the end of the year. What is the size of the loan that Sunvold Systems needs from the bank? What is the effective interest rate of the loan?

Solution - Doone County is going to discount the available funds by 10%, so the bank divides the needed funds of \$495,000 by 1 minus the discount rate of 10%:

$$\text{loan size} = \frac{\$495,000}{1 - 0.10} = \$550,000$$

Sunvold Systems will receive the needed \$495,000 today but will repay \$550,000 at the end of the year. The interest is therefore \$55,000 (\$550,000 – \$495,000), and the effective interest rate is

$$\text{interest rate} = \frac{\$55,000}{\$495,000} = 11.11\%$$

Discount loans are usually very short-term loans.

Letters of Credit or Lines of Credit are preapproved borrowing amounts that work much like credit cards. The company can borrow money at a preset rate from bank at any time without seeking additional approval of the loan each time it needs funds.

The bank, however, is compensated based on the outstanding balance of the loan. The compensation can be a fixed interest rate but often is a floating interest rate tied to a benchmark interest rate.

This borrowing style has changing balances and changing interest rates, so it is difficult to state the effective rate on the loan.

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Compensating balance loans work like lines of credit except that a portion of the loan is not available to the borrower, even though interest is paid on the full face value of the loan. For example, if a firm takes a loan of \$100,000 at a rate of 7.5% per year and a compensating balance requirement of 15%, it will be able to use only \$85,000 and be charged \$7,500 in interest for the year. The effective rate of interest will therefore be:

Effective rate = Interest paid/Amount used → \$7,500/\$85,000 → 8.82%.

15.4 Borrowing for a Stable and Mature Business: Selling Bonds

Corporate bonds represent a major source of long-term financing for established companies. Bonds are typically sold in \$1,000 units, and publicly auctioned or privately placed. The public issue of bonds is regulated by the SEC and typically involves the following five steps:

1. The company **selects an investment bank** to help design and market the bond. An investment bank is an agent that works with the firm to meet all the listing requirements of the bond issue, the design of the bond terms, the marketing of the bond, and the auction of the bond.
2. The company and investment bank **register the bond with the SEC**, providing a prospectus and referencing the indenture for the bond.
3. The bond is **rated** by an agency such as Standard & Poor's or Moody's to help potential buyers determine an appropriate price for the bond.
4. The investment bank **markets** the bond to prospective buyers prior to the auction, using the prospectus as the key information on the bond.
5. An auction is conducted to sell the bond.

Two key documents that are required during the bond issuance process include the prospectus and the indenture agreement.

The **prospectus** contains much of the information filed in the registration and is used to inform potential buyers about the bond.

The **indenture agreement** is the formal contract for the bond between the issuing company and the eventual buyer. It includes vital information about the bond, such as the coupon rate, payment schedule, maturity date, and par value as well as other restrictive covenants, i.e., provisions that restrict the activities of the issuing firm to increase the safety of the bond in the eyes of potential buyers.

Firms that issue coupon bonds have to make periodic coupon payments and a large lump sum payment at maturity.

Sinking funds or reserve accounts are often set up by bond issuers to put away funds every year so as to have the necessary funds available to retire the bond when it matures.

Example 4: Bond proceeds

Alsip Glass and Mirror is about to issue a bond with the help of Becker Investment Bank. The bond will be a twenty-year, semiannual bond with a 7% coupon rate and a \$5,000 par value. A rating agency has given the bond an AA1 rating. Bonds with this maturity and this rating are currently selling to yield 8.5%. Alsip Glass and Mirror has requested authorization from the SEC to sell 2,000 of these bonds. If Becker Investment Bank is receiving a 2.5% commission on the sale of these bonds, what will the total proceeds be for Alsip? What is the cost of these bonds to Alsip in terms of cost of capital?

Solution - First, the 8.5% yield for these bonds will produce the following retail or market price per bond. For a calculator solution,

Mode: P/Y = 2 and C/Y = 2

Coupon payment = $0.07 \times \$5,000 / 2 = \175

Input	40	8.5	?	-175	-5,000
Key					
CPT			4,284.60		

$$\text{gross revenue} = 2,000 \times 4,284.60 = \$8,569,200.$$

The commission for Becker Investment Bank is 2.5% of the proceeds, so commission = $\$8,569,200 \times 0.025 = \$214,230$.

The net proceeds of the sale per bond to Alsip Glass and Mirror are

$$\text{net proceeds per bond} = \frac{\$8,569,200 - \$214,230}{2,000} = \$4,177.485$$

Using the net proceeds per bond, we next find the cost of the bonds to Alsip Glass and Mirror. Solving for the yield to maturity (I/Y = YTM) with the TVM keys, we have

Mode: $P/Y = 2$ and $C/Y = 2$

Input	40	?	4,177.485	− 175	− 5,000
Key					
CPT	8.757%				

15.5 Borrowing for a Stable and Mature Business: Selling Stock

The other major source of capital for a firm to avail of is its common stock or equity.

Equity holders get voting rights as part owners and share in the residual profits of the firm.

Stocks are sold as *initial public offerings* (IPOs) when the firm first goes public and *seasoned* offerings for subsequent issues.

Initial Public Offerings and Underwriting: Firms sell stock to the public with the help of investment banking firms, who perform *due diligence* and are experts in marketing the issue.

Investment banks partner with issuing firms in exchange for compensation that can be set up on a best-efforts basis or on a fixed-commitment basis.

Under a **best efforts arrangement**, the investment bank pledges to use its best efforts to sell all the authorized shares and takes a cut on each individual share sold, but it provides no guarantee as to how many shares will be sold. The more shares sold, the higher the payoff to the investment bank.

Under a **fixed-commitment arrangement**, also known as an **underwriting arrangement**, the investment banker guarantees a fixed amount of proceeds to the issuer. The investment banker makes up/keeps the difference between the actual selling price and the guaranteed price.

Example 5: Best efforts versus fixed commitment underwriting

You have started Mobile Medical Company, and you now want to sell common stock in the company to raise capital for business expansion and allow the venture capital firm to exit. Southern Investment Bank is proposing two types of compensation arrangements. The first is a firm commitment of \$34,000,000. The second is a best efforts arrangement in which Southern will receive \$2.00 for every share of stock it sells of the 2,000,000 shares that it will offer to the public. The offer price to the public is \$20.00 per share. (1) If Southern sells 100% of the shares, what are your proceeds? What is the payment to Southern under each method of issuing

securities? (2) What if it sells 80% of the shares? What is the payment to Southern under each method of issuing securities? (3) At what percentage of sold shares are the proceeds to you the same under the two compensation arrangements? At what percentage is the payment to Southern the same? (4) Also, what is the return for the venture capitalist that loaned you a total of \$1,600,000 in phase three in exchange for 470,000 shares of stock?

Solution

1. For a 100% sale of the 2,000,000 shares at \$20.00 per share to the public, the proceeds are \$40,000,000.

Firm commitment funds to you: **\$34,000,000**

Firm commitment compensation to Southern:

$$\$20 \times 2,000,000 - \$34,000,000 = \$6,000,000$$

$$\text{Best efforts to you: } (\$20 - \$2) \times 2,000,000 = \$36,000,000$$

$$\text{Best efforts to Southern: } \$2 \times 2,000,000 = \$4,000,000$$

Therefore, if the security is 100% sold, you are better off with a best effort, and Southern is better off with a firm commitment.

2. For an 80% sale of the 2,000,000 shares, the proceeds are \$32,000,000.

Firm commitment funds to you: **\$34,000,000**

Firm commitment compensation to Southern:

$\$20 \times 2,000,000 \times 0.8 - \$34,000,000 = -\$2,000,000$ (and Southern Investment Bank now holds 20%, or 400,000 shares, but must pay Mobile Medical Company \$2,000,000 above the funds collected from the sale)

$$\text{Best efforts to you: } (\$20 - \$2) \times 2,000,000 \times 0.8 = \mathbf{\$28,800,000}$$

$$\text{Best efforts to Southern: } \$2 \times 2,000,000 \times 0.8 = \$3,200,000$$

Therefore, if the security is 80% sold, you are better off with a firm commitment, and Southern is better off with a best effort in terms of immediate cash flow.

3. The break-even point in terms of the sales percentage between firm commitment and best efforts for you is

Firm commitment = best effort \$ per share sold

$$\$34,000,000 = \$18 \times 2,000,000 \times X\%$$

$$\begin{aligned} X\% &= \frac{\$34,000,000}{\$18 \times 2,000,000} \\ &= \frac{\$34,000,000}{\$36,000,000} = 94.4444\% \end{aligned}$$

So you will be better off selecting best efforts only if more than 94.4444% of the stock sells at the auction.

We can also see that we have the same break-even point in terms of the sales percentage for Southern with the \$34,000,000 firm commitment:

$$\begin{aligned} \$20 \times 2,000,000 \times X\% - \$34,000,000 &= \$2.00 \times 2,000,000 \times X\% \\ \$34,000,000 &= (\$20 - \$2) \times 2,000,000 \times X\% \\ X\% &= \frac{\$34,000,000}{\$36,000,000} = 94.4444\% \end{aligned}$$

So for Southern Investment Bank, best efforts is the better choice unless it believes it can sell more than 94.4444% of all authorized shares.

4. The original investment of the venture capitalist in phase three was \$1,600,000. To determine the holding period return for the venture capitalist, we need to find the value of the 470,000 shares held by the venture capitalist.

$$\begin{aligned} \text{After-fee value: } (\$20 - \$2) \times 470,000 &= \$8,460,000 \\ &= 4.2875 \text{ or } 428.75\% \end{aligned}$$

This means that for every \$1 the venture capitalists invested they received \$4.2875 back in profit. The effective annual return would be calculated based on how long it took to get this payment. If it took five years, then we have an effective annual return of

$$EAR = (\$8,460,000 / \$1,600,000)^{\frac{1}{5}} - 1 = 0.3952 \text{ or } 39.52\%$$

Registration, Prospectus, and Tombstone: All new issues of shares have to be registered with the SEC prior to being sold in the capital markets.