**Chapter 2: Business (Corporate) Finance**

**Multiple Choice Questions**

1. Section: 2.1 Types of Business Organizations

Learning Objective 2.1

Level of difficulty: Medium

Solution: D

Most partnerships are formed in the professional services areas such as in accounting, investment banking, and medical professions. Factories (including a foundry) are the least likely to be operated as a partnership.

2. Section: 2.1 Types of Business Organizations

Learning Objective 2.1

Level of difficulty: Medium

Solution: B

The limited and general partnerships are generally formed for tax reasons. However, as long as a trust pays out all its income to its income holders, and owns the debt and equity, the use of debt can be maximized to reduce or eliminate corporate income tax.

3. Section: 2.1 Types of Business Organizations

Learning Objective 2.1

Level of difficulty: Medium

Solution: D

In a sole proprietorship, income is taxed at the personal tax rate.

4. Section: 2.1 Types of Business Organizations

Learning Objective 2.1

 Level of difficulty: Medium

Solution: A

A trust has more tax advantages than a corporation because income passes through trusts without any corporate tax to the unit owners. Unit holders pay tax on the income received. It avoids the double taxation of a corporation.

5. Section: 2.1 Types of Business Organizations

Learning Objective 2.1

Level of difficulty: Medium

Solution: A. The corporate form is the most popular form of business. While its ownership and control are separated, it does have double taxation in that both the income of the business and income passed to shareholders are taxed.

6. Section: 2.2 The Goals of the Corporation

Learning Objective 2.2

Level of difficulty: Medium

Solution: C

The goal of a corporation is to maximize shareholders’ wealth.

7. Section: 2.3 The Role of Management and Agency Issues

Learning Objective 2.3

Level of difficulty: Medium

Solution: D

Market prices are the main concern of shareholders.

8 Section: 2.3 The Role of Management and Agency Issues

Learning Objective 2.3

Level of difficulty: Medium

Solution: B

9. Section: 2.3 The Role of Management and Agency Issues

Learning Objective 2.3

Level of difficulty: Medium

Solution: A.

10. Section: 2.4 Corporate Finance

Learning Objective 2.5

Level of difficulty: Medium

Solution: A

All except choice A are concerns of capital budgeting.

11. Section: 2.5 Finance Careers and the Organization of the Finance Function

Learning Objective 2.6

Level of difficulty: Easy

Solution: B

Generally speaking the treasurer does finance-related activities while the controller and accountant do the accounting-related activities.

12. Section: 2.5 Finance Careers and the Organization of the Finance Function

Learning Objective 2.6

Level of difficulty: Medium

Solution: B

The treasurer would usually have the responsibility of credit management.

**Practice Problems**

13. Section: 2.1 Types of Business Organizations

Learning Objective 2.1

Level of difficulty: Easy

Solution:

The four major forms of business organization are:

i) Sole proprietorship – a business owned and operated by one person

ii) Partnership – a business owned and operated by two or more people

iii) Trust – a legal organization where assets are owned and managed, or controlled by different parties

iv) Corporation – a business organized as a separate legal entity under corporation law, with ownership divided into transferable shares

14. Section: 2.1 Types of Business Organizations

Learning Objective 2.1

Level of difficulty: Medium

Solution: The differences are as follows:

First, a sole proprietorship is owned and operated by one person, but a partnership is owned and operated by two or more people.

Second, a sole proprietorship is easier to set up than a partnership.

The similarities are as follows:

First, in both forms, the owner is not separate from the business and therefore has unlimited liability.

Second, income from the business is taxed at the personal tax rate.

15. Section: 2.1 Types of Business Organizations

Learning Objective 2.1

Level of difficulty: Medium

Solution: First, a corporation is a distinct legal identity, which means its life can continue on indefinitely. Second, there is a very clear separation between ownership and control of the corporation. Third, corporate owners have limited liability whereas sole proprietors have unlimited liability.

16. Section: 2.1 Types of Business Organizations

Learning Objective 2.1

Level of difficulty: Medium

Solution: Every director and officer of a corporation in exercising their powers and discharging their duties shall:

(a) Act honestly and in good faith with a view to the best interests of the corporation; and

(b) Exercise the care, diligence, and skill that a reasonably prudent person would exercise in comparable circumstances.

17. Section: 2.1 Types of Business Organizations

Learning Objective 2.1

Topic: Types of Business Organizations

Level of difficulty: Medium

Solution:

The fall in the unit price was mirrored by an increase in the yield. The new yield was ($1.03/$12.26) = 8.4% per year.

18. Section: 2.1 Types of Business Organizations

Learning Objective 2.1

Topic: Limited Liability (Types of Business Organizations)

Level of difficulty: Medium

Solution:

When operating as a sole proprietorship, all of the assets of the company belong to the owner; the company’s debts are also the owner’s debts. Janice will have to pay her friends and family (the debtholders) the full $100,000 they are owed. This will leave her with $8,000.

A corporation exists independently from its owners. The $108,000 obtained from selling the assets will first be used to pay the debtholders what they are owed. Any remaining funds will be paid to Janice. Because the value of the assets is greater than the money owed to the debtholders, the payments are the same as they were with the sole proprietorship.

19. Section: 2.1 Types of Business Organizations

Learning Objective 2.1

Topic: Limited Liability (Types of Business Organizations)

Level of difficulty: Medium

Solution:

The debtholders will receive the entire $93,000 obtained from selling the assets. The remaining $7,000 that they were owed will not be paid because the company has no more funds. Furthermore, the limited liability of shareholders in a corporation means that the debtholders have no legal right to expect Janice to pay them the rest of the money. Nonetheless, Janice receives nothing from the asset sale.

If the business were a sole proprietorship, the debtholders would receive the $93,000 from the sale of assets. However, they would also have the right to force Janice to pay them the extra $7,000 they were owed. Janice would not only receive no money from the sale of the assets, she would have to pay the extra $7,000!

20. Section: 2.3 The Role of Management and Agency Issues

Learning Objective 2.4

Level of difficulty: Medium

Solution: They differ in four areas.

1) Performance appraisal: Managers use accounting numbers like the return on investment or cash while shareholders use market prices.

2) Investment analysis: Managers use the IRR of the best division while shareholders use the external WACC.

3) The order of financing: Managers prefer retentions to debt and prefer debt to new equity while shareholders prefer debt first.

4) Risk concern: Managers are concerned with the preservation of the firm while shareholders are concerned about their portfolios.

21. Section: 2.3 The Role of Management and Agency Issues

Learning Objective 2.4

Topic: Agency Issues

Level of difficulty: Medium

Solution:

Dan is likely to prefer Project A because it will result in a $5,000 annual bonus for him, whereas Project B would provide only a $4,000 annual bonus. On the other hand, you (the owner) would be better off choosing Project B as it creates more value.

22. Section: 2.3 The Role of Management and Agency Issues

Learning Objective 2.4

Topic: Agency Issues

Level of Difficulty: Difficult

Solution:

Referring to Table 2-3, the major components of income are straight salary, annual bonus, share receipts or options, and other. Notice that in all cases, straight salary compensation is relatively low compared with the total package. Annual bonuses are generally somewhat larger, but the largest component by far in most cases is share compensation. This comes in two forms: grants of restricted stock awarded under incentive plans, and stock options, for which if the company’s stock price goes above a certain level, the executive gets the right to buy the stock at a fixed lower price.

23. Section: 2.3 The Role of Management and Agency Issues

Learning Objective 2.4

Topic: Agency Issues

Level of Difficulty: Medium

Solution:

The idea behind a stock option plan is simply to have the best interests of CEOs and senior managers coincide with those of shareholders. But the actual impact is doubtful. In reality, when a company’s stock falls and makes existing options worthless, new ones are granted to continue to provide incentive for managers.

Additionally, some companies were investigated by regulatory institutions on the “back-dating” stock option issue. The fraud was that senior managers would get the compensation committee to award them stock options and then date them to an earlier period when the company’s stock price was low. Effectively, this meant that on the approval date, the stock was already worth a large amount of money, so there was little incentive value to the grant.

24. Section: 2.4 Corporate Finance

Learning Objective 2.5

Topic: Corporate Finance

Level of Difficulty: Medium

Solution:

Capital budgeting considers some basic questions:

1. How does a firm decide to expand its existing buildings or to construct or buy another building?

2. How does a firm decide to replace machinery and equipment? Just because it still works, does this mean that the firm should still use it?

3. How does a firm decide whether to buy or lease machinery and equipment?

4. How much stock or inventory should a firm carry? Should it keep stocks to meet every contingency or perhaps use just-in-time methods to reduce the investment?

25. Section: 2.4 Corporate Finance

Learning Objective 2.5

Topic: Corporate Finance

Level of Difficulty: Medium

Solution:

Financial management includes the following areas.

1. How do firms decide to extend credit to customers to purchase their product?

2. How do firms manage their cash? This is a non-interest-bearing asset, so it seems that it should be minimized, but corporations have considerable amounts of money on deposit at banks.

3. How do firms manage any temporary surplus cash?

4. Finally, why do firms take minority stakes in other firms, or more generally, how do they decide to buy 100 percent or less of another firm? This question leads us into corporate acquisitions and valuation.

26. Section: 2.4 Corporate Finance

Learning Objective 2.5

Topic: Corporate Finance

Level of Difficulty: Medium

Solution:

Corporate financing considers the following basic questions.

1. How does a firm decide between raising money through debt or equity?

2. In terms of equity how does it raise the equity: through retaining earnings or through issuing new equity?

3. In fact, how does a firm decide to go public and issue shares to the general public versus remaining a non-traded private company?

4. If it decides to issue debt, what determines whether this is bank debt or bonds issued to the public debt market?

5. What determines whether firms access the short-term money market versus borrowing from a bank?

27. Section: 2.5 Finance Careers and the Organization of the Finance Function

Learning Objective 2.6

Topic: Finance career and the organization of the finance function

Level of Difficulty: Medium

Solution:

The major jobs available in the financial industry include analysts, associates, managers, account managers, banking associates, security analysts, sales and trading people, private bankers, retail bankers, financial and investment analysts, portfolio managers, fixed income or equity traders, corporate finance associates and consultants. With financial innovations, more jobs are created.

28. Section: 2.5 Finance Careers and the Organization of the Finance Function

Learning Objective 2.6

Level of difficulty: Medium

Solution: The most senior person is the chief financial officer (CFO), or in more traditional companies, the senior vice-president of finance. Under the CFO are the two main finance jobs: the treasurer and the controller. The treasurer is responsible for forecasting, pension management, capital budgeting, cash management, credit management, financing, and risk management. The controller focuses on accounting issues such as compliance, tax management, internal auditing, and budgeting.

29. Section: 2.5 Finance Careers and the Organization of the Finance Function

Learning Objective 2.6

Topic: Corporate Finance and Finance Careers

Level of Difficulty: Medium

Solution:

The controller’s numbers indicate that the computer system will add ($60,000 – $50,000) = $10,000 of value to the firm. That would indicate that you should proceed with the purchase.

In general, the corporate treasurer has responsibility for capital budgeting decisions of this sort, including estimating costs and savings, determining the need for financing, and considering any risks involved. In this case, the interest expense identified by the treasurer brings the net value created down to –$1,000. It would be best to heed the treasurer and not purchase the computer system.