Question #1 of 63

Which of the following statements regarding effective corporate governance systems is *least* accurate?

A) The primary responsibilities of a corporate board of directors are to institute corporate values and establish long-term strategic objectives that are in the best

B) A corporate governance system must be continuously monitored because of changes in management and the board of directors.

C) A comprehensive list of corporate governance best practices can be applied effectively to any corporation worldwide to strengthen the company's corporate

Explanation

Corporate governance systems will differ according to the legal environment, culture, and industry in which a firm operates, so a list of best practices cannot simply be applied to all firms worldwide with any expectation that the corporate governance structure will be strengthened. There are, however, a number of common characteristics that all sound corporate governance structures share.

(Study Session 8, Module 24.1, LOS 24.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #2 of 63

Root causes of unethical behavior would include all of the following EXCEPT:

A) management setting challenging goals in order to motivate employees.

B) a business culture that focuses primarily on rewarding short-term performance.

C) an executive of a company who has never violated any ethical standards at work yet has questionable personal ethics.

Explanation

Setting challenging (but not unrealistic) goals does not necessarily lead to unethical behavior but a flawed business culture where top management sets unrealistic goals can lead to lapses in ethical behavior. Management must communicate that ethical behavior is expected. A culture focused only on short-term profits without asking relevant questions seeking to establish ethical dimension of business decision making is one of the root causes of unethical behavior in businesses. Employees (agents) whose personal ethics are flawed are more likely to violate business ethics.

(Study Session 8, Module 23.1, LOS 23.c)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #3 of 63

Which of the following would be the *most effective* means for a manufacturing firm to communicate its corporate governance policies to shareholders?

A) Include a statement on the company website that the company is committed to global corporate governance best practices.

B) Adopt a statement of governance policies that is provided by the North American Association of Manufacturers.

C) Provide access to internal management performance assessment reports.

Explanation

Management performance assessments as well as reports of director's oversight and review of management are an important element of a statement of governance policies that investors and analysts should assess. Note that a statement of governance practices should be company specific (not a boilerplate statement) and that it should be detailed – simply telling investors that the company is committed to best practices is insufficient.

(Study Session 8, Module 24.1, LOS 24.f)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #4 of 63

Corporate governance systems are primarily concerned with potential principal-agent problems between:

A) managers and creditors.

B) directors and shareholders.

C) managers and directors.

Explanation

Corporate governance systems attempt to minimize or eliminate any potential agent problems that may arise between two groups: (1) directors and shareholders and (2) managers and shareholders.

(Study Session 8, Module 24.1, LOS 24.c)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #5 of 63

Which of the following *least accurately* describes one of the nontraditional "ESG" business factors that may be critical to a company's long-term sustainability?

A) environmental risk exposures

B) governance risk exposures

C) security risk exposures

Explanation

Environmental, social, and governance ("ESG") risk exposures are the nontraditional business factors that are now recognized as critical to a company's long-term sustainability.

(Study Session 8, Module 24.1, LOS 24.g)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #6 of 63

Chen Michiba is an Executive Vice President with the Sakai Corporation. Michiba is concerned that Sakai does not have an effective corporate governance system in place and drafts a memo to the company's senior management team detailing a potential structure for an improved system. Michiba starts his memo by listing the two key objectives of corporate governance:

Objective 1:	Establish clear lines of responsibility and a system of accountability and performance measurement in all phases of a company's operations.
Objective 2:	Ensure that all legal and regulatory requirements are met and complied with fully and in a timely fashion.

Michiba is:

A) correct with respect to Objective 1, but incorrect with respect to Objective 2.

B) incorrect with respect to both Objectives.

C) correct with respect to both Objectives.

Explanation

Although Michiba lists two admirable goals and actions that should be performed by a firm's board of directors, neither item is one of the two key objectives of a corporate governance system. The two key objectives of a corporate governance system: (1) Eliminate or reduce conflicts of interest (particularly those between managers and shareholders), and (2) Ensure that the assets of a company are used efficiently and productively and in the best interests of its investors and other stakeholders.

(Study Session 8, Module 24.1, LOS 24.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #7 of 63

Which of the following statements concerning the audit committee of the board of directors is *least* accurate? The audit committee:

A) should consist entirely of independent board members.

B) should not have any dialogue with management in order to ensure that the committee's actions are independent of management activities.

C) should directly oversee the internal audit staff of the company.

Explanation

The audit committee should have full access to and the cooperation of management in order to perform their duties.

(Study Session 8, Module 24.1, LOS 24.d)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #8 of 63

McCool and Company is a consulting firm that provides research reports on corporate governance at large corporations and whether corporate governance systems are consistent with global best practices. McCool recently completed an evaluation of ARC Industries and listed the following observations:

- 2 of the 10 directors for ARC Industries are former employees and 4 of the 10 have large personal stock holdings in the company.
- The Chief Executive Officer for ARC has regular meetings with the Chairman of the Board.
- Each board member is up for reelection to the board on an annual basis.
- The nominating committee consists of 3 independent directors and the CEO of ARC Industries.
- The compensation committee consists of 5 independent directors.
- ARC has a requirement that all board members serving on the audit committee must be independent and must have a background in finance or accounting.

McCool and Company gives each company they evaluate a score based on how many of the following four items are consistent with global best practice:

Item 1:	Board Independence.
Item 2:	How the board is elected.
Item 3:	Makeup of the nominating committee.
Item 4:	Makeup of the audit committee.

Based on the observations of ARC Industries, what was ARC's *most likely* score on the McCool report?

A) 75%.

B) 50%.

C) 25%.

Explanation

Based on the observations, ARC Industries is in accordance with global corporate governance best practices with respect to 3 of the 4 items, resulting in a score of 75%.

With respect to Board independence, global best practice states that 75% of the directors should be independent. McCool observes that 2 of the 10 directors are former employees, but assuming no other conflicts, this would still result in 80% of the board being independent. Note that personal stock holdings among board members should be encouraged as it puts the board members in the same position as investors and can help align board member and investor interests.

Global corporate governance best practice supports annual elections of each board member rather than staggered elections – based on the observations, ARC is consistent with this practice.

The nominating committee should be made up entirely of independent directors. Having the company CEO on this committee means that ARC is not consistent with corporate governance best practice with respect to this item.

The audit committee should be made up entirely of independent directors and at least two members of the committee should have relevant accounting or auditing experience. It appears from the observations that ARC received a positive score for their requirements for serving on the audit committee.

(Study Session 8, Module 24.1, LOS 24.e)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #9 of 63

Which form of business is *most likely* to have conflicts of interest between managers and owners?

A) Sole-proprietorship.

B) Partnership.

C) Corporation.

Explanation

Corporations are typically owned by shareholders who play no role in day-to-day management decisions. Instead, managers are hired to control and deploy the assets of the company, and supposedly do so in the shareholders' best interest. This separation between ownership and management creates the potential for conflicts of interest. Note that in the case of partnerships and sole proprietorships, the owners and managers are one in the same.

(Study Session 8, Module 24.1, LOS 24.b)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Kathryn Rutherford recently joined the Board of Directors for Orvis Asset Management Company (Orvis) and will participate in its annual Board of Directors meeting. Rutherford is an Executive Vice President with Signature Bank, and knows Orvis' finances well, serving as a commercial lender to Orvis for the last five years. Besides Rutherford, OAMC's board consists of the following seven members:

- Dane Corser, CFO for Orvis who also serves on the board for Spencer Pharmaceuticals
- Tricia DeLucia, a granddaughter of Orvis' founder, Michael Orvis
- Wendy Kepling, a former Executive Vice President with Orvis
- Troy Montgomery, the retired CEO of Forner Capital Management, another asset management firm
- Mike Shute, President of Spencer Pharmaceuticals
- Robert Stuart, an attorney with Bricker and Palmer, Orvis' outside counsel
- Jason Winterfeld, Chairman and CEO of Orvis

Orvis is a publicly traded firm that specializes in managing equity portfolios for both institutional and individual clients. The firm's investment philosophy is to focus on companies with a history of not changing their dividend payments in order to achieve stable returns. The firm's marketing approach focuses on tax-exempt pension funds and endowments as well as individuals who depend on dividend payments to meet living expenses. Historically, Orvis has been a successful manager, but recently performance has declined relative to the firm's benchmark. The primary focus at this board meeting is defining the long-term strategic objectives for the company and making sure the assets of the company, specifically its proprietary investment process, are being used in the best interests of the firm's shareholders.

Winterfeld states that Item 1 on the Board's agenda is to discuss the impact of dividends on shareholder value. Kepling begins the discussion by questioning whether Orvis' investment process should focus on dividends at all. Kepling states, "According to work by Modigliani and

Miller, dividends are irrelevant. If an investor holds a non-dividend paying stock, but wants the benefits of a dividend, all they have to do is sell a portion of the stock to get the cash flow they want. Whether the individual receives a cash dividend or sells a portion of their stock, the combination of the investment in the firm and the cash in hand is the same." Montgomery replies, "I disagree with the theory that dividends are irrelevant. According to work by Gordon and Lintner, dividend payments matter because they are less risky than capital gains. Since investors perceive dividends as being less risky, a firm that starts paying a dividend is likely to see an increase in their P/E ratio."

Kepling is also aware that Modigliani and Miller have done a great deal of work regarding capital structure theory. She asks Corser if Modigiani and Miller's theory on capital structure has any implications for the percentage of debt and equity that Orvis has in its capital structure. Corser replies with two statements:

Statement 1:	Since Orvis has to pay taxes on its earnings, according to Modigliani and Miller, the optimal capital structure would be 100% debt.
Statement 2:	If bankruptcy costs are included in Modigliani and Miller's capital structure theory, the value of a firm will be maximized when a firm's cost of debt is minimized.

Question #10 of 63

Which of the following questions about board independence is *most* accurate?

A) Stuart qualifies as an independent director, but Kepling does not.

B) Montgomery qualifies as an independent director, but Stuart does not.

C) Shute qualifies as an independent director, but DeLucia does not.

Explanation

Montgomery may have prior ties to the asset management business, but there appears to be no prior relationship with Orvis. Stuart, as an attorney with Orvis' outside counsel, cannot be classified as independent due to his firm's relationship with Orvis.

DeLucia, as a family member, and Kepling as a former employee cannot be classified as independent. Also, due to interlocking directorships, Shute cannot be classified as an independent director (Corser serves on the board for Spencer Pharmaceuticals, where Shute is the President and Shute serves on the board for Orvis, where Corser is the CFO).

(Study Session 8, Module 24.1, LOS 24.e)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #11 of 63

Jason Winterfeld is the Chairman of the Board of Directors at Orvis, as well as the firm's CEO. Which of the following *best* describes Winterfeld's position according to corporate governance best practices? Having the CEO also serve as Chairman of the Board is:

A) in the best interest of shareholders because the CEO has the knowledge and experience to provide information to the board about company strategy and

B) not in the best interest of shareholders because the Chairman/CEO could influence the culture of the board room and diminish the role of independent board

C) not in the best interest of shareholders because only an independent Chairman insures the proper functioning of the Board.

Explanation

Corporate governance experts believe that having a CEO also serve in the role of Chairman of the Board can negatively influence boardroom culture and diminish the role of independent board members. It is for this reason that corporate governance best practice supports having the Chairman and CEO as separate positions. Note that while the CEO does have the knowledge and experience to provide information to the board about company strategy and operations, if management is doing their job, it will provide the board with all necessary information, while it is the board's responsibility to see that they get the information. Having the CEO as a knowledge base is not a valid justification for the dual role.

(Study Session 8, Module 24.1, LOS 24.e)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #12 of 63

Given that Orvis does not meet the global corporate governance best practice that 75 percent of directors are independent, which of the following would be the *best* recommendation for a more effective system of corporate governance?

A) Create long-term strategic objectives for the company that are consistent with shareholders' best interests.

B) Reduce the potential for conflicts of interest between principals and agents of the firm.

C) Determine board member responsibilities and how the board will be held accountable.

Explanation

Since one of the two primary objectives of corporate governance is to eliminate or reduce conflicts of interest in a firm, and Orvis obviously has many potential conflicts of interest on their board, reducing the potential conflicts of interest between principals and agents of the firm is the best answer. In a corporation, principal-agent relationships exist between shareholders and management, and directors and shareholders. A principal agent problem occurs when managers or directors (the agent) act in their own best interests rather than those of the owners of the firm (the shareholders/principals). Both remaining answer choices are all good things, but do not get to the core principals of corporate governance which are reducing or eliminating conflicts of interest, and using company assets productively and in the best interests of shareholders.

(Study Session 8, Module 24.1, LOS 24.e)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #13 of 63

Which of the following statements *best* reflects Orvis' investment philosophy and marketing approach? Orvis' investment philosophy is:

A) not consistent with a stable dividend policy, and the marketing approach depends on the signaling effect.

B) not consistent with a stable dividend policy, and the marketing approach depends on the clientele effect.

C) consistent with a stable dividend policy, and the marketing approach depends on the clientele effect.

Explanation

Orvis' investment philosophy is to focus on companies with a history of not changing their dividend payments, which is NOT consistent with a stable dividend policy. A stable dividend policy aligns the company's dividend with the firm's long-term growth rate to achieve stability in the rate of increase for the dividend each year. If the company never changed their dividend payments, the value of the dividend would decline over time as a result of inflation. The marketing approach seems to depend on the clientele effect which refers to the varying preference for dividends among different groups of investors. Tax considerations, institutional investor requirements, and individual investor preferences to spend dividends only and not dip into principal are all rationales for the clientele effect.

(Study Session 8, Module 24.1, LOS 24.e)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #14 of 63

With regard to their statements about dividend theories:

A) Kepling is correct; Montgomery is correct. ✓

B) Kepling is incorrect; Montgomery is correct. ✗

C) Kepling is correct; Montgomery is incorrect. ✗

Explanation

Kepling is correct. According to Modigliani and Miller's dividend irrelevance theory, a stock holder can effectively create their own dividend policy by buying or selling a firm's stock to get the combination of cash flow and ownership they want to receive. Note that Modigliani and Miller's theory only holds in a perfect world with no taxes or brokerage costs. Montgomery is also correct. According to Gordon and Lintner's "bird-in-the-hand theory," a dollar of dividends is less risky than a dollar of capital gains. Since dividends are less risky, a company that pays dividends will cause its cost of equity to decrease. Since the cost of equity declines, the required return for the investor will also decline, which will result in a higher P/E ratio.

(Study Session 8, Module 24.1, LOS 24.e)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #15 of 63

With regard to Corser's statements about Modigliani and Miller's theory on capital structure, Kepling should:

A) disagree with Statement 1, but agree with Statement 2.

B) agree with both Statements 1 and 2.

C) agree with Statement 1, but disagree with Statement 2.

Explanation

Modgliani and Miller's work on capital structure theory concludes that in a world with no taxes and no bankruptcy costs, capital structure is irrelevant. However, in a subsequent study, they updated their work to include the effect of taxes. Since corporations can deduct interest payments when determining taxable income, the stockholders will benefit from the use of debt. According to their theory, the optimal capital structure in a world with taxes is 100% debt – Statement 1 is correct. However, if bankruptcy costs are factored into their results, debt is useful initially for its tax savings to lower the cost of capital, but only up to the point where it increases risk and the cost of debt and equity starts to rise. In a world with taxes and bankruptcy costs, the optimal capital structure is the one that minimizes the weighted average cost of overall capital - not simply the cost of debt.

(Study Session 8, Module 24.1, LOS 24.e)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #16 of 63

Dan Berger, an analyst for Romulus Capital Management Inc. (RCMI), is talking with a colleague, Amy Woods, about the benefits of including corporate governance assessments in the firm's valuation models. Berger makes the following statements:

Statement 1:	Although the results are inconclusive in emerging markets, companies in developed countries that have strong corporate governance systems have provided shareholders with higher returns than companies with weak governance system.
Statement 2:	A weak corporate governance system can cause a company to go bankrupt.

In regard to Berger's statements, Woods should:

A) agree with Statement 1, but disagree with Statement 2.

B) disagree with Statement 1, but agree with Statement 2.

C) agree with both Statements.

Explanation

Woods should disagree with Statement 1. Companies with strong corporate governance systems have been shown to have higher profitability and generate higher returns than companies with weaker corporate governance systems in both developed and emerging markets. Statement 2 is correct – in extreme cases, the lack of an effective corporate governance system could lead to a company's bankruptcy such as the case of Enron in 2001.

(Study Session 8, Module 24.1, LOS 24.h)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #17 of 63

Sunil Reddy is an analyst for Worldwide Financial Services. Reddy thinks that Worldwide's procedures for analyzing companies for inclusion in client portfolios would be more robust if it included a review of the company's board of directors. Reddy prepares a list of five items concerning the board of directors that analysts should assess:

Item 1:	Frequency of separate sessions for independent directors.
Item 2:	Use of independent legal counsel as opposed to company in-house counsel.
Item 3:	Composition of the nominating committee.
Item 4:	Composition of the compensation committee.
Item 5:	Whether the board has staggered or annual elections.

Which of the items on Reddy's list are attributes of a board of directors that are important for an analyst to assess?

A) All five items.

B) Items 2, 3, and 4 only.

C) Items 1, 3, and 5 only.

Explanation

All five of the items on Reddy's list are important factors that an analyst should review when assessing a board of directors.

(Study Session 8, Module 24.1, LOS 24.d)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #18 of 63

A company decides to expand its operations to enter new markets. Which stakeholder's interest is *most likely* to be adversely served by this decision?

A) Creditors

B) Stockholders

C) Union

Explanation

Expansion into new markets is likely to increase the risk of the business and hence would adversely affect the creditors of the firm. Ex-ante increase of risk would not negatively affect the stockholders or employee unions . Ex-post, actual realization of negative outcomes would adversely affect all stakeholders - but that is not the question here.

(Study Session 8, Module 23.1, LOS 23.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #19 of 63

Which of the following choices is NOT a root cause of unethical behavior?

A) Maximizing profits.

B) Flawed organizational culture.

C) Pressure to meet unrealistic goals.

Explanation

The root causes of unethical behavior includes: Flawed personal ethics, failure to see an ethical dimension in business decisions, flawed organizational culture, pressure from top management to meet unrealistic goals, and unethical leadership.

(Study Session 8, Module 23.1, LOS 23.c)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #20 of 63

A principal-agent problem may exist between:

A) shareholders and directors. ✓

B) regulators and directors. ✗

C) managers and directors. ✗

Explanation

An agency relationship exists when an individual (the agent) acts on behalf of another individual (the principal). Such a relationship creates the potential for a principal-agent problem where the agent may act for his own well being rather than that of a principal. The key test of whether a principal-agent problem may exist is if one party is responsible for acting in the best interest of the other. Of the answer choices given, directors are responsible for acting in the best interests of shareholders.

(Study Session 8, Module 24.1, LOS 24.c)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #21 of 63

Kimi Hatcher is a consultant for Druson Corporate Consultants. Hatcher recently evaluated the management team at Burnett Television Productions and wrote a report of her observations.

Observation 1:	Over 65% of senior management compensation is in the form of executive stock options. Management tends to aggressively take on risky projects that will generate large profits if the projects succeed.
Observation 2:	Management frequently uses retained profits to purchase potential competitors as well as business unrelated to television production in an effort to diversify their revenue base.
Observation 3:	Management makes a practice of setting aside provisions for loss contingencies.

A Burnett shareholder that is reading the report is particularly concerned about ways that management may act for their own best interests rather than those of shareholders. Which of observations in Hatcher's report should alarm the shareholder?

A) Observation 1 only.

B) All of the observations.

C) Observations 1 and 2 only.

Explanation

While managers are hired to make decisions to maximize shareholder wealth, they may make decisions to maximize their own wealth. Examples of ways that management may act for their own interests include expanding the size of the firm, which can increase the manager's job security and power, and managers compensated largely by stock option taking large risks that will generate huge payoffs for the managers if successful, but cost the managers nothing if they do not. Note that setting aside provisions for loss contingencies is considered a conservative accounting practice.

(Study Session 8, Module 24.1, LOS 24.c)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #22 of 63

Mike Ransom was recently elected to the board of directors for Tedeschi Chemical Corporation (TCC). Ransom knows that as a board member, he is responsible for serving on at least one board committee. In an effort to understand the board committee structure, he asks Kelly Williams, who has served on the board for 7 years, to describe the structure and practices of various committees to him. Williams makes the following statements:

Statement 1:	The audit committee consists of four independent members, one of which has a background in accounting and auditing.
Statement 2:	The audit committee has an annual meeting with auditors and management to assess any issues which may arise in the audit process.
Statement 3:	TCC's internal auditors report directly to the audit committee.

Which of Williams's statements about TCC's committee structure are consistent with corporate governance best practice?

A) Statements 1, 2, and 3.

B) Statements 2 and 3 only.

C) Statement 3 only.

Explanation

Statement 3 is a best practice – the internal audit staff of the firm should report directly to the audit committee. The other statements are not consistent with best practices. On the audit committee, two or more members should have relevant financial experience. The audit committee should have at least an annual meeting with auditors, but management should **NOT** be present.

(Study Session 8, Module 24.1, LOS 24.e)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #23 of 63

Studies support the conclusion that companies with effective corporate governance systems have been shown to have higher measures of profitability and generate higher returns than companies with weak corporate governance systems. Which of the following is the *most* critical activity that an analyst can engage in to assess the strength of a corporate governance system at a firm?

A) Determine whether a corporate code of ethics and statement of governance policies is easily accessible for investors and stakeholders.

B) Evaluate the quality and quantity of financial information provided to investors.

C) Note whether financial transactions between a company and its senior management are approved by the board of directors.

Explanation

Over the last few years, most of the major corporate scandals (i.e. Enron, Worldcom) have involved attempts to hide or falsify financial information provided to investors. Since investors rely on information provided by management to make investment decisions, having misinformation can result in the mispricing of securities, misallocation of capital, and ultimately a lack of confidence that can reduce the efficiency and effectiveness of financial markets. As a result, one of the most critical roles an analyst can play in the corporate governance process is to evaluate the quantity (more is better) and quality of financial data that companies provide.

(Study Session 8, Module 24.1, LOS 24.h)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #24 of 63

All of the following are attributes of an effective corporate governance system EXCEPT:

A) provide for fair and equitable treatment in all dealings between managers, directors, and shareholders.

B) have complete transparency and accuracy in disclosures regarding operations, performance, risk, and financial position.

C) executive compensation is not excessive in comparison with other industry firms.

Explanation

Although executive compensation that is not excessive may be an outcome of a strong corporate governance system, it is not considered a core attribute.

(Study Session 8, Module 24.1, LOS 24.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #25 of 63

Ashley Jones is considering joining the board of directors of Dusseau Investment Management (DIM). Before joining the board, Jones wants to make sure she fully understands what her responsibilities would be as a board member. Kenley Walker, administrative assistant to DIM's CEO prepares a memo to Jones detailing responsibilities of board members.

Responsibility 1:	Establish corporate values and governance structures to ensure that business is conducted in an ethical, fair, and professional manner.
Responsibility 2:	Determine which proxy issues that have received a majority of shareholder votes should be addressed or ignored.
Responsibility 3:	Hire the company's chief executive officer (CEO), and determine the CEO's compensation package.

Which of the responsibilities listed by Walker are CORRECT?

A) Responsibilities 1, 2, and 3.

B) Responsibilities 1 and 3 only.

C) Responsibility 1 only.

Explanation

Directors should always address all proxy issues that have received a majority of shareholder votes. Responsibilities of directors include hiring the firm's CEO and determining the CEO's compensation, and establishing corporate values and governance structures to ensure that business is conducted in an ethical, fair, and professional manner.

(Study Session 8, Module 24.1, LOS 24.d)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #26 of 63

Mitchell Cash is a corporate governance consultant for Yost and Karl Consulting. In a presentation to a prospective new client, Cash states that an effective corporate governance system will:

- Provide for fair and equitable treatment in all dealings between managers, directors, and shareholders.
- Have complete transparency and accuracy in all disclosures regarding operations, performance, risk, and financial systems.

Which of the following is a core attribute of effective corporate governance systems that Cash left out of his presentation?

A) Chief officers of a corporation are legally authorized to enter into contracts on behalf of the business.

B) Legal and regulatory requirements are complied with fully and in a timely fashion.

C) Clearly defined manager and director governance responsibilities to stakeholders.

Explanation

All effective corporate governance systems share the following attributes:

- Define the rights of shareholders and other important stakeholders.
- Clearly identify manager and director governance responsibilities to stakeholders.
    - Provide clear and measurable accountability for managers and directors in assuming their responsibilities.
- Provide for fair and equitable treatment in all dealings between managers, directors, and shareholders.
- Have complete transparency and accuracy in disclosures regarding operations, performance, risk, and financial position.

(Study Session 8, Module 24.1, LOS 24.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #27 of 63

Jon Fisher is a junior analyst for Folker Capital Management. Jim Russell, Director of Research has asked Fisher to prepare a list of items that may be included in a company's statement of governance practices that would help assess company governance policies concerning the operation of the board of directors. Fisher's list includes the following items:

Item 1:	Board and committee self-assessment reports.
Item 2:	Statement of the responsibilities directors have to review and oversee management.
Item 3:	Reports of findings in directors' oversight and review of management.
Item 4:	Statement detailing how directors are trained before they join the board.

Which items should analysts include in order to understand a company's corporate governance practices as they relate to the board of directors?

A) Items 1 and 3 only.

B) All 4 items should be included.

C) Item 1 only.

Explanation

All of the items on the list are elements of a company's statement of corporate governance policies that should be assessed by investors and analysts.

(Study Session 8, Module 24.1, LOS 24.f)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #28 of 63

Which of the following statements about major business forms is *least* accurate?

A) In a sole proprietorship, there is no legal distinction between the business and its owners.

B) The potential legal liability for the owner of a sole proprietorship is limited to the market value of the business.

C) A key benefit of the corporate form of business is the ease in transferring ownership.

Explanation

In a sole proprietorship, there is no legal distinction between the business and its owner. In the event of losses or bankruptcy, creditors could theoretically go after the owner's personal assets, resulting in unlimited liability.

(Study Session 8, Module 24.1, LOS 24.b)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #29 of 63

Which of the following is *least consistent* with corporate governance best practice?

A) Directors have access to in-house legal counsel whenever necessary to assess the company's compliance with regulatory requirements.

B) The CEO and Chairman of the board are separate positions held by separate individuals.

C) Board members conduct a self-assessment on an annual basis.

Explanation

Directors should have access to independent, not in-house legal counsel for any questions related to the company's compliance with regulatory requirements. Both remaining statements are all considered corporate governance best practices.

(Study Session 8, Module 24.1, LOS 24.e)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #30 of 63

Jill Tangeman and Lawrence Winkelman are shareholders for Hilliard Electric Components, Inc. (HECI). Tangeman and Winkelman are concerned about potential conflicts of interest that may affect them as shareholders of HECI and decide to draft a letter to various HECI decision makers to ask them what they are doing to eliminate or reduce potential conflicts of interest.

The basic premise of Tangeman and Winkelman's letter is that corporate governance systems should focus on two potential areas where decision makers may not act in shareholders best interests: conflicts between managers and shareholders, and conflicts between directors and shareholders.

Winkelman states in the letter than he is concerned about executive compensation. "Having too much executive wealth concentrated in employee stock options can lead to managers avoiding potentially risky projects that would actually maximize wealth for shareholders." Tangeman adds her own comment: "The primary responsibility of the board of directors is to assure that shareholders' interests are balanced with those of management when negotiating on issues such as compensation." When the letter is complete, both sign it as shareholders in the company and mail out 12 copies.

The assertion made by Tangeman and Winkelman about the focus of corporate governance systems is:

A) valid, and only Winkelman makes a correct statement in the letter.

B) valid, and neither Winkelman or Tangeman make a correct statement in the letter.

C) invalid, and only Tangeman makes a correct statement in the letter.

Explanation

The assertion made by Tangeman and Winkelman is valid – one of the two main objectives of corporate governance is to eliminate or reduce conflicts of interest. The two primary areas for potential conflicts of interest in a corporation are conflicts between shareholders and management and conflicts between directors and shareholders.

Winkelman's statement is incorrect. Executive compensation in the form of large amounts of stock options can cause managers to take on too much risk as the asymmetric payoff of those options means that managers can reap huge rewards if the risks pay off, but will not share in the losses if the risky projects fail. Note that managers taking too little risk is also a concern, but taking too little risk is a symptom of managers holding too much stock – not stock options. If the manager has the bulk of their wealth tied to company stock, the manager may want to avoid risky projects to protect the value of the stock even though the risky projects may do a better job of maximizing value for the firm's shareholders.

Tangeman's statement is incorrect in two respects. The most important roles for the board of directors is to institute long-term strategic objectives for the company and institute corporate values that will insure that business is conducted in an ethical and fair manner. Also – the board should not "balance shareholder and management needs" when negotiating with management in areas such as compensation. The board needs to determine management compensation with shareholders' best interest as their sole consideration.

(Study Session 8, Module 24.1, LOS 24.c)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #31 of 63

Which of the following scenarios is *NOT* an example of a principal-agent problem?

A) Top management is awarded large amounts of executive stock options.

B) A senior manager also serves as a director on the board of another company.

C) A board member also serves as a consultant to the company.

Explanation

A senior manager may serve on the board of another company so long as there are no other circumstances that may compromise objectivity. For example, problems arise if the boards of two companies are "interlinked" by way of managers of Company A serving on the board of Company B, and managers of Company B serving on the board of Company A.

(Study Session 8, Module 24.1, LOS 24.c)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #32 of 63

Which of the following would be *least likely* to help control the principal-agent relationship (PAR) problem?

A) Fire employees who misbehave.

B) Increase the asymmetry of information between the owners of the firm and the employees.

C) Alter the behavior of executives through goal setting.

Explanation

Decreasing the asymmetry of information between the owners of the firm (principals) and executives (agents) would help to control the principal-agent relationship (PAR) problem. The PAR problem arises from the agents (executives / employees) having more information about the company than the principals (owners / shareholders) and misusing that information to the advantage of the agents at the expense of the firm or principals. The other two answer choices are methods for reducing the PAR problem by affecting the behavior of agents by setting goals and principles of behavior and removing agents who misbehave and violate ethics.

(Study Session 8, Module 23.1, LOS 23.b)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #33 of 63

Which of the following *best* describes the importance of a corporate governance system? A strong corporate governance system:

A) maximizes shareholder value.

B) gives the firm the ability to attract and fairly compensate qualified managers to ensure that assets of the company are used efficiently and productively.

C) is essential for companies to operate efficiently, while the lack of an effective corporate governance system can threaten the very existence of a firm.

Explanation

A strong corporate governance system is essential for companies and financial markets to operate efficiently, while the lack of strong corporate governance system represents a major operational risk that can threaten the very existence of a firm. A strong corporate governance system cannot in itself maximize shareholder value, but studies have shown that the lack of effective system certainly reduces shareholder value.

(Study Session 8, Module 24.1, LOS 24.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #34 of 63

The Friedman Doctrine can be criticized from the standpoint that:

A) a company can follow all applicable laws and still be guilty of unethical business practices.

B) it does not directly address adherence to society's rules.

C) it does not sufficiently address the long term need of business to be profitable.

Explanation

Milton Friedman addressed the social responsibility of business by stating that business should maximize profitability consistent with law and the "rules of the game." The criticism is that this might still allow unethical behavior. Nike was provided as an example of following the law but still initially engaging in unethical behavior.

(Study Session 8, Module 23.1, LOS 23.d)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #35 of 63

In a presentation to a group of students in an Executive MBA class, Professor Steven Dawes tells the class that corporate governance systems will tend to differ based on the legal environment, culture an industry in which a firm operates, however, all corporate governance systems share certain common attributes. Dawes continues on to make two statements:

Statement 1:	All corporate governance systems will define the rights of shareholders and other important stakeholders.
Statement 2:	All corporate governance systems should be implemented by individuals with no potential conflicts of interest with company management or shareholders.

Which of Dawes' statements are consistent with the core attributes of an effective corporate governance system?

A) Statement 1 is inconsistent, but Statement 2 is consistent.

B) Statement 1 is consistent, Statement 2 is inconsistent.

C) Both Statement 1 and Statement 2 are consistent.

Explanation

All effective corporate governance systems share the following attributes:

- Define the rights of shareholders and other important stakeholders.
- Clearly identify manager and director governance responsibilities to stakeholders.
- Provide clear and measurable accountability for managers and directors in assuming their responsibilities.
- Provide for fair and equitable treatment in all dealings between managers, directors, and shareholders.
- Have complete transparency and accuracy in disclosures regarding operations, performance, risk, and financial position.

Dawes' first statement is consistent with these attributes; however, his second statement is not.

(Study Session 8, Module 24.1, LOS 24.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #36 of 63

Which of the following *best* describes the PAR problem? The PAR problem is when the:

A) owners of the firm gain at the expense of the employees.

B) board of directors take advantage of their position at the expense of the shareholders.

C) agent uses the information advantage for their own best interests to the detriment of the interests of the principal.

Explanation

The principal-agent relationship (PAR) arises when one group delegates decision making or control to another group. The PAR can create problems because the group receiving the power (the agent) generally has an asymmetric information advantage over the group making the delegation (the principal). The PAR problem begins if the agent uses the information advantage for their own best interests to the detriment of the interests of the principal. It is compounded as the asymmetric information makes it difficult for the principal to know enough to detect the problem and evaluate the agent's actions. Modern corporations are built on shareholders (principals) who delegate authority to run the business to executive officers of the company (agents). The board of directors are charged with overseeing the executives of the firm. It is possible for the board of directors to align themselves too closely with the executives of the firm thus contributing to the PAR problem.

(Study Session 8, Module 23.1, LOS 23.b)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #37 of 63

Which of the following statements regarding advantages to the corporate form of business organization compared to other business forms is *least* accurate?

A) It is unnecessary for an owner of a corporation to have knowledge or expertise in the industry in which a business operates.

B) Corporations are easily formed with few legal requirements.

C) A corporation has easier access to capital markets.

Explanation

Advantages to the corporate form of business include the ease of raising capital, the ease of the transferability of stock ownership, and the lack of expertise needed by owners of a corporation since managers control the business' assets. A disadvantage of corporations is the fact that since corporations have many non-manager owners, they are subject to a great deal of legal requirements and regulations.

(Study Session 8, Module 24.1, LOS 24.b)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #38 of 63

John Zehetmeier, an analyst for Folker Capital Management is helping his colleague, Chris Augustine, understand elements of a company's statement of governance policies that would be helpful in analyzing a company. Zehetmeier makes the following statements:

Statement 1:	A corporate code of ethics that conveys the values, responsibilities, and ethical conduct of an organization should be included in a statement of governance policies.
Statement 2:	A statement of director oversight responsibilities would be the best place to find information about nomination and compensation award polices.

Augustine should:

A) disagree with both of Zehetmeier's statements.

B) agree with both of Zehetmaier's statements.

C) agree with Statement 1, but disagree with Statement 2.

Explanation

Augustine should agree with both statements. A corporate code of ethics should articulate the values, responsibilities, and ethical conduct of an organization and should be included in a statement of governance policies. Also, a statement of director's oversight, monitoring, and review responsibilities should include information regarding internal controls, risk management, accounting disclosure, compliance, nominations, and compensation awards.

(Study Session 8, Module 24.1, LOS 24.f)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #39 of 63

Most corporate governance systems focus on the elimination or reduction of any potential conflicts that may arise between management and:

A) shareholders.

B) employees.

C) directors.

Explanation

There is potential for many conflicts of interest to arise in a corporation, but most corporate governance systems focus on those between management and shareholders.

(Study Session 8, Module 24.1, LOS 24.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #40 of 63

Entering into a merger that would provide benefits for management, but ultimately would destroy shareholder value is an example of:

A) strategic policy risk.

B) asset risk.

C) liability risk.

Explanation

Strategic policy risk is the risk that managers may enter into transactions or incur other business risks that would not be in the best long-term interests of shareholders, but would result in large payoffs for managers or directors.

(Study Session 8, Module 24.1, LOS 24.h)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Samantha Zillner, CFA is evaluating corporate governance issues at Peabody Systems Inc. Recently, Peabody has been under market scrutiny as the firm has announced restatements of financial statements for the past three years. Additionally, the Chairman and CEO has resigned amid allegations of improper self-dealings and the company is under review by the SEC.

Zillner notes that:

i. Corporate governance systems will vary according to the legal environment, culture and industry in which the firm operates; however, there are core attributes that all effective corporate governance systems share.
ii. The Board of Directors of a corporation is an important determinant of the effectiveness of corporate governance systems acting as a check and balance between management and shareholders. It is a necessary task for the analyst to assess the effectiveness of the Board.
iii. One of the key objectives of good corporate governance is to try and avoid the potential conflicts of interest that can occur amongst the various stakeholders of the business.
iv. There are three major business forms, Sole Traders, Partnerships and Corporations. Each of these three business structures is thought to suffer to some degree from potential conflicts of interest amongst stakeholders.
v. The strength and effectiveness of a corporate governance system has a direct impact on the value of a business. A number of studies have been undertaken to assess the impact.
    1. The existence of a weak or ineffective corporate governance system increases the risk to the investor. This increased risk will reduce the value of the company and in extreme cases deficient corporate governance can cause a company to go bankrupt.

Question #41 of 63

Which of the following is *least likely* to be a core attribute of an effective corporate governance system? Effective corporate governance systems:

A) define and communicate to stakeholders the oversight responsibilities of managers and directors.

B) lay an integral and leading role in determining the strategic long term direction of the company.

C) provide for fair and equitable treatment in all dealings between managers, directors and shareholders.

Explanation

This would not be a core attribute of the corporate governance system – this is rather something for the senior management of the business to decide upon, with help and input from the board.

(Study Session 8, Module 24.1, LOS 24.h)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #42 of 63

Which of the following statements would be evidence of a corporation that had not adopted global best practice with regards to the Board of Directors?

A) The composition of the Board is made up of 75% of members who are independent.

B) Has not adopted staggered elections for appointment to the Board of Directors.

C) A Board that has a number of independent members who serve on several other Boards, in order to bring a variety of business experience to the Corporation.

Explanation

Best practice recommends that Board Members should not serve on more than two or three boards. Staggered boards are not recommended as they limit the ability of shareholders to alter the composition of the board quickly.

(Study Session 8, Module 24.1, LOS 24.h)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #43 of 63

Looking at the relationship between Directors and Shareholders, which of the following would *least likely* be regarded as a significant potential conflict of interest for those Directors with non-operational responsibilities?

A) Growing the size of the business to receive increased job security, power and compensation.

B) Interlinked Boards.

C) Directors receiving high levels of compensation.

Explanation

This would normally be a conflict of interest that would be associated with a manager of the business not a Board Member with non-executive responsibilities.

(Study Session 8, Module 24.1, LOS 24.h)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #44 of 63

Which of the following statements in respect of these three types of business is *least likely* to be correct?

A) Since stockholders in a corporation have limited liability and can only lose the amount invested and no more, corporations face little or no conflict of interest.

B) Partnerships solve their internal conflicts of interest with the existence of partnership agreements that clearly spell out the roles and responsibilities of

C) Due to the lack of a Board of Directors and a Management team, sole proprietors face conflicts of interest only with their creditors and suppliers.

Explanation

Corporate shareholders have limited liability but this does not preclude the existence of a conflict of interest between the shareholders and the management and/or directors.

(Study Session 8, Module 24.1, LOS 24.h)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #45 of 63

Which of the following statement is *least likely* to be correct with respect to the findings of studies evaluating the impact of corporate governance on firm value?

A) The best governed companies generate an ROE that exceeds poorly governed firms by 23.8%.

B) Portfolios of companies with strong shareholder rights protections were found to outperform companies with weaker protections by 25% per annum.

C) US and International Companies with strong corporate governance have been shown to have higher measures of profitability and generate higher returns to

Explanation

A slightly excessive claim – the study only found the excess to be 8.5%. The other statements are all correct.

(Study Session 8, Module 24.1, LOS 24.h)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #46 of 63

Which of the following is *least likely* the description of one of the risks of poor corporate governance?

A) The directors of the firm invest in assets that are inherently risky and therefore cause volatility in the earnings stream of the business. This is asset risk.

B) Management may enter into transactions that may not be in the best interest of shareholders but will provide benefits to managers. This is strategic policy risk.

C) Information that investors use to make investment decisions about the company is incomplete, misleading or materially misstated. This is financial disclosure risk.

Explanation

Asset risk arises when managers and directors use company assets inappropriately. Examples would include paying excess compensation and perks.

(Study Session 8, Module 24.1, LOS 24.h)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #47 of 63

Which of the following theories related to ethical decision making and the social responsibility of business concludes that people are more than just an economic input and thus deserve more weight and respect?

A) Kantian Ethics. ✓

B) The Friedman Doctrine. ✗

C) Utilitarianism. ✗

Explanation

Kantian ethics is the widely accepted theory that says that people are different from other factors of production and thus deserve more dignity and respect. The Friedman Doctrine is almost just the opposite; it states that the only social responsibility of businesses is to increase profits within the confines of adhering to applicable laws. Utilitarianism argues businesses must weigh the consequences to society of each of their actions and seek to produce the highest good for the largest number of people.

(Study Session 8, Module 23.1, LOS 23.d)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #48 of 63

A manager makes a difficult decision not knowing all the ramifications of that decision other than financial and economic benefits will accrue to society and the firm. The manager reasons that the decision has benefits for some of the poorest countries. This is an example of:

A) a combination of the Friedman doctrine and utilitarianism. ✗

B) the veil of ignorance and the differencing theory. ✓

C) rights and justice theories. ✗

Explanation

Rights theory argues that all individuals have fundamental rights and privileges. Even if an action such as sweatshop labor is legal, it may violate fundamental rights and be unethical.

Justice theory focuses on a just distribution of economic output. Under a "veil of ignorance" managers lacking all the necessary information are charged with making ethical decisions requiring difficult tradeoffs. This theory is based on the premise that as long as there are gains to all parties involved this is a legitimate way of making ethical decisions. Justice theory recognizes unequal divisions of wealth and income may be acceptable under the *differencing principal*, which holds the unequal division must benefit the least advantaged members of society.

Milton **Friedman** addressed the social responsibility of business which touches on the issue of business ethics by stating that as long as the business has followed all applicable laws then it has met its obligation to the employee.

Utilitarianism argues that businesses must weigh the consequences to society of each of their actions and seek to produce the highest good for the largest number of people.

Kantian ethics argues that people are different from other factors of production, they are more than just an economic input and deserve dignity and respect.

(Study Session 8, Module 23.1, LOS 23.d)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #49 of 63

All of the following are responsibilities of the board of directors for a corporation EXCEPT:

A) ensure new board members are adequately trained to perform board functions.

B) make disclosures regarding company operations, risk, and financial position that are accurate and transparent.

C) ensure that management has supplied the board with sufficient information to be fully informed and make appropriate decisions.

Explanation

Actually making disclosures about company operations is the responsibility of management. It is the responsibility of the board to make sure management is acting in the best interests of shareholders, which may entail appointing/serving on the audit committee to review those disclosures. Both remaining choices listed are all board responsibilities.

(Study Session 8, Module 24.1, LOS 24.d)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #50 of 63

The principal-agent problem can *best* be described as:

A) the agent may act for the well being of the principal rather than that of the stakeholders.

B) the agent may act for his own well being rather than that of the principal.

C) the agent may act for the well being of management rather than that of the stakeholders.

Explanation

In a principal-agent relationship, one party (the agent) acts on behalf of another party (the principal). A principal-agent problem arises when the agent places his own interests ahead of the principal.

(Study Session 8, Module 24.1, LOS 24.c)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #51 of 63

The purpose of the board of directors is to act as an intermediary between shareholders and management to assure that management is acting in shareholders' best interest. Which of the following is NOT a factor that may cause directors to align more closely with managers than shareholders?

A) Directors are employed by financial institutions that lend money to the firm.

B) Directors receive excessive compensation.

C) Directors are responsible for CEO succession planning.

Explanation

Succession planning for the CEO is one of the duties of the board of directors, and should not cause directors to align with management over shareholders. Factors that could cause directors to align more closely with management include:

- Lack of independence (i.e. family relationships, prior employment, or existing business relationships).
- Interlinked boards.
- Directors are overcompensated.

(Study Session 8, Module 24.1, LOS 24.c)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #52 of 63

All of the following are examples of the principal-agent relationship (PAR) problem EXCEPT:

A) two members of a board of directors are having an illicit relationship.

B) a senior executive routinely leaves the office early claiming to work from home yet there is no accountability.

C) an employee calls in sick to use up their sick time since they cannot carry it over to the next year.

Explanation

The PAR problem is generally viewed as being between shareholders (principals) and company executives (agents) but any employee of the firm could be viewed as an agent and therefore contribute to the principal-agent problem if they act in their own best interests to the detriment of the firm. Examples of the PAR problem are:

- CEOs enjoying on-the-job consumption in the form of excessive corner offices or lavish travel that is passed off as a necessary business expense.
- CEOs manipulating the board of directors for excessive compensation packages which are not linked to company performance.
- Executives seeking status by expanding the business (empire building) through acquisitions that do not benefit the existing shareholders. Company size has been strongly linked to executive compensation.

(Study Session 8, Module 23.1, LOS 23.b)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #53 of 63

Which of the following choices is *least likely* to be an internal stakeholder?

A) Employees.

B) Suppliers.

C) Stockholders.

Explanation

Employees, managers, stock holders and board members are key internal stakeholders. Suppliers are external stakeholders.

(Study Session 8, Module 23.1, LOS 23.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #54 of 63

Michael Tormey and Amy Arnett are the founding partners of McMillan Corporate Services. Founding the business was relatively straightforward and over the last 20 years, the expertise provided by Tormey and Arnett have been key to making McMillan a success. Every Friday afternoon, Tormey and Arnett meet to discuss the status of the business, and have decided to devote this week's meeting to strategic alternatives. Tormey believes that while the partnership structure has served McMillan well during its history, it may be time to reform the business into a corporate structure. Arnett, however, is not so sure. Which of the following arguments would be *most* effective to convince Arnett that a corporate structure would be beneficial for McMillan? The corporate structure would:

A) create a legal separation between the owners and the business, allow for fewer conflicts of interest, and reduce the liability that they as owners would incur.

B) allow for easier transition of ownership, reduce legal requirements associated with running the business, and create a legal separation between the owners and the

C) provide more opportunities for raising capital, allow for easier transition of ownership, and reduce the liability that they as owners would incur.

Explanation

A partnership allows two or more people to start a business with few legal requirements. Disadvantages of the partnership structure include a limited ability to raise capital, unlimited liability for owners, and non-transferability of ownership. A corporation is a distinct legal entity that has rights similar to a person. Compared to a partnership, a corporation has a nearly unlimited ability to raise capital, ownership is easily transferable, and the legal separation between the business and its owners limits the liability of the business owners. Disadvantages to the corporate form include increase legal and regulatory requirements and increased conflicts of interest as a result of the separation between owners and managers of the business.

(Study Session 8, Module 24.1, LOS 24.b)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #55 of 63

Which of the following statements *least accurately* describes a flaw of Utilitarianism which advocates producing in a manner that results in the most benefit to the largest number of individuals?

A) Producing for the greatest benefit to the largest number of people can discriminate against a smaller subgroup of individuals.

B) It is difficult to accurately measure costs and benefits to society across large numbers of individuals.

C) This doctrine is not sufficient to be considered a complete philosophy.

Explanation

Utilitarianism argues business must weigh the consequences to society of each of their actions and seek to produce the highest good for the largest number of people. The flaws of this philosophy include that many costs and benefits of actions are difficult to measure. In addition utilitarianism fails to consider that justice as the greatest good for the many could well come at the expense of exploiting a smaller subgroup.

(Study Session 8, Module 23.1, LOS 23.d)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #56 of 63

Which of the following statements is *least* accurate regarding roots of unethical behavior?

A) Business ethics is completely separate from personal ethics.

B) A person with strong sense of personal ethics is likely to behave ethically in a business setting.

C) Lapses in ethical behavior by businesses may be due to failure to ask relevant questions.

Explanation

Business ethics is not divorced from personal ethics and hence persons with strong sense of personal ethics are unlikely to behave unethically in business settings. Not asking relevant question removes any consideration of ethical dimension in business decision making.

(Study Session 8, Module 23.1, LOS 23.c)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #57 of 63

In general, a corporate governance system will NOT strive to manage a potential conflict of interest that may arise between management and which of the following groups?

A) Auditors.

B) Creditors.

C) Employees.

Explanation

Corporate governance policies attempt to eliminate the opportunity for management to place their own interest ahead of other stakeholders, such as shareholders, creditors, directors, employees, and customers.

(Study Session 8, Module 24.1, LOS 24.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #58 of 63

Corporate governance is defined as:

A) the system of principles, policies, procedures, and clearly defined responsibilities and accountabilities used by stakeholders to overcome conflicts of interest inherent

B) the system in a corporate structure that ensures fairness and equitable treatment in all dealings between managers, directors, and shareholders.

C) a system designed to ensure that a corporation's business is conducted in an ethical, fair, and professional manner.

Explanation

McEnally and Kim define corporate governance as "the system of principles, polices, procedures, and clearly defined responsibilities and accountabilities used by stakeholders to overcome conflicts of interest in the corporate form."

(Study Session 8, Module 24.1, LOS 24.a)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3

Question #59 of 63

Which of the following is NOT a risk arising from having an ineffective corporate governance system?

A) An otherwise profitable company may not have cash on hand to pay its bondholders.

B) Management may use company assets for personal or inappropriate purposes.

C) Management may enter into off-balance sheet obligations that reduce the value of a company.

Explanation

A profitable company having inadequate cash to pay its bondholders is an example of liquidity risk and would be a result of poor financial management rather than poor corporate governance. The primary risks of an ineffective corporate governance system include financial disclosure risk, asset risk, liability risk, and strategic policy risk.

(Study Session 8, Module 24.1, LOS 24.h)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #60 of 63

An external stakeholder would be an example of which of the following?

A) An independent member of the board of directors of the firm.

B) A customer who wants to buy the firm's product at a lower price.

C) A stockholder who is supplying risk capital.

Explanation

Customers would be considered an external stakeholder along with suppliers, creditors, unions, and governments. Internal stakeholders would be stockholders, employees, managers, and members of the board of directors.

(Study Session 8, Module 23.1, LOS 23.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #61 of 63

The main objectives of a corporate governance system are *best* described as to:

A) eliminate or reduce conflicts of interest, and to use the company's assets in a manner consistent with the stakeholders' best interests.

B) facilitate open communication between management and stakeholders, and to most effectively utilize corporate assets.

C) define the rights of shareholders, and to facilitate fair and equal treatment in dealings between management and other stakeholders.

Explanation

A corporate governance system generally focuses on the elimination or reduction of conflicts of interest, particularly between management and shareholders, as well as the prudent utilization of corporate assets for the benefit of investors and other stakeholders.

(Study Session 8, Module 24.1, LOS 24.a)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #62 of 63

Which of the following is *most consistent* with corporate governance best practice?

A) Half of the board members are independent.

B) Elections are staggered with at least 3 directors up for reelection to the board each year.

C) Any related-party transactions must be approved in advance by the board of directors.

Explanation

Any insider or related-party transactions, such as making a personal loan to a company CEO should be approved in advance by the board of directors. Note that for purposes of the exam, global best practice calls for 75% of board members to be independent, board members do not serve on more than 2-3 boards total, and that all directors are elected annually.

(Study Session 8, Module 24.1, LOS 24.e)

Related Material

SchweserNotes - Book 2

SchweserNotes - Book 3

Question #63 of 63

Mitchell Cash of Yost and Karl Consulting is comparing and contrasting sole proprietorships, partnerships, and corporations for a new client that is looking to start a business. Cash makes the following statements to the client:

Statement 1:	Sole proprietorships have potentially unlimited liability, but the liability for a corporate owner is limited to the amount of their investment.
Statement 2:	Sole proprietorships and partnerships have fewer corporate governance risks than corporations.
Statement 3:	In most cases, there is no legal distinction between the owner and the business within a sole-proprietor structure.

Regarding Cash's statements:

A) Statements 2 and 3 are incorrect, but Statement 1 is correct.

B) all three statements are correct.

C) Statements 1 and 3 are correct, but Statement 2 is incorrect.

Explanation

Cash is correct with respect to all three statements.

(Study Session 8, Module 24.1, LOS 24.b)

Related Material

SchweserNotes - Book 2
SchweserNotes - Book 3