**1)** The board of directors is ultimately responsible for all investment decisions.

⊚ true  
 ⊚ false

**2)** A corporation has a legal existence of its own and is based on "articles of incorporation."

⊚ true  
 ⊚ false

**3)** Real assets of a corporation are claims on their financial assets.

⊚ true  
 ⊚ false

**4)** A firm's total asset value belongs entirely to the shareholders.

⊚ true  
 ⊚ false

**5)** Managers, shareholders, and the firm's debtholders have identical information about the value of the firm.

⊚ true  
 ⊚ false

**6)** This book is mainly about:

A) financial decisions made by corporations.   
 B) financial decisions made by households.  
 C) financial decisions made by governments.  
 D) financial decisions made by employees.

**7)** Shareholders of a corporation may be:

A) individuals only.   
 B) individuals and pension funds only.  
 C) pension funds only.  
 D) individuals, pension funds, and insurance companies.

**8)** Generally, a corporation is owned by its:

A) managers.   
 B) board of directors and shareholders.  
 C) shareholders.  
 D) managers, board of directors, and shareholders.

**9)** A corporation, potentially, has infinite life because it;

A) is a legal entity.   
 B) has the same ownership and management.  
 C) has limited liability.  
 D) is closely regulated.

**10)** Limited liability is an important feature of:

A) sole proprietorships.   
 B) partnerships.  
 C) corporations.  
 D) both partnerships and corporations.

**11)** As a legal entity, a corporation can perform the following functions EXCEPT:

A) borrow money and lend money.   
 B) borrow money, lend money, and sue and be sued.  
 C) vote.  
 D) borrow money, lend money, sue and be sued, and vote.

**12)** Which of the following assets is tangible?

A) ExxonMobil's corporate headquarters building   
 B) Apple Incorporated's trademark  
 C) Hewlett-Packard's most recent printer patent  
 D) Microsoft's technical expertise

**13)** Which of the following types of assets are intangible?

A) production machinery   
 B) factories  
 C) trademarks  
 D) office equipment

**14)** A firm's investment decision is also called its:

A) financing decision.   
 B) liquidity decision.  
 C) capital budgeting decision.  
 D) leasing decision.

**15)** Which of the following is not a financial asset?

A) common stock   
 B) bank loans   
 C) preferred stock  
 D) buildings

**16)** Which of the following is an important function of financial markets?

A) providing financing   
 B) providing financing and liquidity  
 C) providing financing, providing liquidity, reducing risk, and providing information  
 D) providing information

**17)** Disadvantages of the corporate form include:

A) agency costs.   
 B) double taxation.  
 C) cost of managing the corporation.  
 D) all of the options.

**18)** In the principal-agent framework:

A) shareholders are the principals.   
 B) managers are the principals.  
 C) managers are the agents and principals.  
 D) shareholders are the principals and managers are the agents.

**19)** Costs associated with the conflicts of interest between the managers and the shareholders of a corporation are called:

A) legal costs.   
 B) bankruptcy costs.  
 C) administrative costs.  
 D) agency costs.

**20)** A corporation may incur agency costs because:

A) managers may not attempt to maximize the value of the firm to shareholders.   
 B) shareholders incur monitoring costs.  
 C) of the separation of ownership and management.  
 D) all of the responses are correct.

**21)** The following groups are some of the claimants to a firm's income stream:

A) shareholders and bondholders only.   
 B) shareholders, bondholders, and employees only.  
 C) shareholders, bondholders, employees, and management only.  
 D) shareholders, bondholders, employees, management, and government.

**22)** The financial goal of a corporation is to:

A) maximize short-run profits.   
 B) maximize sales.  
 C) maximize the value of the firm for the shareholders.  
 D) maximize managers' benefits.

**23)** The firm's purchase of real assets is also referred to as the:

A) capital structure decision.   
 B) CFO decision.  
 C) financing decision.  
 D) capital investment decision.

**24)** The sale of financial assets by a corporation is also referred to as the:

A) capital budgeting decision.   
 B) CFO decision.  
 C) financing decision.  
 D) investment decision.

**25)** The choice of the proper mixture of debt and equity, used to finance a corporation, is also referred to as the:

A) capital budgeting decision.   
 B) capital structure decision.  
 C) investment decision.  
 D) liquidity decision.

**26)** Which of the following groups are referred to as stakeholders?

A) employees, customers, and suppliers only   
 B) shareholders only  
 C) employees and customers only  
 D) employees, customers, shareholders, and suppliers

**27)** The following are examples of real assets:

A) machinery, office buildings, and warehouses only.   
 B) machinery and office buildings only.  
 C) common stock only.  
 D) machinery only.

**28)** The following are examples of tangible assets except:

A) machinery only.   
 B) machinery and office buildings only.  
 C) training courses for employees only.  
 D) machinery, office buildings, and warehouses only.

**29)** The ultimate financial goal of a corporation is to:

A) minimize stockholder risk.   
 B) maximize short-run profit.  
 C) maximize the value of the corporation to the stockholders.  
 D) increase size of the firm.

**30)** Mr. Free has $100 in income this year and will have zero income next year. The market interest rate is 10 percent per year. If Mr. Free consumes $30 this year and invests the rest in the market, what will be available for his consumption next year?

A) $50   
 B) $55  
 C) $77  
 D) $100

**31)** Mr. Bird has $100 in income this year and will have zero income next year. The market interest rate is 10 percent per year. Mr. Bird also has an investment opportunity in which he can invest $50 today and receive $80 next year. Suppose Mr. Bird consumes $30 this year and invests in the project. How much will be available for his consumption next year?

A) $80   
 B) $82  
 C) $100  
 D) $102

**32)** Ms. Venus has $100 in income this year and will have $110 next year. The market interest rate is 10 percent per year. Suppose Ms. Venus consumes $60 this year. How much will be available for her consumption next year?

A) $120   
 B) $154  
 C) $170  
 D) $210

**33)** Mr. Thomas has $100 in income this year and will have zero income next year. The market interest rate is 10 percent per year. Mr. Thomas also has an investment opportunity in which he can invest $50 this year and receive $80 next year. Suppose Mr. Thomas consumes $50 this year and invests in the project. How much will be available for his consumption next year?

A) $50   
 B) $55  
 C) $80  
 D) $110

**34)** Mr. Dell has $100 in income this year and will have zero income next year. The expected return from investing in the stock market is 10 percent a year. Mr. Dell also has an investment opportunity—having the same risk as the market in which he can invest $50 this year and receive $80 next year. Suppose Mr. Dell consumes $50 this year and invests in the project. What is the NPV of the investment opportunity?

A) none of the options   
 B) $0  
 C) $5  
 D) $22.73  
 E) none of the options

**35)** Ms. Delgado has $60,000 in income this year and will have $40,000 next year. The market interest rate is 10 percent per year. Suppose Ms. Delgado consumes $80,000 this year. How much will be available for her consumption next year?

A) $18,000   
 B) $30,000  
 C) $60,000  
 D) $70,000

**36)** The line that connects the maximum that one can consume this year (now, on the horizontal axis) and the maximum one can consume next year:

A) has a slope of (1 + *r*).   
 B) has a slope of − (1 + *r*).  
 C) has a slope of *r*.  
 D) has a slope of 1/*r*.

**37)** Ms. Newcastle has $60,000 in income this year and will have $40,000 next year. The market interest rate is 10 percent per year. Suppose Ms. Newcastle wishes to consume $62,000 next year. How much will she be able to consume this year?

A) $19,000   
 B) $40,000  
 C) $60,000  
 D) $70,000

**38)** Mr. Cobb has an income of $40,000 this year and will have $60,000 next year. He can invest in a project that costs $30,000 this year, which generates an income of $36,000 next year. The market interest rate is 10 percent. What will be available for his consumption next year if Mr. Cobb invests in the project and consumes $50,000 this year?

A) $40,000   
 B) $52,000  
 C) $60,000  
 D) $62,000

**39)** Explain the term *corporation*.

**40)** Briefly explain the term *limited liability*.

**41)** Briefly explain the advantages of a corporation as a form of business organization.

**42)** Briefly explain the sequence of cash flows between financial markets and the firm.

**43)** Briefly explain the functions of financial markets.

**44)** Briefly discuss the role of financial managers.

**45)** Briefly explain the term *agency costs* as related to a corporation.

**46)** Briefly discuss principal-agent problems as related to a corporation.

**47)** Explain why “maximization of shareholders' wealth” is the appropriate ultimate, long-term goal of the firm.

**48)** Briefly explain some of the institutional arrangements that ensure that managers work toward increasing the value of a firm.

**49)** Briefly explain how individuals can adjust their current and future consumption according to their preferences.

**Answer Key**Test name: Brealey14eCh1

1) FALSE

2) TRUE

3) FALSE

4) FALSE

5) FALSE

6) A

7) D

8) C

9) A

10) C

11) C

12) A

13) C

14) C

15) D

16) C

17) D

18) D

19) D

20) D

21) D

22) C

23) D

24) C

25) B

26) D

27) A

28) C

29) C

30) C

Available for consumption next year = ($100 − 30) × 1.1 = $77.

31) D

Available for consumption next year = ($100 − 30 − 50) × 1.1 + $80 = $102.

32) B

Available for consumption next year = ($100 − 60) × 1.1 + $110 = $154.

33) C

Available for consumption next year = ($100 − 50 − 50) × 1.1 + $80 = $80.

34) D

NPV = ($80/1.1) − $50 = $22.73.

35) A

Borrow $20,000 this year to consume $60,000 + 20,000 = $80,000. Available for consumption next year = $40,000 − ($20,000 × 1.1) = $18,000.

36) B

37) B

Consumption this year = $60,000 − ($22,000/1.1) = $40,000.

38) B

Available for consumption next year = [$40,000 − 30,000 − 50,000] × 1.1 + ($60,000 + 36,000) = $52,000.

39)A corporation is a legal entity and has an existence of its own. Generally, large businesses are organized as corporations.

40)The shareholders of a corporation cannot be held personally responsible for the debts of the corporation. This is called *limited liability.* Hence, a shareholder's loss is limited to the amount he has invested in a corporation. This is an attractive feature for investors.

41)● Corporations have infinite life.  
● Corporations have very many owners called shareholders and therefore corporations can raise funds more easily than other forms of business.  
● There is a separation of ownership and management that is helpful in running the corporation on a day-to-day basis.  
● It is relatively easy to transfer ownership in a corporation.  
● Corporations have limited liability.

42)● Cash is raised by selling financial assets to investors.  
● Cash is invested in the firm's operation and used to purchase real assets.  
● Cash is generated by the firm's operations.  
● Cash is reinvested or returned to investors.

43)There are five important functions of financial markets. They are:  
● providing financing for corporations  
● providing liquidity for investors  
● reducing risk for investors  
● providing information  
● monitoring firms' financial performance

44)Chief financial officer (CFO): Supervises the treasurer and the controller in a large corporation. CFO is involved in corporate planning and financial policy.  
Treasurer: Is responsible for obtaining funds and managing cash, banking relationships, and investor relationships.  
Controller: Is responsible for accounting functions, payroll, and taxes.

45)Agency costs arise in a corporation as a result of principal-agent problems. For example, managers may not act in the best interests of shareholders while making decisions. Hence, shareholders incur monitoring costs that are called agency costs. It also arises because of informational asymmetry between managers and other stakeholders of a firm. Agency costs tend to reduce the value of a firm.

46)Principal-agent problems arise in a corporation as a result of the separation of ownership and management. Managers may not act in the best interests of the shareholders while making decisions. Hence, shareholders incur monitoring and bonding costs, which are a part of agency costs. It also arises as a result of informational asymmetry between managers and other stakeholders of a firm. Agency costs tend to reduce the value of a firm.

47)Under perfect market conditions, everyone can borrow or lend at the same interest rate. This implies that differences in consumption patterns can be adjusted in the financial markets. Given this, all investors will agree that they are better off if the firm maximizes their current wealth, i.e., maximizing shareholders' wealth.

48)● the board of directors, elected by shareholders, which scrutinizes managers' actions  
● competition among managers  
● the threat of takeover that brings a new management team  
● incentive schemes that are closely tied to the value of the firm like stock options

49)Individuals can adjust their preferences for consumption by borrowing or lending in the financial market. The appropriate balance between present and future consumption that each individual will choose depends on personal preferences. Nevertheless, individuals with different preferences can adjust their preferences using the financial market. Individuals desiring current consumption can borrow from future income. Meanwhile, individuals favoring future consumption can refrain from current consumption and invest in the same financial market.