

***Managerial Economics, 7e (Keat)***  
**Chapter 2 The Firm and Its Goals**

Multiple-Choice Questions

1) Transaction costs include

- A) costs of negotiating contracts with other firms.
- B) cost of enforcing contracts.
- C) the existence of asset-specificity.
- D) All of the above

Answer: D

Diff: 1

2) A company will strive to minimize

- A) transaction costs.
- B) costs of internal operations.
- C) total costs of transactions and internal operations combined.
- D) variable costs.

Answer: C

Diff: 1

3) The best example of an economic goal of a firm is

- A) providing good products/services to its customers.
- B) improving its public image.
- C) increasing employee morale.
- D) increasing shareholder wealth.

Answer: D

Diff: 1

4) A large corporation's profit objective may not be profit or wealth maximization, because

- A) stockholders have little power in corporate decision making.
- B) management is more interested in maximizing its own income.
- C) managers are overly concerned with their own survival and may not take all prudent risks.
- D) All of the above

Answer: D

Diff: 2

5) One of the weaknesses in pursuing the objective of profit maximization is that it ignores

- A) the timing of cash flows.
- B) the time-value of money concept.
- C) the riskiness of cash flows.
- D) All of the above

Answer: D

Diff: 1

6) Goals which are concerned with creating and maintaining employee and customer satisfaction and social responsibility are referred to as \_\_\_\_\_ objectives.

- A) social
- B) noneconomic
- C) welfare
- D) public relations

Answer: B

Diff: 1

7) Financial risk occurs due to variations in returns which

- A) is induced by leverage.
- B) is due to the ups and downs of the economy.
- C) is due to changes in government regulations.
- D) is a result of changes in exchange rates.

Answer: A

Diff: 2

8) Financial risk is associated with changes in

- A) the demand for a firm's products.
- B) a firm's debt.
- C) a firm's labor costs.
- D) government regulations of a firm's activities.

Answer: B

Diff: 2

9) \_\_\_\_\_ risk involves variation in returns due to the ups and downs of the economy, the industry and the firm.

- A) Structural
- B) Fluctuational
- C) Business
- D) Financial

Answer: C

Diff: 1

10) Unlike an accountant, an economist measures costs on a(n) \_\_\_\_\_ basis.

- A) explicit
- B) replacement
- C) historical
- D) conservative

Answer: B

Diff: 1

11) \_\_\_\_\_ maximization is achieved when a company manages its business in such a way that its cash flows over time, discounted at the appropriate discount rate, will cause the value of the company's common stock to be at a maximum.

- A) Profit
- B) Stockholder wealth
- C) Asset
- D) None of the above

Answer: B

Diff: 1

12) The calculation of stockholder wealth involves

- A) the time-value of money concept.
- B) the cash flow stream.
- C) business and financial risk.
- D) All of the above

Answer: D

Diff: 1

13) Another name for stockholder wealth maximization is

- A) profit maximization.
- B) maximization of earnings per share.
- C) maximization of the value of the common stock.
- D) maximization of cash flows.

Answer: C

Diff: 1

14) Accounting costs

- A) are historical costs.
- B) are replacements costs.
- C) usually include implicit costs.
- D) usually include normal profits.

Answer: A

Diff: 1

15) A firm earns a normal profit when its total revenues just offset both the \_\_\_\_\_ cost and \_\_\_\_\_ cost.

- A) accounting; opportunity
- B) accounting; replacement
- C) historical; replacement
- D) explicit; accounting

Answer: A

Diff: 2

- 16) A firm's "normal profit" is best characterized by the
- A) average of a firm's profits over the past five years.
  - B) amount of profit necessary to keep the price of a firm's stock from changing.
  - C) amount of profit a firm could earn in its next best alternative activity.
  - D) the average amount of profit earned in the firm's industry.

Answer: C

Diff: 3

- 17) MVA (Market Value Added)
- A) will always be a positive number.
  - B) may be a negative number.
  - C) measures the market value of the firm.
  - D) None of the above

Answer: B

Diff: 2

- 18) Opportunistic behavior is best described as a firm
- A) gathering as much information as possible before dealing with another entity.
  - B) attempting to make a profit from its dealings with another entity.
  - C) firm trying to take advantage of another entity in its dealings with it.
  - D) selecting another entity to deal with.

Answer: C

Diff: 2

- 19) Firms are organized to keep their costs as low as possible by
- A) comparing external transactions costs with internal operating cost.
  - B) analyzing supply and demand conditions.
  - C) minimizing their use of borrowed funds.
  - D) utilizing the latest technology.

Answer: A

Diff: 2

## Analytical Questions

- 1) a. If a stock is expected to pay an annual dividend of \$20 forever, what is the approximate present value of the stock, given that the discount rate is 5%?
- b. If a stock is expected to pay an annual dividend of \$20 forever, what is the approximate present value of the stock, given that the discount rate is 8%?
- c. If a stock is expected to pay an annual dividend of \$20 this year, what is the approximate present value of the stock, given that the discount rate is 8% and dividends are expected to grow at a rate of 2% per year?

Answer:

- a.  $P = D/k = 20/.05 = \$400$
- b.  $P = 20/.08 = \$250$
- c.  $P = D1/(k - g) = 20/ (.08 - .02) = \$333.33$

- 2) If a stock is expected to pay a dividend of \$40 for the current year, what is the approximate present value of this stock, given at discount rate of 5% and a dividend growth rate of 3%?

Answer:  $P = \$40/(0.05 - 0.03) = \$40/0.02 = \$2,000$

- 3) Describe the difference between the Economic Value Added (EVA) and the Market Value Added (MVA) approach to determining stockholder wealth.

Answer: EVA is the difference between a firm's return on total capital and its cost of capital, while MVA is the difference between the market value (equity plus debt) of a firm and the amount of capital investors have paid into the company.