

## Chapter 1: Introduction to Finance

### MULTIPLE CHOICE

- 1) Finance is
- A) the study of investment management.
  - B) the study of the stock exchange.
  - C) the study of the capital market and its many players.
  - D) the study of money management for personal use.

ANS: C

Finance is the study of the capital market and its many players.

DIF: Easy REF: Section 1.2 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

- 2) What is the purpose of the capital market?
- A) to match people with money to entrepreneurs with great business ideas or concepts
  - B) to more easily regulate the flow of money between parties
  - C) to make money without trying
  - D) to allow people to buy stocks for retirement

ANS: A

The capital market matches entrepreneurs with great business ideas or concepts to people with money.

DIF: Easy REF: Section 1.2 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

- 3) Which of the following is NOT one of the basic questions for corporate finance?
- A) How should we raise the money?
  - B) What are we going to make?
  - C) What do we do with our profits?
  - D) How big of a bonus should we get?

ANS: D

The three questions for corporate finance are: How should we raise the money? What are we going to make? Do we pay out our profits, or invest them?

DIF: Easy REF: Section 1.2 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

- 4) Which one of the following would a financial advisor say is most important?
- A) making decent dough over the long haul
  - B) making a quick buck
  - C) avoiding paying taxes whenever possible
  - D) properly financing a large purchase

ANS: A

Most importantly, financial advisors help you make decent dough over the long haul.

DIF: Easy REF: Section 1.2 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

5) Which of the following would be the course where you learn to tell the good stocks from the bad, and the sure things from the really risky?

- A) corporate Finance
- B) investments
- C) personal Finance
- D) derivative Securities

ANS: B

Investments is the course where you learn to tell the good stocks from the bad, and the sure things from the really risky.

DIF: Easy REF: Section 1.2 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

6) Which of the following is NOT a financial intermediary?

- A) investment banks
- B) the United States Treasury Department
- C) hedge funds
- D) insurance companies
- E) thrift institutions

ANS: B

Financial intermediaries include banks and thrifts, investment banks, pension, mutual, and hedge funds, and insurance companies.

DIF: Easy REF: Section 1.3 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

7) The primary role of a financial system is to

- A) make savvy investors rich.
- B) regulate the banking system.
- C) enable financial managers to evaluate investment projects with a system that always selects the correct opportunity for their firm.
- D) channel funds from savers to borrowers who need funds for investment projects.
- E) provide employees in financial institutions with a code of ethics.

ANS: D

The financial system transfers money from suppliers to users.

DIF: Easy REF: Section 1.3 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

8) The financial system connects entrepreneurs with which of the following?

- A) people with money
- B) capitalists
- C) the supply side
- D) the government
- E) investment bankers

ANS: A

The financial system transfers money from suppliers to users.

DIF: Easy REF: Section 1.3 KEY: AACSB/Analytical Thinking OBJ: F-01: Describe the different financial markets and the role of the financial managers

9) According to your text, major players in the money market include all of the following EXCEPT:

- A) the U.S. Treasury
- B) the Federal Reserve System
- C) commercial banks
- D) companies
- E) the U.S. Commerce Department

ANS: E

The U.S. Commerce Department is not a major player in the money market.

DIF: Easy REF: Section 1.4 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

10) Which of the following is NOT considered a capital market security?

- A) mortgage-backed securities
- B) corporate bonds
- C) common stock
- D) foreign currencies
- E) municipal bonds

ANS: D

Foreign currencies are not capital market securities

DIF: Easy REF: Section 1.4 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

11) Money markets are markets for

- A) foreign currency exchange.
- B) corporate stocks.
- C) long-term bonds.
- D) short-term debt securities.
- E) preferred securities.

ANS: D

In a money market, the securities are short term and highly liquid.

DIF: Easy REF: Section 1.4 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

12) Which of the following statements is TRUE regarding common and preferred shares?

- A) Preferred shareholders have more voting power than common shareholders.
- B) Common shareholders are guaranteed a fixed dividend.
- C) Common shareholders have a more senior claim against assets than preferred shareholders.
- D) Preferred shareholders are entitled to their dividends before common shareholders.
- E) Common shareholders earn a better return than preferred shareholders.

ANS: D

Preferred shareholders are entitled to their dividends before common shareholders.

DIF: Easy REF: Section 1.4 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

13) Common stockholders expect to receive a return through capital gains and

- A) interest payments.
- B) dividends.
- C) fixed periodic dividends.
- D) coupon payments.
- E) receiving shares of preferred stock.

ANS: B

Common shareholders receive a dividend at the discretion of the board.

DIF: Easy REF: Section 1.4 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

14) Which of the following is NOT a major participant in the money market?

- A) money market mutual funds
- B) commercial banks
- C) Wall Street dealers
- D) Federal Reserve
- E) U.S. Treasury

ANS: C

The players in the money market are the U.S. Treasury, corporations, funds, Federal Reserve, insurance companies, pensions, and banks.

DIF: Easy REF: Section 1.4 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

15) Shares of which of the following are units of ownership interest, or equity, in a corporation?

- A) debt
- B) common stock
- C) bank loans
- D) commercial paper
- E) debentures

ANS: B

Shares of common stock represent ownership in a corporation.

DIF: Easy REF: Section 1.4 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

16) Which of the following are long-term debt instruments that businesses and the government use to raise large sums of money?

- A) T-bills
- B) bonds
- C) common stocks
- D) preferred stocks
- E) commercial papers

ANS: B

Bonds are debt instruments issued by governments and corporations with a maturity of more than a year.

DIF: Easy REF: Section 1.4 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

- 17) Which of the following statements best describes mutual funds?
- A) They are illegal in the United States, but popular in Europe.
  - B) They enable investors to buy many shares of stock in a single firm at a lower cost than using a stockbroker.
  - C) They provide good investment returns, but insufficient diversification.
  - D) They enable many investors with limited funds to buy a diversified portfolio.
  - E) They appeal only to wealthy investors.

ANS: D

A mutual fund is a professionally managed pool of money which comes from a disparate group of investors who exchange their money for shares in the fund.

DIF: Easy REF: Section 1.4 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

- 18) The \_\_\_\_\_ is a financial relationship created by a number of institutions with arrangements that allow the suppliers and demanders of long-term funds to make transactions.
- A) money market
  - B) Eurobond market
  - C) bond market
  - D) capital market
  - E) futures market

ANS: D

Capital markets are markets in which securities have an original maturity greater than one year.

DIF: Easy REF: Section 1.4 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

- 19) Which of the following are rights of stockholders?
- A) to share in the firm's profits after all other creditors have been satisfied
  - B) to be guaranteed a dividend
  - C) to decide whether or not to pay taxes on capital gains
  - D) to vote for directors, but never on specific issues
  - E) to avoid losses when the firm's prospects decline

ANS: A

Stockholders are residual claimants, meaning they share in the profits after all other creditors have been satisfied.

DIF: Easy REF: Section 1.4 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

- 20) What is the maximum maturity of securities that trade on the money markets?
- A) 1 year
  - B) 2 years
  - C) 3 years
  - D) 30 years

ANS: A

In the money market, the securities mature in less than 1 year from their issue date.  
DIF: Easy REF: Section 1.4 KEY: AACSB/Analytical Thinking OBJ: F-01:  
Describe the different financial markets and the role of the financial managers

- 21) The \_\_\_\_\_ price is \_\_\_\_\_ the \_\_\_\_\_ price.  
A) bid; above; ask  
B) bid; below; ask  
C) ask; below; bid  
D) ask; above; bid  
E) Both B and D are correct.

ANS: E

The ask price is the price the seller wants to receive, and the bid price is the price the buyer is willing to pay.

DIF: Easy REF: Section 1.5 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

- 22) A firm raises capital to finance new equipment by selling bonds in the  
A) secondary market.  
B) primary market.  
C) futures market.  
D) options market.  
E) federal funds market.

ANS: B

Primary markets are for securities offered for sale for the first time.

DIF: Easy REF: Section 1.5 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

- 23) The \_\_\_\_\_ is the financial market in which securities are initially issued.  
A) private placement  
B) OTC  
C) primary market  
D) secondary market  
E) NASDAQ

ANS: C

Primary markets are for securities offered for sale for the first time.

DIF: Easy REF: Section 1.5 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

- 24) The over-the-counter market is  
A) the New York Stock Exchange.  
B) an organized stock exchange.  
C) a physical place where securities are bought and sold.  
D) an intangible market for unlisted securities.  
E) where commodities futures are bought and sold.

ANS: D

The over-the-counter market is an intangible market for unlisted securities.

DIF: Easy REF: Section 1.5 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

- 25) Which of the following is a role of the secondary market?

- A) keep prices level
- B) give information for securities on sale in the primary market
- C) trade long term securities only
- D) offer securities for sale for the first time
- E) establish security prices

ANS: E

One of the most important roles of the secondary market is establishing security prices.  
DIF: Easy REF: Section 1.5 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

- 26) \_\_\_\_\_ are further divided into two groups: Auctions and Dealer markets.
- A) Secondary markets
  - B) Primary markets
  - C) Money markets
  - D) Capital markets
  - E) Investment markets

ANS: A

Secondary markets are further divided into two groups: (1) Auctions and (2) Dealer markets.

DIF: Easy REF: Section 1.5 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

- 27) The primary market is intermediated by \_\_\_\_\_ banks, which buy securities from the issuer and sell them to individuals and funds.
- A) commercial
  - B) investment
  - C) central
  - D) retail
  - E) underwriter

ANS: B

The primary market is intermediated by investment banks. The banks (alone or in groups) buy the new securities from the issuer and sell them to individual investors and funds.

DIF: Easy REF: Section 1.5 KEY: AACSB/Analytical Thinking OBJ: F-01: Describe the different financial markets and the role of the financial managers

- 28) When you buy from a dealer, you pay the \_\_\_\_\_ price.
- A) bid
  - B) ask
  - C) quoted
  - D) market

ANS: B

In a dealer market, multiple dealers simultaneously make a market in an individual security. Each dealer holds an inventory of the security, posts buy (bid) and sell (ask) prices, and stands ready to trade.

DIF: Easy REF: Section 1.5 KEY: AACSB/Analytical Thinking OBJ: F-01: Describe the different financial markets and the role of the financial managers

- 29) Is the foreign exchange market an auction or a dealer market?

- A) auction
- B) dealer
- C) neither

ANS: B

There is no centralized market for trading foreign currency, so the market is a dealer market.

DIF: Easy REF: Section 1.5 KEY: AACSB/Analytical Thinking OBJ: F-01: Describe the different financial markets and the role of the financial managers

- 30) Which of the following is not an important dimension of the liquidity of a market?
- A) daily number of trades on the market
  - B) number of traders participating in the market
  - C) the quantity of shares available to be traded (depth)
  - D) the number of securities listed on the market

ANS: D

The three dimensions of liquidity are: 1) number of trades; 2) number of traders; and 3) the depth of trading.

DIF: Easy REF: Section 1.5 KEY: AACSB/Analytical Thinking OBJ: F-01: Describe the different financial markets and the role of the financial managers

- 31) The purchase and sale of securities after the original issuance occurs in the
- A) primary market.
  - B) secondary market.
  - C) dealer market.
  - D) auction market.
  - E) liquidation market.

ANS: B

Primary markets are for securities offered for sale for the first time. The secondary market is where all subsequent transactions in those securities occur.

DIF: Easy REF: Section 1.5 KEY: AACSB/Analytical Thinking OBJ: F-01: Describe the different financial markets and the role of the financial managers

- 32) Which of the following are agency costs?
- I. Forgoing an investment opportunity which would add to the market value of the owner's equity
  - II. Paying a dividend to each of the existing shareholders
  - III. Purchasing new equipment which increases the value of each share of stock
  - IV. Hiring outside auditors to verify the accuracy of the company financial statements
- A) I and III
  - B) I and IV
  - C) II and III
  - D) II and IV
  - E) I, II, and IV

ANS: B

Agency costs are the loss of the principal's wealth associated with the agent's waste and cost of resources used to monitor agents' behavior and align incentives.

DIF: Easy REF: Section 1.6 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers



- 33) What is the principal-agent problem?  
A) when the principal misrepresents the agent to the board  
B) when an agent does not maximize the utility of the principal  
C) the cost of training new agents  
D) when an agent misrepresents the principal to the board

ANS: B

The principal-agent problem is the problem and cost that occurs when an agent does not maximize the utility of the principal.

DIF: Easy REF: Section 1.6 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

- 34) Agency costs pose the biggest problem for  
A) insiders.  
B) shareholders.  
C) directors.  
D) agents.  
E) executives.

ANS: B

When principals cannot monitor agents, managers have the opportunity to use resources to benefit themselves and not the shareholders.

DIF: Easy REF: Section 1.6 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

- 35) In a broad sense, every business asset is ultimately owned by  
A) individuals.  
B) the federal government.  
C) foreign governments.  
D) trust funds.  
E) None of the above.

ANS: A DIF: Easy REF: Section 1.6 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

- 36) Which of the following statements is TRUE?  
A) The presence of asymmetric information in financial markets increases the likelihood that these markets are efficient.  
B) Accounting profits are always more important to shareholders than cash flows.  
C) Managers should choose investment projects that maximize shareholder wealth.  
D) The study of finance only benefits students who aspire to careers in business.  
E) Investors should not be compensated with a higher return for owning risky securities since they should know better than to buy stock in a firm that has uncertain prospects.

ANS: C

The goal of management is to maximize the share price—in other words, maximize shareholder wealth.

DIF: Easy REF: Section 1.6 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

37) Which of the following is an advantage of a partnership?

- A) no license, charter, or agreement legally required
- B) joint liability for company debts
- C) least regulated form of business
- D) ownership is easy to transfer
- E) can raise money using capital markets (debt and equity)

ANS: A

Advantages of a partnership include no license, charter, or agreement legally required, and pay personal taxes on all business income.

DIF: Easy REF: Section 1.6 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

38) Which of the following is the top of the organizational chart of organizations?

- A) CEO
- B) Board of Directors
- C) V.P. of Finance
- D) shareholders
- E) Executive Chairman

ANS: D

At the top of the organizational chart for a corporation are shareholders, who are owners of the company.

DIF: Easy REF: Section 1.6 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

39) Which of the following is the best way to prevent an agency problem between shareholders and managers?

- A) Maintain a proportional relationship between a manager's bonus and the number of employees in the firm.
- B) Compensate managers to a significant degree with shares of stock in their firm.
- C) Reward managers if they keep costs below the budgeted amount.
- D) Pay managers a bonus if their division exceeds its targeted market share.
- E) Pay managers a bonus if their division exceeds its quarterly sales target.

ANS: B

Aligning managers' interest with shareholder interest helps prevent the principal-agent problem.

DIF: Easy REF: Section 1.6 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

40) \$100 today is worth

- A) the same as \$100 to be received in one year, since the inflation rate has been low recently and funds received in the near future should have the same purchasing power that they have today.
- B) less than \$100 to be received in one year, since many people will spend money foolishly today and will become more careful in their spending habits as they mature.

- C) more than \$100 to be received in one year, since you can invest the money received today for this period, leaving you with more than \$100 in the future.
- D) the same as a future receipt of \$100, since the physical characteristics of U.S. currency are unchanged for long periods of time.
- E) less than \$100 received by someone ten years ago, since many products have been improved over this time period.

ANS: C

A dollar today is worth more than the promise of a dollar next year.

DIF: Easy REF: Section 1.7 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

- 41) As the risk of a stock investment increases,
- A) return will increase.
  - B) return will decrease.
  - C) required rate of return will decrease.
  - D) required rate of return will increase.
  - E) the beta approaches zero.

ANS: D

As the risk of an investment increases, the required return will increase.

DIF: Easy REF: Section 1.7 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

- 42) Which of the following statements about risk is FALSE?
- A) Risk is one of the determinants of the required return.
  - B) Risk requires the possibility of at least one outcome less favorable than the expected value.
  - C) Risk requires the possibility of more than one outcome.
  - D) High risk should require low return.

ANS: D

Higher risk requires higher returns.

DIF: Easy REF: Section 1.7 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

- 43) The efficient market hypothesis states that
- A) requiring firms to issue more stock will reduce volatility.
  - B) requiring investors to hold securities longer will reduce volatility.
  - C) electing a pro-business Republican president makes the market more efficient.
  - D) taxing security returns will raise prices.
  - E) markets price securities fairly at all times and that new information is rapidly reflected in the price.

ANS: E

The efficient market hypothesis states that markets price securities fairly at all times and that new information is rapidly reflected in the price.

DIF: Easy REF: Section 1.7 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

- 44) Information asymmetry is  
A) false information spread by competitors.  
B) when two pieces of information counteract each other.  
C) when some know more than others.  
D) when information is not reflected properly in the market.  
E) incomplete information.

ANS: C

Information asymmetry is when information is not spread evenly among all participants.

DIF: Easy REF: Section 1.7 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

TRUE/FALSE

- 45) Regulating the banking institutions is one of the Federal Reserve's duties.

ANS: T

The Federal Reserve has 3 duties: 1) Conduct monetary policy; 2) Regulate banking institutions; 3) Provide financial services to depository institutions.

DIF: Easy REF: Section 1.3 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

- 46) Money market securities have maturities of one year or less.

ANS: T

Money market securities mature less than 1 year from their issue date.

DIF: Easy REF: Section 1.4 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

- 47) T-bonds are money market securities, while T-bills and T-notes are traded in the capital market.

ANS: F

T-Bills are instruments of the money market.

DIF: Easy REF: Section 1.4 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

- 48) Preferred stock pays a variable dividend.

ANS: F

Preferred stockholders receive a fixed dividend that does not change.

DIF: Easy REF: Section 1.4 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

- 49) Capital markets have maturities of one year or less.

ANS: F

Capital markets are markets in which the securities have an original maturity greater than 1 year.

DIF: Easy REF: Section 1.4 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

50) Agency costs are fees paid by the management of a corporation to compensate any investor that feels it has suffered a loss due to the agency problem.

ANS: F

Agency costs are the loss of shareholder wealth associated with managerial waste and the cost of resources used to monitor agents' behavior and align incentives.

DIF: Easy REF: Section 1.6 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

51) The higher the probability that the return on an investment will not pay off its averaged promised value, the higher the expected return must be to induce an investor to invest in it.

ANS: T

Higher risk requires higher return.

DIF: Easy REF: Section 1.7 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers

52) A firm's net income is a true representation of cash flows available to the stockholders.

ANS: F

Net income is a number meant to represent the average profit available to shareholders.

DIF: Easy REF: Section 1.7 KEY: AACSB/Analytical Skills OBJ: F-01: Describe the different financial markets and the role of the financial managers