Chapter 1

Student: ____

1. The balance sheet is made up of what five key components:

A. fixed assets, current liabilities, long term debt, tangible current assets and shareholders equity.

B. intangible fixed assets, current liabilities, long term debt, net income and current assets.

C. fixed assets, long term debt, current assets, current liabilities and shareholders equity.

D. current assets, fixed assets, long term debt, shareholders equity and retained earnings.

2. In terms of the balance sheet model of the firm, the value of the firm in financial markets is equal to:

A. tangible fixed assets plus intangible fixed assets.

B. sales minus costs.

C. cash inflow minus cash outflow.

D. the value of the debt plus the value of the equity.

E. the value of the debt minus the value of the equity.

3. Inventory is a component of:

A. current assets.

B. current liabilities.

C. equity.

D. fixed assets.

4. Using the balance sheet model of the firm, finance may be thought of as analysis of three primary subject areas. Which of the following groups correctly lists these three areas?

A. Capital budgeting, capital structure, net working capital.

B. Capital budgeting, capital structure, security marketing.

C. Capital budgeting, net working capital, tax analysis.

D. Capital budgeting, tax analysis, security marketing.

E. Net working capital, tax analysis, security marketing.

5. Which of the following is not considered one of the basic questions of corporate finance?

A. What long-lived assets should the firm invest?

B. How much inventory should the firm hold?

C. How can the firm raise cash for required capital expenditures?

D. How should the short-term operating cash flows be managed?

6. The need to manage net working capital arises because:

A. financial management is naturally broken into those areas.

B. shareholders want to ensure they receive dividend payments.

C. there is a mismatch between the timing of cash inflows and cash outflows.

D. the sum of current assets and current liabilities usually is zero.

E. the capital structure pie is limited in size.

7. In the managerial structure of the corporation the two officers and their responsibilities that report directly to the Chief Financial Officer are:

A. the credit manager who handles accounts receivable and the tax manager who minimizes tax payments.
B. the personnel manager who manages salaries and compensation and the production operations manager who manages facility operations.
C. the treasurer who is responsible handling cash flow and making financial decisions and the tax manager who minimizes tax payments.
D. the controller who manages the accounting function and the treasurer who is responsible handling cash flow and making financial decisions.

8. Value is created and recognized over time if:

A. cash raised is invested in the investment activities of the firm.
B. funds are raised in the capital markets.
C. cash paid to investors, shareholders and bondholders, is greater than cash raised in the financial markets.
D. management pursues activities to reduce taxes to zero.

9. Time preference refers to the fact that:

A. corporations match current assets with current liabilities to minimize the chance of bankruptcy.
B. corporations match both current and long-term assets with current and long-term liabilities to minimize the change of bankruptcy.
C. investors prefer current cash flows to future cash flows.
D. investors seek to time cash flows to minimize tax liabilities.

10. A corporate security can be viewed as a contingent claim on the firm. This means that:

A. debt holders will receive their payoff from the firm based on their fixed claim or the firm cash flows if less than the fixed claim.

B. debt holders will receive the maximum of the firm cash flows or the fixed claim.

C. no payoff will be made unless the firms makes more than the fixed claim of the debt.

D. no debt payoff will be made if there is an equity payoff.

11. If a firm has debt outstanding the contingent claim of an equity shareholder is:

A. equal to the payment to the debtholders

B. equal to the firm cash flows minus the fixed debt payment if the residual cash flows are positive

C. equal to the firm cash flows minus the fixed debt payment whether positive or negative

D. equal to the debt payment plus the residual cash flow of the firm.

12. The Simple Corporation has outstanding obligation to the Complex Corporation of $250. It is year-end and the total cash flow of Simple from all sources is $325. The contingent payoff to the debtholders and the equity shareholders is:

A. $250; $325.

B. $75; $250.

C. $250; $75.

D. $325; $250.

13. The general partner(s) in a general partnership agree to share work, costs and profits and losses. Each partner:

A. has liability only up to the amount of their investment.
B. has liability for the debts of the partnership.
C. has liability only if it is formally documented.
D. never has any liability but the limited partners do.

14. The division of profits and losses among the members of a partnership is formalized in the:

A. indemnity clause.
B. indenture contract.
C. statement of purpose.
D. partnership agreement.

15. The Splitz Corporation has borrowed $5 million in debt with a promise to repay $5.5 million in one year. The corporation had 10 million shares outstanding worth $2 each at the time of the borrowing. Splitz earns $6 million during the year. What is the debtholder's contingent claim; how much do the debtholders receive; and, how much do the equity holders receive?

A. 5.5; 6; 20.
B. 5; 5.5; 0.
C. 5; 5.5; 20.
D. 5.5; 5.5; .5.

16. The Splitz Corporation has borrowed $5 million in debt with a promise to repay $5.5 million in one year. The corporation had 10 million shares outstanding worth $2 each at the time of the borrowing. Splitz earns $5 million during the year. What is the debtholder's contingent claim; how much does the debtholder receive; and, how much do the equity holders receive?

A. 5; 5.5; 20.

B. 5.5; 5; 0.

C. 5; -.5; 20.

D. -.5; 5; 0.

17. Corporate securities are contingent claims because:

A. they don't represent a direct claim on the firm.

B. the firm may be bought out.

C. the securities value is derived from the total value of the firm.

D. book value can be negative.

18. Agency costs as the sum costs of:

A. monitoring costs of the shareholders and the residual loss of wealth due to divergent management behavior.

B. the costs of implementing control devices and the monitoring costs of the shareholders.

C. the costs of implementing control devices and the residual loss of wealth due to divergent management behavior.

D. the set-of-contracts needed to structure the firm and residual wealth.

19. Agency costs refer to:

A. the total dividends paid to stockholders over the lifetime of a firm.

B. the costs that result from default and bankruptcy of a firm.

C. corporate income subject to double taxation.

D. the costs of any conflicts of interest between stockholders and management.

E. the total interest paid to creditors over the lifetime of the firm.

20. Managerial goals may differ from those of the shareholders. It is noted that managers may:

A. have a preference for expense consumption.

B. be motivated by controlling sufficient resources to stay in business.

C. avoid the control of the capital market and rely on internally generated funds.

D. be wanted to depend on external parties.

21. What is the primary goal of the corporation?

A. Maximize the pay and compensation of employees and managers of the firm.

B. Maximize the value of the stockholders as they are the owners of the corporation.

C. Minimize the wealth of the shareholders and maximize the wealth of managers.

D. Maximize the societal value to minimize governmental interference.

22. Financial markets are composed of:

A. capital markets and equity markets.

B. capital markets and debt markets.

C. capital markets and money markets.

D. equity markets and money markets.

23. The primary market is defined as:

A. the market for insured securities.

B. the market for new issues.

C. the market for securities of the largest firms.

D. the over-the-counter market.

24. Which one of the following is a primary market transaction?

A. A dealer selling shares of stock to an individual investor.

B. A dealer buying newly issued shares of stock from a corporation.

C. An individual investor selling shares of stock to another individual.

D. A bank selling shares of a medical firm to an individual.

25. Flea Fall Inc., a maker of dog flea collars, paid $125,000 cash for inventory on January 1, 2014. On December 31, 2014, the company's sales total $147,000 of which $117,000 has been collected. If inventory represents Flea Falls only cost, calculate the firms accounting profit as well as its cash flow as of December 31.

26. The Harlow Corporation has promised to pay its debtholders an amount of $2,700 over the next year. The firm's shareholders hold claim to whatever is left after the debtholders' claims have been satisfied. Calculate Harlow's debt and equity level if its assets total $1100 at the end of the year. Recalculate for asset levels of $2,200 and $6,000.

27. A financial manager's most important job is to create value from capital budgeting, financing, and liquidity activities. Explain how financial managers create value.

28. The decision to incorporate must consider the fact that earnings will be taxed at both the corporate and personal levels. Since this is disadvantageous, provide three reasons why one may want to incorporate.

29. How can shareholders attempt to control managerial behavior to match shareholder interest?

30. Do you think agency problems arise in sole proprietorships and/or partnerships?

31. If the corporate form of business organization has so many advantages over the sole proprietorship, why is it so common for small businesses to initially be formed as sole proprietorships?

Chapter 1 Key

1. The balance sheet is made up of what five key components:

A. fixed assets, current liabilities, long term debt, tangible current assets and shareholders equity.

B. intangible fixed assets, current liabilities, long term debt, net income and current assets.

C. fixed assets, long term debt, current assets, current liabilities and shareholders equity.

D. current assets, fixed assets, long term debt, shareholders equity and retained earnings.

Accessibility: Keyboard Navigation
Difficulty: Medium
Learning Objective: 01-01 What Is Corporate Finance?
Ross - Chapter 01 #1

2. In terms of the balance sheet model of the firm, the value of the firm in financial markets is equal to:

A. tangible fixed assets plus intangible fixed assets.

B. sales minus costs.

C. cash inflow minus cash outflow.

D. the value of the debt plus the value of the equity.

E. the value of the debt minus the value of the equity.

Accessibility: Keyboard Navigation
Difficulty: Easy
Learning Objective: 01-01 What Is Corporate Finance?
Ross - Chapter 01 #2

3. Inventory is a component of:

A. current assets.

B. current liabilities.

C. equity.

D. fixed assets.

Accessibility: Keyboard Navigation

Difficulty: Easy

Learning Objective: 01-01 What Is Corporate Finance?

Ross - Chapter 01 #3

4. Using the balance sheet model of the firm, finance may be thought of as analysis of three primary subject areas. Which of the following groups correctly lists these three areas?

A. Capital budgeting, capital structure, net working capital.

B. Capital budgeting, capital structure, security marketing.

C. Capital budgeting, net working capital, tax analysis.

D. Capital budgeting, tax analysis, security marketing.

E. Net working capital, tax analysis, security marketing.

Accessibility: Keyboard Navigation

Difficulty: Easy

Learning Objective: 01-01 What Is Corporate Finance?

Ross - Chapter 01 #4

5. Which of the following is not considered one of the basic questions of corporate finance?

A. What long-lived assets should the firm invest?

B. How much inventory should the firm hold?

C. How can the firm raise cash for required capital expenditures?

D. How should the short-term operating cash flows be managed?

Accessibility: Keyboard Navigation
Difficulty: Easy
Learning Objective: 01-01 What Is Corporate Finance?
Ross - Chapter 01 #5

6. The need to manage net working capital arises because:

A. financial management is naturally broken into those areas.

B. shareholders want to ensure they receive dividend payments.

C. there is a mismatch between the timing of cash inflows and cash outflows.

D. the sum of current assets and current liabilities usually is zero.

E. the capital structure pie is limited in size.

Accessibility: Keyboard Navigation
Difficulty: Easy
Learning Objective: 01-01 What Is Corporate Finance?
Ross - Chapter 01 #6

7. In the managerial structure of the corporation the two officers and their responsibilities that report directly to the Chief Financial Officer are:

A. the credit manager who handles accounts receivable and the tax manager who minimizes tax payments.

B. the personnel manager who manages salaries and compensation and the production operations manager who manages facility operations.

C. the treasurer who is responsible handling cash flow and making financial decisions and the tax manager who minimizes tax payments.

D. the controller who manages the accounting function and the treasurer who is responsible handling cash flow and making financial decisions.

Accessibility: Keyboard Navigation
Difficulty: Easy
Learning Objective: 01-01 What Is Corporate Finance?
Ross - Chapter 01 #7

8. Value is created and recognized over time if:

A. cash raised is invested in the investment activities of the firm.

B. funds are raised in the capital markets.

C. cash paid to investors, shareholders and bondholders, is greater than cash raised in the financial markets.

D. management pursues activities to reduce taxes to zero.

Accessibility: Keyboard Navigation
Difficulty: Medium
Learning Objective: 01-01 What Is Corporate Finance?
Ross - Chapter 01 #8

9. Time preference refers to the fact that:

A. corporations match current assets with current liabilities to minimize the chance of bankruptcy.

B. corporations match both current and long-term assets with current and long-term liabilities to minimize the change of bankruptcy.

<u>C.</u> investors prefer current cash flows to future cash flows.

D. investors seek to time cash flows to minimize tax liabilities.

Accessibility: Keyboard Navigation
Difficulty: Medium
Learning Objective: 01-01 What Is Corporate Finance?
Ross - Chapter 01 #9

10. A corporate security can be viewed as a contingent claim on the firm. This means that:

<u>A.</u> debt holders will receive their payoff from the firm based on their fixed claim or the firm cash flows if less than the fixed claim.

B. debt holders will receive the maximum of the firm cash flows or the fixed claim.

C. no payoff will be made unless the firms makes more than the fixed claim of the debt.

D. no debt payoff will be made if there is an equity payoff.

Accessibility: Keyboard Navigation
Difficulty: Medium
Learning Objective: 01-02 Corporate Securities as Contingent Claims on Total Firm Value
Ross - Chapter 01 #10

11. If a firm has debt outstanding the contingent claim of an equity shareholder is:

A. equal to the payment to the debtholders

B. equal to the firm cash flows minus the fixed debt payment if the residual cash flows are positive

C. equal to the firm cash flows minus the fixed debt payment whether positive or negative

D. equal to the debt payment plus the residual cash flow of the firm.

Accessibility: Keyboard Navigation

Difficulty: Medium

Learning Objective: 01-02 Corporate Securities as Contingent Claims on Total Firm Value

Ross - Chapter 01 #11

12. The Simple Corporation has outstanding obligation to the Complex Corporation of $250. It is year-end and the total cash flow of Simple from all sources is $325. The contingent payoff to the debtholders and the equity shareholders is:

A. $250; $325.

B. $75; $250.

C. $250; $75.

D. $325; $250.

Accessibility: Keyboard Navigation

Difficulty: Medium

Learning Objective: 01-02 Corporate Securities as Contingent Claims on Total Firm Value

Ross - Chapter 01 #12

13. The general partner(s) in a general partnership agree to share work, costs and profits and losses. Each partner:

A. has liability only up to the amount of their investment.

B. has liability for the debts of the partnership.

C. has liability only if it is formally documented.

D. never has any liability but the limited partners do.

Accessibility: Keyboard Navigation
Difficulty: Medium
Learning Objective: 01-03 The Corporate Firm
Ross - Chapter 01 #13

14. The division of profits and losses among the members of a partnership is formalized in the:

A. indemnity clause.

B. indenture contract.

C. statement of purpose.

D. partnership agreement.

Accessibility: Keyboard Navigation
Difficulty: Easy
Learning Objective: 01-03 The Corporate Firm
Ross - Chapter 01 #14

15. The Splitz Corporation has borrowed $5 million in debt with a promise to repay $5.5 million in one year. The corporation had 10 million shares outstanding worth $2 each at the time of the borrowing. Splitz earns $6 million during the year. What is the debtholder's contingent claim; how much do the debtholders receive; and, how much do the equity holders receive?

A. 5.5; 6; 20.

B. 5; 5.5; 0.

C. 5; 5.5; 20.

<u>D.</u> 5.5; 5.5; .5.

Accessibility: Keyboard Navigation
Difficulty: Medium
Learning Objective: 01-03 The Corporate Firm
Ross - Chapter 01 #15

16. The Splitz Corporation has borrowed $5 million in debt with a promise to repay $5.5 million in one year. The corporation had 10 million shares outstanding worth $2 each at the time of the borrowing. Splitz earns $5 million during the year. What is the debtholder's contingent claim; how much does the debtholder receive; and, how much do the equity holders receive?

A. 5; 5.5; 20.

<u>B.</u> 5.5; 5; 0.

C. 5; -.5; 20.

D. -.5; 5; 0.

Accessibility: Keyboard Navigation
Difficulty: Medium
Learning Objective: 01-03 The Corporate Firm
Ross - Chapter 01 #16

17. Corporate securities are contingent claims because:

A. they don't represent a direct claim on the firm.

B. the firm may be bought out.

C. the securities value is derived from the total value of the firm.

D. book value can be negative.

Accessibility: Keyboard Navigation
Difficulty: Hard
Learning Objective: 01-02 Corporate Securities as Contingent Claims on Total Firm Value
Ross - Chapter 01 #17

18. Agency costs as the sum costs of:

A. monitoring costs of the shareholders and the residual loss of wealth due to divergent management behavior.

B. the costs of implementing control devices and the monitoring costs of the shareholders.

C. the costs of implementing control devices and the residual loss of wealth due to divergent management behavior.

D. the set-of-contracts needed to structure the firm and residual wealth.

Accessibility: Keyboard Navigation
Difficulty: Hard
Learning Objective: 01-04 Goals of the Corporate Firm
Ross - Chapter 01 #18

19. Agency costs refer to:

A. the total dividends paid to stockholders over the lifetime of a firm.

B. the costs that result from default and bankruptcy of a firm.

C. corporate income subject to double taxation.

D. the costs of any conflicts of interest between stockholders and management.

E. the total interest paid to creditors over the lifetime of the firm.

Accessibility: Keyboard Navigation
Difficulty: Easy
Learning Objective: 01-04 Goals of the Corporate Firm
Ross - Chapter 01 #19

20. Managerial goals may differ from those of the shareholders. It is noted that managers may:

A. have a preference for expense consumption.

B. be motivated by controlling sufficient resources to stay in business.

C. avoid the control of the capital market and rely on internally generated funds.

D. be wanted to depend on external parties.

Accessibility: Keyboard Navigation
Difficulty: Hard
Learning Objective: 01-04 Goals of the Corporate Firm
Ross - Chapter 01 #20

21. What is the primary goal of the corporation?

A. Maximize the pay and compensation of employees and managers of the firm.

B. Maximize the value of the stockholders as they are the owners of the corporation.

C. Minimize the wealth of the shareholders and maximize the wealth of managers.

D. Maximize the societal value to minimize governmental interference.

Accessibility: Keyboard Navigation

Difficulty: Easy

Learning Objective: 01-04 Goals of the Corporate Firm

Ross - Chapter 01 #21

22. Financial markets are composed of:

A. capital markets and equity markets.

B. capital markets and debt markets.

<u>C.</u> capital markets and money markets.

D. equity markets and money markets.

Accessibility: Keyboard Navigation

Difficulty: Easy

Learning Objective: 01-05 Financial Institutions; Financial Markets; and the Corporation

Ross - Chapter 01 #22

23. The primary market is defined as:

A. the market for insured securities.

<u>B.</u> the market for new issues.

C. the market for securities of the largest firms.

D. the over-the-counter market.

Accessibility: Keyboard Navigation

Difficulty: Easy

Learning Objective: 01-05 Financial Institutions; Financial Markets; and the Corporation

Ross - Chapter 01 #23

24. Which one of the following is a primary market transaction?

A. A dealer selling shares of stock to an individual investor.

B. A dealer buying newly issued shares of stock from a corporation.

C. An individual investor selling shares of stock to another individual.

D. A bank selling shares of a medical firm to an individual.

Accessibility: Keyboard Navigation
Difficulty: Medium
Learning Objective: 01-05 Financial Institutions; Financial Markets; and the Corporation
Ross - Chapter 01 #24

25. Flea Fall Inc., a maker of dog flea collars, paid $125,000 cash for inventory on January 1, 2014. On December 31, 2014, the company's sales total $147,000 of which $117,000 has been collected. If inventory represents Flea Falls only cost, calculate the firms accounting profit as well as its cash flow as of December 31.

Accounting Profit = Sales - Cost ($147,000 - $125,000 = $22,000)
Cash Flow = Cash Inflow-Cash Outflow ($117,000 - $125,000 = $8,000)

Difficulty: Medium
Learning Objective: 01-01 What Is Corporate Finance?
Ross - Chapter 01 #25

26. The Harlow Corporation has promised to pay its debtholders an amount of $2,700 over the next year. The firm's shareholders hold claim to whatever is left after the debtholders' claims have been satisfied. Calculate Harlow's debt and equity level if its assets total $1100 at the end of the year. Recalculate for asset levels of $2,200 and $6,000.

If assets total $1100: Value of Debt = $1100, Value of Equity = $0
If assets total $2200: Value of Debt = $2200, Value of Equity = $0
If assets total $6000: Value of Debt = $2700, Value of Equity = $3300

Difficulty: Medium
Learning Objective: 01-01 What Is Corporate Finance?
Ross - Chapter 01 #26

27. A financial manager's most important job is to create value from capital budgeting, financing, and liquidity activities. Explain how financial managers create value.

Buy assets that generate more than their cost.
Sell financial securities that raise more cash than they cost.
Minimize cash payouts to non-investors, ie., taxes to governments.

Difficulty: Medium
Learning Objective: 01-01 What Is Corporate Finance?
Ross - Chapter 01 #27

28. The decision to incorporate must consider the fact that earnings will be taxed at both the corporate and personal levels. Since this is disadvantageous, provide three reasons why one may want to incorporate.

Easier access to capital markets.

Retention of funds for reinvestment opportunities.

Market pricing and trading of securities.

Difficulty: Hard

Learning Objective: 01-03 The Corporate Firm

Ross - Chapter 01 #28

29. How can shareholders attempt to control managerial behavior to match shareholder interest?

Vote for directors with shareholder's interest to select management.

Provide incentive contracts; performance shares or options.

Outside threat of takeover, (Board should not be willing to launch poison pills.)

Managerial labor market.

Difficulty: Hard

Learning Objective: 01-04 Goals of the Corporate Firm

Ross - Chapter 01 #29

30. Do you think agency problems arise in sole proprietorships and/or partnerships?

Agency conflicts typically arise when there is a separation of ownership and management of a business. In a sole proprietorship and a small partnership, such separation is not likely to exist to the degree it does in a corporation. However, there is still potential for agency conflicts. For example, as employees are hired to represent the firm, there is once again a separation of ownership and management.

Difficulty: Hard
Learning Objective: 01-04 Goals of the Corporate Firm
Ross - Chapter 01 #30

31. If the corporate form of business organization has so many advantages over the sole proprietorship, why is it so common for small businesses to initially be formed as sole proprietorships?

A significant advantage of the sole proprietorship is that it is cheap and easy to form. If the sole proprietor has limited capital to start with, it may not be desirable to spend part of that capital forming a corporation. Also, limited liability for business debts may not be a significant advantage if the proprietor has limited capital, most of which is tied up in the business anyway. Finally, for a typical small business, the heart and soul of the business is the person who founded it, so the life of the business may effectively be limited to the life of the founder during its early years.

Difficulty: Medium
Learning Objective: 01-03 The Corporate Firm
Ross - Chapter 01 #31

Chapter 1 Summary

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