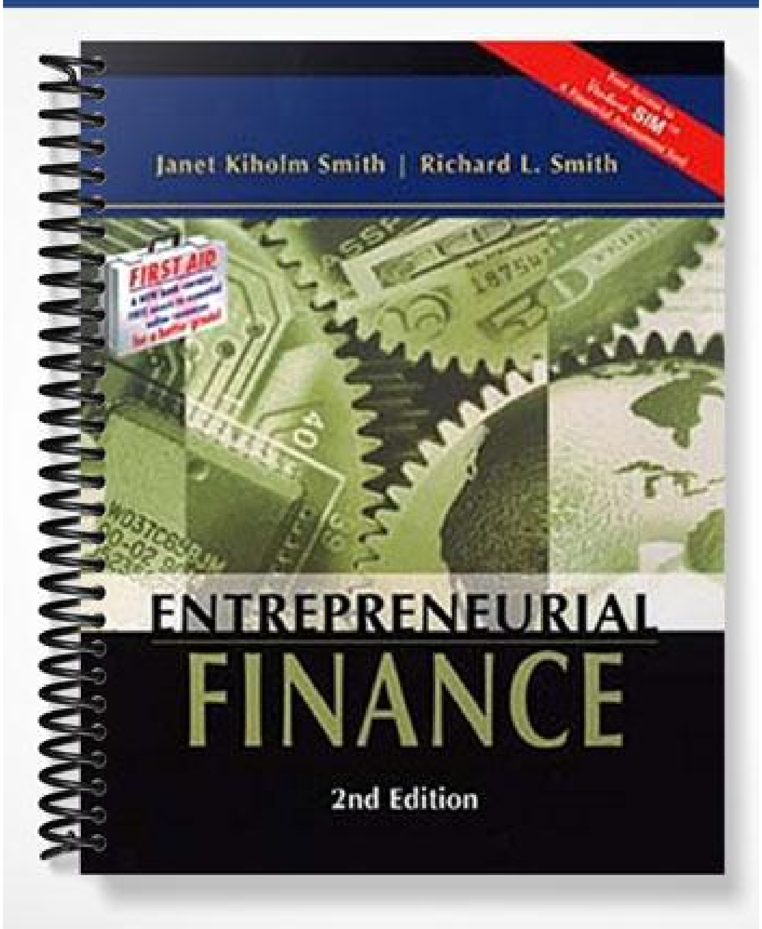
TEST BANK


Janet Kiholm Smith | Richard L. Smith
FIRST AID
ENTREPRENEURIAL
FINANCE
2nd Edition

Test Bank

<u>Entrepreneurial Finance</u>

2nd Edition

Janet Kiholm Smith and Richard L. Smith

Questions and problems in this test bank are intended to assess student understanding of the most central concepts from each chapter. Except where student understanding and recollection of mathematical models is central to a basic understanding of chapter material, the questions and problems emphasize concepts over memorization.

Chapter 1:

1. **A sound investment decision is to seek out and acquire assets that are worth more than they cost. Ultimately, the worth, or value, of an investment depends on:**

   A) the expected future prices of the investment's assets.
   B) the current market prices of the investment's assets.
   C) the investment's ability to generate cash flows and the riskiness of those cash flows.
   D) all of the above.

Answer: C

2. **Empirical studies show that the most new ventures fail because of:**

   A) neglect and inexperience.
   B) economic and financial troubles.
   C) unsuccessful idea and implementation.
   D) all of the above.

Answer: B

3. **What are the most important differences between corporate finance and entrepreneurial finance?**

Answer:
- The separability of investment decisions from financing decisions
- The role of diversification of risk as a determinant of investment value
- The extent of managerial involvement by outside investors
- The importance of options as a determent of project value
- The effect of information problems on the firm's ability to undertake a project
- The role of contracting to resolve incentive problems
- The importance of harvesting as an aspect of valuation and the investment decision
- The focus on maximizing value for the entrepreneur as distinct from maximizing value for shareholders

4. **Unlike in corporate finance, entrepreneurial investing and financing decisions are highly interdependent. Explain.**

Answer:
The entrepreneur usually is required to invest substantially more capital than outside investors, which in turn affects the required rate of return and creates a difference in valuation between the entrepreneur and the outside investors. In some cases, the entrepreneur will be willing to invest in a project only if a substantial amount of the project financing will be generated from outside investors (on terms favorable to the entrepreneur).

5. Why is it valuable to emphasize the concept of "real options" in entrepreneurial finance?

Answer:
The value of real options associated with an investment depends on the level of uncertainty surrounding the investment. Because the uncertainty surrounding a start-up is usually high, the values of real options become important. In fact, a new venture can be viewed as a portfolio of real options.

6. Which of the following are examples of "real options" that arise in a new venture setting?

A) The investor has the right to abandon the project if a particular performance milestone is *not* met.
B) If a milestone is met, the entrepreneur has the right to invest additional cash.
C) The entrepreneur and investor each has the right to "wait and see" how the project develops before deciding to invest more time and money.
D) All of the above.
E) None of the above.

Answer: D

7. Why does the objective of "maximizing value for the entrepreneur" result in different decisions than the objective of "maximizing value for the investor"? Provide an example.

Answer:
An entrepreneur generally will hold an undiversified position in the venture. An investor, on the other hand, generally will hold a diversified portfolio. Therefore, given an expected cash flow stream, the entrepreneur will place a lower value on the cash flows of the venture than will the diversified investor.

8. How does an entrepreneur decide whether to pursue a venture?

Answer:
The entrepreneur must weigh the expected benefits of the venture, including any nonpecuniary benefits he or she anticipates (associated with being self-employed, for example), against the expected costs, including opportunity costs of being employed elsewhere. In making the decision, the entrepreneur's objective is to maximize the value of the financial claims and other benefits that the entrepreneur is able to retain in the business.

Chapter 2:

1. What are some considerations in deciding on the legal form for a new venture?

Answer:

- The tax implications associated with the legal form of the venture
- The effect of the legal form on the venture's ability to raise capital
- The effect of the legal form on future harvesting opportunities
- Legal liability

2. In the case of a *limited partnership*, the legal liability that applies is:

A) each partner is fully liable for business debts
B) liability of partners is limited to the extent of their investments
C) each general partner is fully liable for business debts; limited partners are liable to the extent of their investments
D) partners have no legal liability

Answer: C

3. In the case of *a limited-liability partnership,* the legal liability that applies is:

A) each partner is fully liable for business debts
B) liability of partners is limited to the extent of their investments
C) each general partner is fully liable for business debts; limited partners are liable to the extent of their investments
D) partners have no legal liability

Answer: B

4. The tax treatment applicable to an *S corporation* is best described as:

A) earnings pass through to owners
B) earnings are taxable to the corporation when earned and to the shareholders when realized
C) earnings pass through to shareholders (corporation does not pay taxes)
D) earnings are taxable to the corporation

Answer: C

5. The use of "milestone financing" is beneficial to the entrepreneur as well as the outside investors. Explain.

Answer:
Milestone financing allows the outside investor to postpone the commitment to finance additional stages. So the investor can "wait and see" the results of the initial investment before

offering additional financing. The staging of cash infusions also serves the interest of the entrepreneur. An untested entrepreneur has a limited ability to convince others that the money will be invested wisely. Investors' concerns about the project make early investment capital expensive for the entrepreneur (large fraction of the ownership will be exchanged with a small amount of capital). Staging allows the entrepreneur to decrease the amount of the expensive early-stage financing.

6. Mezzanine financing is used to support:

A) early- stage financing and research and development.
B) later-stage financing and harvesting.
C) all-equity financing.
D) low-risk financing.
***E)* firms located on second floors of buildings.**

Answer: B

7. Bridge financing is:

A) temporary financing for later-stage and to facilitate harvesting, leverage buyout, or management buyout.
B) early-stage financing of research and development.
C) permanent debt financing.
D) government-subsidized debt financing.
E) financing for bridges and tunnels.

Answer: A

8. When a deal contract includes a "ratchet," the venture capitalist has the right to:

A) withdraw from the contract.
B) negotiate with the entrepreneur for financing before seeking any new outside financing.
C) receive protection from dilution of value in the event of subsequent financing at a lower valuation.
D) sell shares at any time.

Answer: C

9. The early-growth stage is characterized by:

A) positive cash flow.
B) revenue growth with negative cash flow and negative net income.
C) declining rate of revenue growth with positive cash flow and positive net income.
D) revenue growth with positive cash flow and positive net income.

Answer: B

10. Identify sources of financing for an entrepreneur and identify which type of financing is most appropriate for the four basic development stages for a new venture: Development, start-up, early growth, rapid growth, and exit.

Answer:
See Figure 2.3 in text. Sources are: entrepreneur, friends and family, angel investors, strategic partners, venture capital, asset-based lender, equipment lessor, SBIC, trade credit, factor; mezzanine lender, private loans, public debt, IPO, acquisition, LBO, MBO.

11. Identify at least four factors that an entrepreneur should consider when choosing a venture capitalist?

Answer:
Aside from the fact that the venture has to be actively searching for a new investment, there are four main factors:

- The suitability of the venture's development stage to the financing preference of the VC.
- The industry where the VC operates. VCs tend to focus on industries in which their expertise is most valuable.
- The geographic region in which the VC operates. VCs tend to concentrate in particular geographic areas.
- The compatibility of the investment horizon between the venture and the VC. VC funds have a finite life (usually 7-10 years, sometimes with extensions)

12. Identify at least two advantages of a private placement relative to public placement of debt?

Answer:

- The cost of private placement tends to be lower and sometimes quicker than a public placement.
- With private placement, it is possible to negotiate greater flexibility in the security arrangements and terms.
- Private placement results in concentrated ownership and may permit the investor to monitor the performance of the venture.

13. Identify and discuss some considerations (costs and benefits) involved in a decision of taking a private company public.

Answer:
Benefits: IPO is a way for early-stage investors to realize gains on investments, achieve liquidity, and diversify asset holdings. IPO also provides a market-determined valuation that can be used as a basis for negotiating mergers and acquisitions with other firms. In addition, having a market price for the firm's stocks provides the firm manager with information on the market expectation of the firm's performance. An IPO may bring a higher share price than private placement. Public

ownership also provides a way to create equity incentives for employees. Finally, a publicly traded firm may be able to raise capital more quickly and cheaply then a private firm.
Costs: An IPO involves opportunity costs of managerial time and expenses, as well as out-of-pocket expenses for compliance with SEC regulations and reporting requirements. The presence of a price for the firm's stock may divert the attention away from management from the long-term strategic considerations and toward the short-term fluctuations in the stock price.

14. Consider a deal in which the investor will contribute $1 million for 400,000 of the firm shares and the entrepreneur will retain 600,000 shares. Compute the "post-money valuation" and "pre-money valuation" in this deal and discuss the difference in the concepts.

Answer:
The post-money valuation is the total value of the venture that is implied by multiplying $2.50 per share by the entire 1 million shares. The pre-money valuation is $1.5 million, which equals the post-money valuation less the $1 million investment. The post-money valuation is a measure of the value of the venture for the outside investor.

15. The Macrosoft Co. sells to its customers on a 1/30 net 60 basis. Jack's Club buys $20,000 worth of goods from them.

A) How much can Jack deduct from the bill if he pays on day 30?
B) What is the effective annual rate of interest if Jack pays on the due date rather than on day 30?

Answer:
A) 1% of $20,000, or $200

B) Using the equation in the text, the implicit interest rate is: $((1+\text{ discount percent})^{365/\text{credit period}} - 1)$, or $1.01^{365/30} - 1$, or 12.87 %.

16. Why do firms offer "free" credit, such as net 30 or net 60 terms? Would it be better to make all sales for cash and then charge late payers an interest fee?

Answer:
Possible explanations for the bundling of goods and credit include:

- Buyers may demand time to inspect the product prior to paying the bill.
- Demand for the product or service is greater, other things the same, if offered on credit.
- The seller has a better ability to assess the creditworthiness of the buyer and to monitor the buyer if the seller offers credit rather than relying on a bank to offer credit.
- Selling on terms that include a discount period, may provide the seller the ability to "screen" repeat buyers—those buyers who take the expensive credit and do not pay by the discount date may be in more precarious financial circumstances, and may warrant more monitoring, than those customers who take the prompt-payment discount and do not accept the credit.