

## c02; Chapter 2: Financial Management

## Multiple Choice

1. Which form of business would most likely describe the following, a college student who tutors other students, a retired woman who babysits children, a teenager who mows lawns, and a party clown?

- A. Partnership
- B. Corporation
- C. Sole proprietorship
- D. Limited liability company

Answer B

Difficulty Easy

Learning outcome LO 2.1

Bloom's taxonomy Describe

AACSB Analytical skills

Feedback A sole proprietorship is a business owned and operated by one person.

2. Which of the following is not a major form of business organization in the U.S.?

- A. Partnership
- B. Corporation
- C. Sole Proprietorship
- D. Public limited company
- E. Limited liability company

Answer D

Difficulty Easy

Learning outcome LO 2.1

Bloom's taxonomy Remember

AACSB Analytical skills

Feedback In the U.S., the major forms of business organizations are the:

- 1. sole proprietorship;
- 2. partnership;
- 3. limited liability company; and
- 4. corporation.

Public Limited company would be a major form of business in the United Kingdom.

3. The major forms of business that have unlimited liability would best be described as:

- A. sole proprietorships and partnerships.
- B. corporations and subchapter s corporations.
- C. limited liability partnerships and limited liability companies.

Answer A

Difficulty Easy

Learning outcome LO 2.1

Bloom's taxonomy Describe

AACSB Analytical skills

Feedback	Unlimited liability means that responsibility for obligations of a business that extends beyond the original investment, including personal assets.
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4. The major forms of business that have limited liability would best be described as:

- A. partnerships.
- B. sole proprietorships.
- C. corporations and limited liability companies.

Answer	C
Difficulty	Easy
Learning outcome	LO 2.1
Bloom's taxonomy	Describe
AACSB	Analytical skills
Feedback	Limited liability is responsibility for only the initial amount of the investment.

5. Your best friend wants to start a car detailing business to pay for college. Which of the following is a disadvantage of sole proprietorships that he should consider?

- A. Easy to form
- B. Limited liability
- C. Limited access to additional funds
- D. Business income is taxed once, at the individual's personal level.

Answer	C
Difficulty	Easy
Learning outcome	LO 2.1
Bloom's taxonomy	Describe
AACSB	Analytical skills
Feedback	The sources of funds available for sole proprietorships are the same ones that are available to individuals. No complicated finance options are available—owners borrow from relatives and friends or, depending on their credit rating, from the bank, through either a loan or a credit card.

6. Your best friend wants to start a car detailing business to pay for college. Which of the following is an advantage of sole proprietorships that he should consider?

- A. Easy to form
- B. Unlimited life
- C. Limited liability
- D. Access to capital

Answer	A
Difficulty	Easy
Learning outcome	LO 2.1
Bloom's taxonomy	Describe
AACSB	Analytical skills
Feedback	The big advantage of a sole proprietorship is that setting one up is easy—no paperwork is involved, and the owner needs only to start doing business.

7. Flow-through taxation is a characteristic for all but the following forms of business?

- A. Partnership
- B. Corporation
- C. Sole proprietorship
- D. Limited liability company

Answer B

Difficulty Easy

Learning outcome LO 2.1

Bloom's taxonomy Remember

AACSB Analytical skills

Feedback Flow-through taxation is where income flows directly to the owners as taxable income and is not taxed at the business entity level.

8. Which of the following forms of business have flow-through taxation?

- A. Apple Inc.
- B. IBM Corporation
- C. Deloitte & Touche LLP
- D. Microsoft Corporation

Answer C

Difficulty Easy

Learning outcome LO 2.1

Bloom's taxonomy Remember

AACSB Analytical skills

Feedback Flow-through taxation is where income flows directly to the owners as taxable income and is not taxed at the business entity level. This does not occur with corporations, but is the case for partnerships and limited partnerships.

9. An advantage of the corporate form of business is its:

- A. Limited life
- B. Access to capital
- C. Unlimited liability

Answer B

Difficulty Easy

Learning outcome LO 2.1

Bloom's taxonomy Remember

AACSB Analytical skills

Feedback An advantage of a corporation is that it can issue stock.

10. An advantage of the partnership form of business is its:

- A. Limited life
- B. Access to capital
- C. Unlimited liability
- D. Flow-through taxation

Answer	D
Difficulty	Easy
Learning outcome	LO 2.1
Bloom's taxonomy	Remember
AACSB	Analytical skills
Feedback	An advantage of a partnership is that income is only taxed at the owner's level (that is, flow-through taxation).

11. Which of the following statements would not be a reason Ford Motor Company uses the corporate form of business?

- A. Unlimited life
- B. Limited liability
- C. Access to capital
- D. Business income is taxed once, at the individual owner's level

Answer	D
Difficulty	Easy
Learning outcome	LO 2.1
Bloom's taxonomy	Remember
AACSB	Analytical skills
Feedback	A disadvantage of corporations is that income is taxed at the corporate level and at the owner's level, when distributed.

12. Dentists' offices, accounting firms, law firms, and physician's offices are best described as examples of which major type of business?

- A. corporation
- B. partnership
- C. sole proprietorship

Answer	B
Difficulty	Easy
Learning outcome	LO 2.1
Bloom's taxonomy	Describe
AACSB	Analytical skills
Feedback	A partnership is a business owned and operated by two or more people.

13. Your sister wants to start a tee shirt business on e-Bay with you to help pay for college tuition. Which of the following is a disadvantage of partnerships that you both should consider?

- A. Difficult to form
- B. Separation of owners and managers
- C. Unlimited liability for general partners
- D. Income taxed at the business level and the owners' level, when distributed

Answer	C
Difficulty	Easy
Learning outcome	LO 2.1
Bloom's taxonomy	Describe
AACSB	Analytical skills

Feedback                      A disadvantage of partnerships is unlimited liability for general partners.

14. A corporation that elects to be taxed as a partnership is best described as:

- A. C corporation
- B. limited liability company
- C. subchapter S corporation
- D. None of these describe corporations that are taxed as partnerships

Answer                      C

Difficulty                      Easy

Learning outcome              LO 2.1

Bloom's taxonomy              Remember

AACSB                      Analytical skills

Feedback                      Sub S corporation - corporation that elects to be taxed as a partnership

15. Which of the following forms of business have limited liability for all its owners?

- A. Partnership
- B. C corporation
- C. Sole proprietorship

Answer                      B

Difficulty                      Easy

Learning outcome              LO 2.1

Bloom's taxonomy              Remember

AACSB                      Analytical skills

Feedback                      All shareholders of a corporation have limited liability.

16. Which of the following forms of business have unlimited liability for all its owner(s)?

- A. C corporation
- B. Sole proprietorship
- C. Limited Partnership

Answer                      B

Difficulty                      Easy

Learning outcome              LO 2.1

Bloom's taxonomy              Remember

AACSB                      Analytical skills

Feedback                      

- The owner of a sole proprietorship has unlimited liability.
- All owners of a C corporation have limited liability.
- The limited partners of a limited partnership have limited liability, whereas the general partners have unlimited liability.

17. Which of the following forms of business partnership interests that are traded in the public market?

- A. C corporation
- B. Sole proprietorship
- C. General partnership
- D. Master limited partnership

Answer	D
Difficulty	Easy
Learning outcome	LO 2.1
Bloom's taxonomy	Remember
AACSB	Analytical skills
Feedback	The master limited partnership has both general and limited partners, and the partnership interests of the limited partners trade in markets.

18. Which of the following forms of business does not have flow-through taxation?

- A. Partnership
- B. C corporation
- C. Sole proprietorship
- D. Limited liability company

Answer	B
Difficulty	Easy
Learning outcome	LO 2.1
Bloom's taxonomy	Remember
AACSB	Analytical skills
Feedback	The income of the corporation is taxed at the corporate level and once again when paid out to owners in the form of dividends.

19. Your sister wants to start a tee shirt business on e-Bay with you to help pay for college tuition. All of the following are advantages to partnerships that you should both consider, except \_\_\_\_\_?

- A. Easy to form
- B. Access to capital
- C. Business income is taxed once, at the individual partner's level

Answer	B
Difficulty	Easy
Learning outcome	LO 2.1
Bloom's taxonomy	Describe
AACSB	Analytical skills
Feedback	Partnerships access to capital, though easier than a sole proprietorship's access to capital is still limited because raising capital beyond the partners' contributions and local banks may be challenging, especially in some economic environments. And because a partnership is owned 100% by partners, bringing in additional owners would not be possible unless the partnership agreement is rewritten

20. Your parents inherit \$100,000 and want to invest these funds for their retirement. They are very concerned about entering into any form of investment from which they would incur liability. Which of the following investment opportunities would not be appropriate for them?

- A. Common stock of McDonald's Corporation
- B. General partner of an oil and gas limited partnership
- C. Limited partner in a real estate limited liability company
- D. Stock of British Petroleum, public limited company (PLC)

Answer	B
Difficulty	Moderate
Learning outcome	LO 2.1
Bloom's taxonomy	Apply
AACSB	Analytical skills
Feedback	General partners make management decisions and have unlimited liability.

21. Your dad inherits \$100,000 and wants to invest these funds for their retirement. They are very concerned about business continuity and want to be able to pass on this investment to the next generation of the family. Which of the following investment opportunities would not be appropriate for them?

- A. Common stock of McDonald's Corporation
- B. Food truck business operating as a sole proprietorship
- C. Limited partner in a real estate limited liability company
- D. Stock of British Petroleum, public limited company (PLC)

Answer	B
Difficulty	Moderate
Learning outcome	LO 2.1
Bloom's taxonomy	Apply
AACSB	Analytical skills
Feedback	A disadvantage of sole proprietorships is lack of continuity.

22. The form of business in which all partners share in the management and the profits of the business and the income and the losses from the business are reflected on the individual owners' tax returns is best described as which of the following:

- A. Corporation
- B. Limited partnership
- C. General partnership
- D. Master limited partnership

Answer	C
Difficulty	Moderate
Learning outcome	LO 2.1
Bloom's taxonomy	Remember
AACSB	Analytical skills
Feedback	general partnership - form of business in which all partners share in the management and the profits of the business, and the income and losses from the business are reflected on the individual owners' tax returns.

23. Which of the following statements is not true?

- A. There is no such thing as limited liability
- B. Limited liability means liability only for the initial investment.
- C. The general partner has limited liability as the operator of the business.
- D. As long as the limited partners are not active in the business, they have the advantage of limited liability.

Answer	C
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Difficulty	Moderate
Learning outcome	LO 2.1
Bloom's taxonomy	Describe
AACSB	Analytical skills
Feedback	The general partner has unlimited liability as the operator of the business.

24. A business organization which has limited liability, is a distinct legal entity, is immortal, and may have issues of control would best be described as a:

- A. corporation.
- B. partnership.
- C. sole proprietorship.
- D. limited liability partnership.

Answer	A
Difficulty	Moderate
Learning outcome	LO 2.1
Bloom's taxonomy	Describe
AACSB	Analytical skills
Feedback	These characteristics all belong to a corporation.

25. The Bumble Bee Corporation had income before taxes of \$1 million. Bumble Bee paid taxes at a flat rate of 30% and paid 40 percent of its earnings to its shareholders in the form of cash dividends. If its shareholders are taxed at the rate of 15 percent on dividend income, the effective tax rate on the income generated by Bumble Bee, considering both corporate and individual taxation, is closest to:

- A. 30.0%
- B. 31.8%.
- C. 34.2%.
- D. 45.0%.

Answer	C																						
Difficulty	Difficult																						
Learning outcome	LO 2.1																						
Bloom's taxonomy	Analyze																						
AACSB	Analytical skills																						
Feedback	<table> <tr> <td>Corporate income</td><td>\$1,000,000</td></tr> <tr> <td>Corporate tax</td><td><u>300,000</u></td></tr> <tr> <td>Income after tax</td><td>\$700,000</td></tr> <tr> <td>Dividend income</td><td>\$280,000</td></tr> <tr> <td>Tax on dividends</td><td><u>42,000</u></td></tr> <tr> <td>Income after tax</td><td>\$238,000</td></tr> <tr> <td>Corporate tax</td><td>\$300,000</td></tr> <tr> <td>Individual tax</td><td><u>+42,000</u></td></tr> <tr> <td>Total tax</td><td>\$342,000</td></tr> <tr> <td>Effective tax</td><td>34.2%</td></tr> <tr> <td>or</td><td></td></tr> </table>	Corporate income	\$1,000,000	Corporate tax	<u>300,000</u>	Income after tax	\$700,000	Dividend income	\$280,000	Tax on dividends	<u>42,000</u>	Income after tax	\$238,000	Corporate tax	\$300,000	Individual tax	<u>+42,000</u>	Total tax	\$342,000	Effective tax	34.2%	or	
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or																							



$$0.30 + [(1-0.3) \times 0.4 \times 0.15] = 34.2\%$$

26. The Madison Corporation had income before taxes of \$1 million. Madison paid taxes at a flat rate of 35% and paid 40 percent of its earnings to its shareholders in the form of cash dividends. If its shareholders are taxed at the rate of 15 percent on dividend income, the effective tax rate on the income generated by Madison, considering both corporate and individual taxation, is closest to:

- A. 37.1%.
- B. 38.9%.
- C. 50.0%.

Answer  
Difficulty  
Learning outcome  
Bloom's taxonomy  
AACSB  
Feedback

B  
Difficult  
LO 2.1  
Analyze

Analytical skills

Corporate income	\$1,000,000
Corporate tax	<u>350,000</u>
Income after tax	\$650,000

Dividend income	\$260,000
Tax on dividends	<u>39,000</u>
Income after tax	\$221,000

Corporate tax	\$350,000
Individual tax	<u>+39,000</u>
Total tax	\$389,000

Effective tax 38.9%

or

$$0.35 + [(1-0.35) \times 0.4 \times 0.15] = 38.9\%$$

27. The Window Corporation had income before taxes of \$1 million. Window paid taxes at a flat rate of 35% and paid 30 percent of its earnings to its shareholders in the form of cash dividends. If its shareholders are taxed at the rate of 15 percent on dividend income, the effective tax rate on the income generated by Window, considering both corporate and individual taxation, is closest to:

- A. 35.000%
- B. 36.575%.
- C. 37.925%.
- D. 50.000%.

Answer  
Difficulty  
Learning outcome  
Bloom's taxonomy  
AACSB  
Feedback

C  
Difficult  
LO 2.1  
Analyze

Analytical skills

Corporate income	\$1,000,000
Corporate tax	<u>350,000</u>

Income after tax	\$650,000
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Dividend income	\$195,000
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Tax on dividends	<u>29,250</u>
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Income after tax	\$165,750
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Corporate tax	\$350,000
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Individual tax	<u>+29,250</u>
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Total tax	\$379,250
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Effective tax	37.925%
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or

$$0.35 + [(1 - 0.35) \times 0.3 \times 0.15] = 37.925\%$$

28. Compare the effective tax rate of the following: A sole proprietorship (\$25,000 in income, all of the income is paid out, and the individual's tax rate is 38%) to a corporation (the same \$25,000 in income, with all of the income paid out in dividends and a corporate tax rate of 35%. Individual tax rate is 38%). What is the effective tax rate of the sole proprietorship? What is the effective tax rate of the corporation?

	Sole Proprietorship	Corporation
A.	38%	35%
B.	35%	38%
C.	35%	59.7%
D.	35%	61.6%

Answer

C

Difficulty

Difficult

Learning outcome

LO 2.1

Bloom's

Apply

taxonomy

AACSB

Analytical skills

Feedback

Effective tax rate of sole proprietorship is 35%.

Effective tax rate of corporation is calculated as follows:

Corporate income before taxes	\$25,000
Tax at 35%	<u>8,750</u>
Income after tax	\$16,250

Dividend income of individuals	\$16,250
Tax at 38%	<u>6,175</u>
Income after tax	\$10,075

$$\text{Total taxes paid } \$8,750 + \$6,175 = \$14,925$$

$$\$14,925 \div \$25,000 \text{ income} = 59.7\% \text{ effective tax rate}$$

29. Compare the effective tax rate of the following: A sole proprietorship (\$100,000 in income, all of

the income is paid out, and the individual's tax rate is 28%) to a corporation (the same \$100,000 in income, with all of the income paid out in dividends and a corporate tax rate of 30%. Individual tax rate is 28%). What is the effective tax rate of the sole proprietorship? What is the effective tax rate of the corporation?

- |    | Sole Proprietorship | Corporation |
|----|---------------------|-------------|
| A. | 30%                 | 28%         |
| B. | 28%                 | 30%         |
| C. | 28%                 | 49.8%       |
| D. | 28%                 | 49.6%       |

Answer D

Difficulty Difficult

Learning outcome LO 2.1

Bloom's Apply

taxonomy

AACSB Analytical skills

Feedback Effective tax rate of sole proprietorship is 35%.

Effective tax rate of corporation is calculated as follows

Corporate income before taxes	\$100,000
Tax at 35%	<u>30,000</u>
Income after tax	\$70,000
Dividend income of individuals	\$70,000
Tax at 38%	<u>19,600</u>
Income after tax	\$50,400

Total taxes paid \$30,000 + \$19,600 = \$49,600

$\$49,600 \div \$100,000 = 49.6\%$  effective tax rate

30. The goal of the business enterprise is to maximize:

- A. net profit.
- B. net income.
- C. economic profit.

Answer C

Difficulty Moderate

Learning outcome LO 2.2

Bloom's taxonomy Remember

AACSB Analytical skills

Feedback Economic profit is the difference between revenue and expenses after considering the opportunity cost of funds.

31. The goal of the business enterprise is to maximize:

- A. net income.
- B. economic profit.
- C. earnings before interest and taxes.

Answer B

Difficulty	Moderate
Learning outcome	LO 2.2
Bloom's taxonomy	Remember
AACSB	Analytical skills
Feedback	Economic profit is the difference between revenue and expenses after considering the opportunity cost of funds.

32. The goal of the business enterprise is to maximize:

- A. revenues.
- B. total assets.
- C. owners' wealth.
- D. the book value of shareholders' equity.

Answer	C
Difficulty	Moderate
Learning outcome	LO 2.2
Bloom's taxonomy	Remember
AACSB	Analytical skills
Feedback	The goal is to maximize the wealth or equity of the owners.

33. Which of the following is most likely considered an externality with respect to a business entity?

- A. Maximizing the value of shareholders' wealth.
- B. Managers using company assets for personal use.
- C. Closing a plant, laying-off a significant portion of a town's population.

Answer	C
Difficulty	Moderate
Learning outcome	LO 2.2
Bloom's taxonomy	Remember
AACSB	Analytical skills
Feedback	Externalities are effects that extend outside of the company.

34. Which of the following takes into account the opportunity cost of funds?

- A. Net profit
- B. Economic profit
- C. Accounting profit

Answer	B
Difficulty	Moderate
Learning outcome	LO 2.2
Bloom's taxonomy	Remember
AACSB	Analytical skills
Feedback	Economic profit is the difference between revenue and expenses after considering the opportunity cost of funds.

35. In the agency relationship between shareholders and management,

- A. shareholders are agents of the managers.
- B. managers are agents of the shareholders.
- C. neither managers nor shareholders are agents.

Answer B  
 Difficulty Easy  
 Learning outcome LO 2.3  
 Bloom's taxonomy Remember  
 AACSB Analytical skills  
 Feedback In the agency relationship, managers are the agents of the shareholders (who we often refer to as the principals in the agency relationship).

36. An issue or conflict that arises due to potential divergence of interest between managers, shareholders, and creditors is best described as a(n):

- A. agency problem.
- B. business problem
- C. personal problem.
- D. employment problem.

Answer A  
 Difficulty Easy  
 Learning outcome LO 2.3  
 Bloom's taxonomy Remember  
 AACSB Analytical skills  
 Feedback agency problem - issue or conflict that arises due to potential divergence of interest between managers, shareholders, and creditors

37. Which of the following statements about weighted average cost of capital is not true?

- A. It is the marginal cost of funds
- B. It measures profits and returns and is preferred by managers.
- C. It is calculated as the weighted average of the costs of debt, preferred equity, and common equity.
- D. Shareholders compare it to return on a project to determine if their money is best being used by the company or should be paid out to shareholders.

Answer B  
 Difficulty Easy  
 Learning outcome LO 2.3  
 Bloom's taxonomy Describe  
 AACSB Analytical skills  
 Feedback Weighted average cost of capital (WACC) is a marginal cost of funds, but it is not a measure of profits and returns.

38. If the management of a company cannot invest in investment projects that return more than what the suppliers of capital require, the company should:

- A. invest the funds in risk-free securities.
- B. put the funds to work as best as possible.

C. pay out the funds to be reinvested by shareholders.

Answer C

Difficulty Easy

Learning outcome LO 2.3

Bloom's taxonomy Describe

AACSB Analytical skills

Feedback Weighted average cost of capital (WACC) is a marginal cost of funds; if the company cannot invest to provide the required rate of return on its investments, it should pay out these funds to shareholders.

39. Jeffrey R. Immelt, CEO of General Electric, earned \$3,300,000 in base salary, \$5,800,000 in cash bonus, and \$4,713,000 in stocks granted in 2007. The compensation of Mr. Immelt is an example of which of the following:

A. insider trading.

B. monitoring cost.

C. compensation scheme to encourage him to act in the best interest of shareholders.

Answer C

Difficulty Easy

Learning outcome LO 2.3

Bloom's taxonomy Describe

AACSB Analytical skills

Feedback Agency costs are costs associated with agency problems, corporate governance – set of processes and procedures established to manage the organization in the best interests of its owners. Compensation schemes such as this are intended to encourage managers to act in the best interest of shareholders.

40. Which of the following is not a primary concern from the point of view of a company's management?

A. Minimize risk

B. Market value of equity

C. Maximize earnings per share

D. Maximize accounting return on investment

Answer B

Difficulty Moderate

Learning outcome LO 2.3

Bloom's taxonomy Describe

AACSB Analytical skills

Feedback Management is more concerned with things they have some control over like risk, earnings per share, and return on accounting investment. Management does not have control over market value of equity and therefore this is not a primary concern.

41. The framework for analyzing long-term investment or asset decisions is best described by the following:

- A. Cost of capital
- B. Working capital
- C. Internal rate of return
- D. Capital budgeting or capital expenditure

Answer D  
 Difficulty Easy  
 Learning outcome LO 2.4  
 Bloom's taxonomy Remember  
 AACSB Analytical skills  
 Feedback capital budgeting or capital expenditure - analysis framework for analyzing investment or asset decisions

42. When we talk about capital structure, this refers to:

- A. the cash, inventory, and accounts receivable.
- B. mix of debt and equity to finance an enterprise.
- C. the investment in plant, property and equipment.

Answer B  
 Difficulty Easy  
 Learning outcome LO 2.4  
 Bloom's taxonomy Apply  
 AACSB Analytical skills  
 Feedback capital structure – mix of debt and equity used to finance an enterprise

43. Which of the following would most likely not be a financing decision?

- A. The Coca Cola company buys Pepsi.
- B. Pfizer buys back \$500,000 in common stock.
- C. Rosetta Stone does a public offering of its stock.
- D. McDonald's issues \$40,000,000 in corporate bonds.

Answer A  
 Difficulty Easy  
 Learning outcome LO 2.4  
 Bloom's taxonomy Describe  
 AACSB Analytical skills  
 Feedback A would be an investment decision.

44. Which of the following would not likely be considered an investment decision?

- A. Bank of America acquired Merrill Lynch
- B. LEGOLAND opened a new park in Orlando
- C. Facebook completes a public offering of its stock
- D. James Madison University bought a former hospital to turn into classrooms

Answer C  
 Difficulty Easy  
 Learning outcome LO 2.4  
 Bloom's taxonomy Apply  
 AACSB Analytical skills

Feedback C would be a financing decision.

45. The mix of debt and equity that is used to finance a business enterprise is best described as the enterprise's:

- A. assets.
- B. working capital.
- C. capital structure.
- D. capital expenditures

Answer C  
 Difficulty Easy  
 Learning outcome LO 2.4  
 Bloom's taxonomy Apply  
 AACSB Analytical skills  
 Feedback Capital structure is the mix of long-term sources of funds.

46. The uncertainty associated with the use of debt to finance a business enterprise is best described as:

- A. financial risk.
- B. business risk.
- C. operating risk.

Answer A  
 Difficulty Easy  
 Learning outcome LO 2.4  
 Bloom's taxonomy Apply  
 AACSB Analytical skills  
 Feedback Capital structure is the mix of long-term sources of funds.

47. Which of the following is associated with how a company finances its assets?

- A. financial risk.
- B. business risk.
- C. operating risk.

Answer A  
 Difficulty Easy  
 Learning outcome LO 2.4  
 Bloom's taxonomy Apply  
 AACSB Analytical skills  
 Feedback Financial risk is the volatility of earnings to owners; the more debt in the capital structure, the more financial risk.

True-False

48. Corporations are not specific to the U.S.

- A. True
- B. False



Answer	A
Difficulty	Moderate
Learning outcome	LO 2.1
Bloom's taxonomy	Describe
AACSB	Analytical skills
Feedback	A corporation is easy to recognize because it has Inc. for incorporated, Ltd. for limited, or, in Europe, PLC for private limited corporation or AG for Aktiengesellschaft, after its name.

49. Income is taxed at only one level, the owners' individual income, for corporations.

- A. True
- B. False

Answer	B
Difficulty	Easy
Learning outcome	LO 2.1
Bloom's taxonomy	Describe
AACSB	Analytical skills
Feedback	Corporations' income is taxed at the corporate level and at the owner's level, when distributed.

50. If limited liability is your primary concern, one should not become a limited partner?

- A. True
- B. False

Answer	B
Difficulty	Easy
Learning outcome	LO 2.1
Bloom's taxonomy	Apply
AACSB	Analytical skills
Feedback	Limited partners are passive investors with limited liability.

51. If limited liability is your primary concern, one should not become a general partner?

- A. True
- B. False

Answer	A
Difficulty	Easy
Learning outcome	LO 2.1
Bloom's taxonomy	Apply
AACSB	Analytical skills
Feedback	General partners make management decisions and have unlimited liability.

52. At least one general partner is required for all partnerships?

- A. True
- B. False

Answer	A
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Difficulty	Easy
Learning outcome	LO 2.1
Bloom's taxonomy	Describe
AACSB	Analytical skills
Feedback	All partnerships have at least one general partner

53. The difference between general and limited partnerships is that general partnerships include only general partners, while limited partnerships include both limited and general partners.

A. True

B. False

Answer	A
Difficulty	Moderate
Learning outcome	LO 2.1
Bloom's taxonomy	Describe
AACSB	Analytical skills
Feedback	General partnership – all partners are general partners, limited partnerships - both general and limited partners, with general partners making management decisions and having unlimited liability, and the limited partners being passive investors with limited liability.

54. The difference between a limited partnership and a master limited partnership is that the limited partnership interests of the master limited partnership can be traded publicly.

A. True

B. False

Answer	A
Difficulty	Moderate
Learning outcome	LO 2.1
Bloom's taxonomy	Describe
AACSB	Analytical skills
Feedback	master limited partnership - form of business in which there are general and limited partners, with limited partner interests traded in the public market.

55. ABC partnership has \$500,000 in income before taxes. The partnership pays out all of its income to the partners. If individual income tax rates are 33% and the corporate tax rate is 30%, the effective tax rate of the partnership is 33%.

A. True

B. False

Answer	A
Difficulty	Moderate
Learning outcome	LO 2.1
Bloom's taxonomy	Describe
AACSB	Analytical skills
Feedback	Effective tax rate for partnership is the individual tax rate because of flow-through taxation.

56. A limited liability company is a combination of some of the best features of both the partnership and sole proprietorship forms of business.

A. True

B. False

Answer B

Difficulty Easy

Learning outcome LO 2.1

Bloom's taxonomy Describe

AACSB Analytical skills

Feedback A limited liability company is a combination of some of the best features of both the partnership and corporate forms of business.

57. Any company may become a limited liability company.

A. True

B. False

Answer B

Difficulty Moderate

Learning outcome LO 2.1

Bloom's taxonomy Describe

AACSB Analytical skills

Feedback It depends on state laws, but generally insurance companies, banks, law firms, and nonprofit organizations are prohibited from becoming LLCs.

58. The share of revenue from corporations in the U.S. is significantly higher than the share of revenues from sole proprietorships and partnerships.

A. True

B. False

Answer A

Difficulty Moderate

Learning outcome LO 2.1

Bloom's taxonomy Describe

AACSB Analytical skills

Feedback The most common form of business in the U.S. is the sole proprietorship. Although there are fewer corporations, they account for the largest share of revenue.

59. A stockholder is any party affected by the decisions and actions of an entity.

A. True

B. False

Answer B

Difficulty Easy

Learning outcome LO 2.2

Bloom's taxonomy Remember

AACSB Analytical skills

Feedback                      A stakeholder is any party affected by the decisions and actions of an entity.

60. Economic profit is another name for accounting profit.

A. True

B. False

Answer                      B

Difficulty                      Easy

Learning outcome              LO 2.2

Bloom's taxonomy              Remember

AACSB                      Analytical skills

Feedback                      Economic profit considers the opportunity cost of funds, whereas accounting profit does not.

61. For a given company, economic profit will always be greater than accounting profit.

A. True

B. False

Answer                      B

Difficulty                      Easy

Learning outcome              LO 2.2

Bloom's taxonomy              Remember

AACSB                      Analytical skills

Feedback                      Though economic profit includes opportunity costs, accounting profits are subject to accounting principles that may overstate or understate the true economic profit of a company.

62. A stakeholder is any party affected by the decisions and actions of an entity.

A. True

B. False

Answer                      A

Difficulty                      Easy

Learning outcome              LO 2.2

Bloom's taxonomy              Remember

AACSB                      Analytical skills

Feedback                      A stakeholder is any party affected by the decisions and actions of an entity.

63. A stakeholder is any party affected by the decisions and actions of an entity.

A. True

B. False

Answer                      A

Difficulty                      Easy

Learning outcome              LO 2.2

Bloom's taxonomy              Remember

AACSB                      Analytical skills

Feedback                      A stakeholder is any party affected by the decisions and actions of an entity.

64. The goal of management of a company is to enhance the owners' wealth.

A. True

B. False

Answer A

Difficulty Easy

Learning outcome LO 2.2

Bloom's taxonomy Remember

AACSB Analytical skills

Feedback The goal of management of a company is to enhance owners' wealth.

65. In the agency relationship that involves a company's management and its shareholders, the shareholders are the agents.

A. True

B. False

Answer B

Difficulty Easy

Learning outcome LO 2.2

Bloom's taxonomy Remember

AACSB Analytical skills

Feedback The shareholders are the principals and the managers are the agents.

66. The weighted average cost of capital is a marginal cost.

A. True

B. False

Answer A

Difficulty Easy

Learning outcome LO 2.3

Bloom's taxonomy Remember

AACSB Analytical skills

Feedback The weighted average cost of capital is the average of the marginal costs of the business's different sources of capital.

67. The cost of providing stock options to motivate managers is an example of an indirect agency cost.

A. True

B. False

Answer A

Difficulty Easy

Learning outcome LO 2.3

Bloom's taxonomy Remember

AACSB Analytical skills

Feedback Indirect agency costs include such things as the cost of making suboptimal investments and providing stock options to motivate managers.

68. Corporate governance is a set of policies and procedures that are intended to promote for the best interests of the shareholders.

A. True

B. False

Answer	A
Difficulty	Easy
Learning outcome	LO 2.3
Bloom's taxonomy	Remember
AACSB	Analytical skills
Feedback	Corporate governance is intended to reduce agency costs.

69. Costs associated with producing financial statements and annual reports for investors and shareholders are examples of indirect agency costs.

A. True

B. False

Answer	B
Difficulty	Easy
Learning outcome	LO 2.3
Bloom's taxonomy	Remember
AACSB	Analytical skills
Feedback	Direct agency costs include such things as costs associated with producing financial statements and annual reports for investors and shareholder.

70. The interests of managers and shareholders are usually fundamentally the same.

A. True

B. False

Answer	B
Difficulty	Describe
Learning outcome	LO 2.3
Bloom's taxonomy	Remember
AACSB	Analytical skills
Feedback	The interests of managers and shareholders are usually fundamentally the different.

71. Weighted average cost of capital (WACC) is calculated as the weighted average of the costs of a firm's different sources of capital, such as debt, preferred equity, and common equity.

A. True

B. False

Answer	A
Difficulty	Remember
Learning outcome	LO 2.3
Bloom's taxonomy	Remember
AACSB	Analytical skills
Feedback	The weighted average cost of capital (WACC) is the marginal cost of funds, calculated as the weighted average of the costs of the different sources of capital (that is, debt,

preferred equity, and common equity).

72. Incentive plans are used to affiliate the best interests of CEOs and senior managers with those of shareholders.

A. True

B. False

Answer A

Difficulty Remember

Learning outcome LO 2.3

Bloom's taxonomy Remember

AACSB Analytical skills

Feedback Shareholders are more concerned with stock price, CEOs and managers are more concerned with earnings. The use of incentives makes a rising stock price more in the interest of CEOs and senior managers.

73. The set of processes and procedures established to manage the organization in the best interests of its owners is best described as an operating agreement.

A. True

B. False

Answer B

Difficulty Remember

Learning outcome LO 2.3

Bloom's taxonomy Remember

AACSB Analytical skills

Feedback This would be corporate governance, a set of processes and procedures established to manage the organization in the best interests of its owners.

74. The interests of CEOs and business managers can still be considered aligned with shareholders even if on the downside CEOs and managers do not suffer along with shareholders.

A. True

B. False

Answer B

Difficulty Remember

Learning outcome LO 2.3

Bloom's taxonomy Describe

AACSB Analytical skills

Feedback The important point to remember is that the interests of managers and shareholders are not aligned if, on the downside, managers do not suffer along with the shareholders.

75. Stock options do not properly align the interests of CEOs and business managers with shareholders.

A. True

B. False

Answer A

Difficulty	Moderate
Learning outcome	LO 2.3
Bloom's taxonomy	Describe
AACSB	Analytical skills
Feedback	Problems with aligning management's interests with shareholders' include the following:

- Few companies require executives to own the stock after exercising an option, so often the shares obtained with an option exercise are sold immediately.
- Some companies reprice the options if the stock's price is far under the original exercise price, setting the exercise price much below the original price.
- It is challenging to establish a plan that compensates executives for making long-term strategy and investment decisions today that take the long-run view of maximizing owners' equity.

The important point to remember is that the interests of managers and shareholders are not aligned if, on the downside, managers do not suffer along with the shareholders.

76. Finance people believe that the market for corporate control, not managerial incentives, ascertains that shareholder value creation is the company's objective.

- A. True  
B. False

Answer	A
Difficulty	Moderate
Learning outcome	LO 2.3
Bloom's taxonomy	Describe
AACSB	Analytical skills
Feedback	The best defense against a hostile takeover is a high stock price. This provides management incentive to maximize equity value.

77. Finance people believe that managerial incentives, not the market for corporate control ascertains that shareholder value creation is the company's objective.

- A. True  
B. False

Answer	B
Difficulty	Moderate
Learning outcome	LO 2.3
Bloom's taxonomy	Describe
AACSB	Analytical skills
Feedback	The best defense against a hostile takeover is a high stock price. This provides management incentive to maximize equity value.

78. Agency costs may arise because managers may not act in the best interests of shareholders or because they must be induced to act optimally.

- A. True  
B. False



Answer	A
Difficulty	Easy
Learning outcome	LO 2.3
Bloom's taxonomy	Remember
AACSB	Analytical skills
Feedback	Agency costs are <b>costs</b> associated with agency problems that arise with the separation of ownership and management of a business enterprise.

79. The investment in plant, property, and equipment are examples of operating assets.

- A. True
- B. False

Answer	B
Difficulty	Easy
Learning outcome	LO 2.4
Bloom's taxonomy	Describe
AACSB	Analytical skills
Feedback	operating assets -short-lived assets that support the company's long-term investments.

80. Cash, inventory, and accounts receivable are examples of working capital.

- A. True
- B. False

Answer	A
Difficulty	Easy
Learning outcome	LO 2.4
Bloom's taxonomy	Describe
AACSB	Analytical skills
Feedback	working capital - current, operating assets of a company; also known as operating assets

81. Interest-bearing obligations of an enterprise are equity capital.

- A. True
- B. False

Answer	B
Difficulty	Easy
Learning outcome	LO 2.4
Bloom's taxonomy	Remember
AACSB	Analytical skills
Feedback	Debt capital is the interest-bearing obligations of an enterprise.

82. Ownership interest of an enterprise is equity capital.

- A. True
- B. False

Answer	A
Difficulty	Easy
Learning outcome	LO 2.4
Bloom's taxonomy	Remember
AACSB	Analytical skills
Feedback	equity capital - ownership interest of an enterprise

83. Buying a new plant in Mexico is an investment decision.

- A. True
- B. False

Answer	A
Difficulty	Easy
Learning outcome	LO 2.4
Bloom's taxonomy	Describe
AACSB	Analytical skills
Feedback	These long-term investments include building a new plant, introducing a new product, and acquiring another company.

84. The more debt capital, relative to equity capital, the greater the company's financial risk.

- A. True
- B. False

Answer	A
Difficulty	Easy
Learning outcome	LO 2.4
Bloom's taxonomy	Describe
AACSB	Analytical skills
Feedback	Because debt obligates the company to pay interest and repay the principal amount of the loan—whereas no such obligation exists with stock—using debt introduces some risk. Therefore, the capital structure decision affects the financial risk of a company: the more debt capital, relative to equity capital, the greater the company's financial risk.

85. The uncertainty associated with the use of debt to finance an enterprise is financial risk.

- A. True
- B. False

Answer	A
Difficulty	Easy
Learning outcome	LO 2.4
Bloom's taxonomy	Remember
AACSB	Analytical skills
Feedback	financial risk - uncertainty associated with the use of debt to finance an enterprise.

## Short Answer

86. Describe what a limited liability company (LLC) is and the benefits of this form of business.

**Answer** limited liability company (LLC) - business organized as a separate legal entity in which owners have limited liability, but the income is passed through to the owners for tax purposes. Benefits are limited liability for the owners, unlimited life, income taxed only at the owner's level.

**Difficulty** Moderate

**Learning outcome** LO 2.1

**Bloom's taxonomy** Remember

**AACSB** Analytical skills

**Feedback** limited liability company (LLC) - business organized as a separate legal entity in which owners have limited liability, but the income is passed through to the owners for tax purposes. Benefits are limited liability for the owners, unlimited life, income taxed only at the owner's level.

87. Compare a Sub Chapter S Corporation and a limited liability company (LLC), and explain why a LLC is often viewed as a preferred form of business.

<b>Answer</b>	<b>Characteristic</b>	<b>Sub S</b>	<b>LLC</b>
	Taxation	Pass-through	Pass-through
	Ownership	Maximum of 75 shareholders	No maximum
	Liability	Limited liability	Limited liability
	Life	Perpetual	Limited

The Sub S status was once popular with small corporations, allowing them to avoid the double taxation that befalls corporations. However, with the widespread acceptance of limited liability companies, which accomplish this same tax treatment without such an election, the LLC is often viewed as a preferred form of business.

**Difficulty** Moderate

**Learning outcome** LO 2.1

**Bloom's taxonomy** Evaluation

**AACSB** Analytical skills

**Feedback**

<b>Characteristic</b>	<b>Subchapter S</b>	<b>LLC</b>
Taxation	Pass-through	Pass-through
Ownership	Maximum of 75 shareholders	No maximum
Liability	Limited liability	Limited liability
Life	Perpetual	Limited

The Sub S status was once popular with small corporations, allowing them to

avoid the double taxation that befalls corporations. However, with the widespread acceptance of limited liability companies, which accomplish this same tax treatment without such an election, the LLC is often viewed as a preferred form of business.

88. You are consulting with a start-up business. At your first meeting, the owner asks you why a business may be formed as a limited liability company instead of as a partnership. How would you answer the owner?

Answer

Characteristic	Partnership	LLC
Taxation	Pass-through	Pass-through
Ownership	No maximum	No maximum
Liability	Unlimited liability	Limited liability
Life	Perpetual	Limited

The primary advantage of a limited liability company over a partnership is the limited liability it possesses. Owners are limited in liability to the amount of their investment. In partnerships, owners have unlimited liability.

Difficulty  
Learning  
outcome  
Bloom's  
taxonomy  
AACSB  
Feedback

Moderate

LO 2.1

Evaluation

Analytical skills

The primary advantage of a limited liability company over a partnership is the limited liability it possesses. Owners are limited in liability to the amount of their investment. In partnerships, owners have unlimited liability.

89. Calculate the effective tax rate on corporate income using the following information.

Dividend Payout	50%
Corporate Tax Rate	40%
Shareholders' Tax on Corporate Income	15%

Answer 44.5%

Difficulty Moderate

Learning outcome LO 2.1

Bloom's taxonomy Application

AACSB Analytical skills

Feedback Effective tax rate on corporate income =  $t_c + [(1 - t_c) \text{DPO } t_i]$   
 $0.40 + [(1 - 0.4) \times 0.50 \times 0.15] = 0.445$

90. Calculate the effective tax rate on corporate income using the following information.

Dividend Payout	25%
Corporate Tax Rate	35%

Shareholders' Tax on Corporate Income      15%

Answer                      37.4%  
 Difficulty                  Moderate  
 Learning outcome       LO 2.1  
 Bloom's taxonomy      Application  
 AACSB                      Analytical skills  
 Feedback                  Effective tax rate on corporate income =  $t_c + [(1 - t_c) \text{DPO } t_i]$   
                                   $= 0.35 + [(1-0.35) \times 0.25 \times 0.15] = 0.374$

91. Calculate the effective tax rate on corporate income using the following information.

Dividend Payout                      30%  
 Corporate Tax Rate                   40%  
 Shareholders' Tax on Corporate Income      15%

Answer                      42.7%  
 Difficulty                  Moderate  
 Learning outcome       LO 2.1  
 Bloom's taxonomy      Application  
 AACSB                      Analytical skills  
 Feedback                  Effective tax rate on corporate income =  $t_c + [(1 - t_c) \text{DPO } t_i]$   
                                   $= 0.40 + [(1-0.4) \times 0.30 \times 0.15] = 0.427$

92. Fill in the blanks. Considerations in evaluating the form of business enterprise include liability, \_\_\_\_\_, control, and \_\_\_\_\_.

Answer                      taxation, continuity.  
 Difficulty                  Moderate  
 Learning outcome       LO 2.1  
 Bloom's taxonomy      Application  
 AACSB                      Analytical skills  
 Feedback                  Does not need to be in the same order as above. May use different terminology that means the same thing.

93. Calculate the effective tax rate on corporate income using the following information.

Dividend Payout                      30%  
 Corporate Tax Rate                   40%  
 Shareholders' Tax on Corporate Income      15%

Answer                      42.7%  
 Difficulty                  Moderate  
 Learning outcome       LO 2.1  
 Bloom's taxonomy      Application  
 AACSB                      Analytical skills  
 Feedback                  Effective tax rate on corporate income =  $t_c + [(1 - t_c) \text{DPO } t_i]$

$$= 0.40 + [(1-0.4) \times 0.30 \times 0.15] = 0.427$$

94. Who are the stakeholders of a university?

Answer Students, Employees, the State (if it is a state university), the community, potential employers, student loan lenders, owners of student housing, suppliers like textbook companies and food suppliers.

Difficulty Easy

Learning outcome LO 2.2

Bloom's taxonomy Describe

AACSB Analytical skills

Feedback A stakeholder is any party affected by the decisions and actions of an entity. Students may list the above and other possible answers.

95. Who are the stakeholders of a ski resort?

Answer Owners, creditors, ski equipment suppliers, local property owners, skiers, employees, local community, snowboarders, hotel and restaurant owners, local medical facilities.

Difficulty Easy

Learning outcome LO 2.2

Bloom's taxonomy Describe

AACSB Analytical skills

Feedback A stakeholder is any party affected by the decisions and actions of an entity. Students may list the above and other possible answers.

96. What is the goal of a publicly traded company?

Answer The goal of the company is to maximize market value of the equity interest or alternatively, maximize shareholder value.

Difficulty Easy

Learning outcome LO 2.2

Bloom's taxonomy Remember

AACSB Analytical skills

Feedback The goal of the company is to maximize market value of the equity interest or alternatively, maximize shareholder value.

97. List some typical incentive plans to align the best interests of CEOs and senior managers with those of shareholders?

Answer Salary, bonus, options

Difficulty Easy

Learning outcome LO 2.3

Bloom's taxonomy Describe

AACSB Analytical skills

Feedback The challenge is to design compensation schemes that encourage managers to act in the best interest of shareholders. The elements that are typically included are salary, bonus, and options.

98. What is wrong with using an incentive system that rewards managers based on earnings per share?

Answer Managers can manipulate earnings in the short run, this leads to a short term focus, which may not be in the best interest of the shareholders.

Difficulty Easy

Learning outcome LO 2.3

Bloom's taxonomy Describe

AACSB Analytical skills

Feedback The pressure to meet or exceed analysts' forecasts—or to insure making bonus targets—may encourage companies' management to manage or manipulate its reported financial statements. The reality is that companies most likely cannot always produce a pattern of smooth earnings over time and may not be able to meet or exceed analysts' forecasts each period.

99. Fill in the blanks. Financial management is the management of the \_\_\_\_\_ of a business or government entity, where financial resources include both the \_\_\_\_\_ of the entity, but also how the entity \_\_\_\_\_ these assets.

Answer Financial resources, investments, financing

Difficulty Moderate

Learning outcome LO 2.4

Bloom's taxonomy Remember

AACSB Analytical skills

Feedback Financial management is the management of the financial resources of a business or government entity, where financial resources include both the investments of the entity, but also how the entity finances these assets.

100. Why does changing a firm's capital structure to include more debt increase the risk to the firm?

Answer Because debt obligates the company to pay interest and repay the principal amount of the loan—whereas no such obligation exists with stock—using debt introduces some risk. Therefore, the capital structure decision affects the financial risk of a company: the more debt capital, relative to equity capital, the greater the company's financial risk.

Difficulty Moderate

Learning outcome LO 2.4

Bloom's taxonomy Describe

AACSB Analytical skills

Feedback Because debt obligates the company to pay interest and repay the principal amount of the loan—whereas no such obligation exists with stock—using debt introduces some risk. Therefore, the capital structure decision affects the financial risk of a company: the more debt capital, relative to equity capital, the greater the company's financial risk.