Test Bank for Fundamentals of Corporate Finance CDN 6th Brealey

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TRUE/FALSE. Write 'T' if the statement is true and 'F' if the statement is false.

1) Only small companies can go through financial markets to obtain financing.
Answer: True False

2) The reinvestment of cash back into the firm's operations is an example of a flow of savings to investment.
Answer: True False

3) Smaller businesses are especially dependent upon internally generated funds.
Answer: True False

4) An individual can save and invest in a corporation only by lending money to it or by purchasing additional shares.
Answer: True False

5) Previously issued securities are traded among investors in the secondary markets.
Answer: True False

6) Only the IPOs for large corporations are sold in primary markets.
Answer: True False

7) The markets for long-term debt and equity are called capital markets.
Answer: True False

8) The derivative market is also a source of financing for corporations.
Answer: True False

9) Apple Computer is well known for its product innovations. Access to financing was vital to Apple's growth and profitability.
Answer: True False

10) Whenever there is uncertainty, investors might be interested in trading, either to speculate or to lay off their risks, and a market may rise to meet the trading demand.
Answer: True False

11) Financing for public corporations must flow through financial markets.
Answer: True False

12) Financing for private corporations must flow through financial intermediaries.
Answer: True False

13) Hedge fund managers, unlike mutual fund managers, do not receive fund-performance-related fees.
Answer: True False

14) In the United States, banks are the most important source of long-term financing for businesses.
Answer: True False

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15) A financial intermediary invests in financial assets rather than real assets.
Answer: True False

16) The stocks of major corporations trade in many markets throughout the world on a continuous or near-continuous basis.
Answer: True False

17) The key to the banks' ability to make illiquid loans is their ability to pool liquid deposits from thousands of depositors.
Answer: True False

18) For corporate bonds, the higher the credit quality of an issuer, the higher the interest rate.
Answer: True False

19) Like public companies, private companies can also use their stock price as a measure of performance.
Answer: True False

20) Financial markets and intermediaries allow investors and businesses to reduce and reallocate risk.
Answer: True False

21) Almost all foreign exchange trading occurs on the floors of the FOREX exchanges in New York and London.
Answer: True False

22) The cost of capital is the interest rate paid on a loan from a bank or some other financial institution.
Answer: True False

23) The opportunity cost of capital is the expected rate of return that shareholders can obtain in the financial markets on investments with the same risk as the firm's capital investments.
Answer: True False

24) The cost of capital is the minimum acceptable rate of return for capital investment.
Answer: True False

25) The rates of return on investments outside the corporation set the minimum return for investment projects inside the corporation.
Answer: True False

26) During the Financial Crisis of 2007-2009, the U.S. government bailed out all firms in danger of failing.
Answer: True False

27) From June 2001 to June 2006, housing prices in the United States doubled.
Answer: True False

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28) The effects of the financial crisis of 2007-2009 were confined to the U.S. and domestic companies.
Answer: True False

29) One root of the financial crisis of 2007-2009 was the strict money policies promoted by the U.S. Federal Reserve and other central banks after the technology bubble burst (i.e., money was relatively expensive during this time).
Answer: True False

MULTIPLE CHOICE. Choose the one alternative that best completes the statement or answers the question.

30) Which one of these is a money market security?
A) commercial paper
B) 2-year bond
C) common stock
D) 20-year bond
Answer: A

31) Which one of these assists in shifting an individual's consumption forward in time?
A) a life insurance policy
B) a bank line of credit
C) a retirement savings plan
D) a bank savings account
Answer: B

32) Which of the following is *not* typically considered a function of financial intermediaries?
A) providing a payment mechanism
B) spreading, or pooling risk among individuals
C) investing in real assets
D) accumulating funds from smaller investors
Answer: C

33) Commodity and derivative markets:
A) are always over-the-counter markets.
B) deal only in foreign currencies.
C) are additional sources of financing for corporate projects.
D) enable the financial manager to adjust a firm's exposure to various business risks.
Answer: D

34) Which one of these transports income forward in time?
A) car loan
B) retirement savings
C) credit card purchase
D) bank line of credit
Answer: B

35) Who was responsible for the financial crisis of 2007-2009?
A) The U.S. Federal Reserve, for its policy of easy money
B) The U.S. Federal Reserve, the U.S. government, rating agencies, and bankers
C) The U.S. government, for pushing banks to expand credit for low-income housing
D) bankers, who aggressively promoted and resold subprime mortgages
Answer: B

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36) Which one of the following funds not provides a tax advantage to individual investors?
A) funds that are invested in foreign countries
B) bond funds
C) balanced funds
D) pension funds
Answer: A

37) Which of the following financial assets is *least* likely to have an active secondary market?
A) common stock of a large public firm
B) debt issued by the U.S. Treasury
C) bonds of a major, multinational corporation
D) bank loans made to smaller firms
Answer: D

38) A company can pay for its expansion in all the following ways *except*:
A) by purchasing bonds in the secondary market.
B) by using the earnings generated from its sale of obsolete equipment.
C) by selling stock certificates for a new subsidiary.
D) by persuading a director's mother to make a personal loan to the company.
Answer: A

39) Short-term financing decisions commonly occur in the:
A) money markets.
B) capital markets.
C) primary markets.
D) secondary markets.
Answer: A

40) Long-term financing decisions commonly occur in the:
A) capital markets.
B) money markets.
C) option markets.
D) secondary markets.
Answer: A

41) Which type of financial institution generally does not accept deposits but does underwrite stock offerings?
A) Mutual fund
B) Insurance company
C) Investment bank
D) Commercial bank
Answer: C

42) You can buy silver in the:
A) commodities markets.
B) option markets.
C) foreign exchange markets.
D) capital markets.
Answer: A

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43) Which of the following actions does *not* help reduce risk?
A) buying Japanese yen now when you plan to study in Japan next year
B) converting your money market account to a mutual fund account
C) contracting to sell your farm produce to the neighborhood grocery
D) extending the service warranty for your notebook
Answer: B

44) Financing for public corporations flows through:
A) the financial markets, financial intermediaries, or both.
B) derivatives markets.
C) financial intermediaries only.
D) the financial markets only.
Answer: A

45) One reason suggesting that banks may be better than individuals at matching lenders to borrowers is that banks:
A) can shift loan risk to their deposit customers.
B) do not have any income tax liability.
C) are motivated by the potential for profit.
D) have information to evaluate creditworthiness.
Answer: D

46) Which of the following factors contributed to the financial crisis of 2007-2009?
A) Greece's debt
B) Both Greece's debt and subprime mortgages
C) Subprime mortgages
D) Drought conditions in the mid-west
Answer: B

47) Which one of the following financial intermediaries has shown the greatest preference for investing in *long-term* financial assets?
A) Finance companies
B) Commercial banks
C) Insurance companies
D) Savings banks
Answer: C

48) U.S. bonds and other debt securities are mostly held by:
A) institutional investors.
B) state and local governments.
C) households.
D) foreign investors.
Answer: A

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49) Financial markets and intermediaries:
A) generally reduce the liquidity of securities.
B) increase risks for businesses.
C) prevent the transportation of cash across time.
D) channel savings to real investment.
Answer: D

50) A bond differs from a share of stock in that a bond:
A) has more risk.
B) represents a claim on the firm.
C) has guaranteed dividend payments.
D) has a maturity date.
Answer: D

51) Corporate debt instruments are most commonly traded:
A) on NASDAQ.
B) in the over the counter market.
C) on the NYSE.
D) in the money market.
Answer: B

52) Which one of these may provide a financial return to some investors while not providing any financial return to other investors?
A) Hedge fund
B) Pension funds
C) Insurance companies
D) Mutual funds
Answer: C

53) Which one of these parties *cannot* invest in a hedge fund?
A) wealthy individuals
B) pension funds
C) insurance companies
D) small retail investors
Answer: D

54) Which of the following are both a financial intermediary and a financial institution?
A) mutual funds
B) insurance companies
C) pension funds
D) hedge funds
Answer: B

55) Which one of these was a contributing factor to the need for many foreign banks to seek aid from their governments as a result of the financial crisis of 2007-2009?
A) interest rate spikes
B) investments in U.S. subprime mortgages
C) currency controls
D) decrease in their exchange rates
Answer: B

56) Which one of these enterprises generally acts as an underwriter for an initial public offering?
A) insurance company
B) government
C) commercial bank
D) investment bank
Answer: D

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57) The financial crisis of 2007-2009 contributed to the largest sovereign default in history by which one of these countries?

A) Italy B) Ireland C) Portugal D) Greece

Answer: D

58) The cost of capital:

A) for risky investments is normally higher than the firm's borrowing rate.
B) is the expected rate of return on a capital investment.
C) is an opportunity cost determined by the risk-free rate of return.
D) is the interest rate that the firm pays on a loan from a bank or insurance company.

Answer: A

59) The cost of capital:

A) is the interest rate that the firm pays on a loan from a financial institution.
B) is the minimum acceptable rate of return on a project.
C) is the maximum acceptable rate of return on a project.
D) is always less than 10%.

Answer: B

60) During the Financial Crisis of 2007-2009, the U.S. government bailed out all of the following firms *except:*

A) Fannie Mae. B) AIG.
C) Freddie Mac. D) Lehman Brothers.

Answer: D

61) A mother in a developing country wants to borrow the equivalent of $20 to enable her to start a small restaurant run by her family. Which type of financing is she looking to obtain?

A) IPO B) micro loan
C) public bond issue D) futures contract on a commodity

Answer: B

62) Which of the following information is *not* provided by the financial markets?

A) the cost of one million yen in U.S. dollars B) Microsoft's earnings in 2013
C) the price of six ounces of gold D) the cost of borrowing $500,000 for 5 years

Answer: B

63) Which one of the following is the biggest provider of payment mechanisms?

A) insurance companies B) mutual funds
C) banks D) hedge funds

Answer: C

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64) "Reinvestment" means:
A) new investment by new shareholders.
B) new investment in new operations.
C) additional investment in existing operations.
D) additional savings by existing shareholders.
Answer: D

65) Liquidity is important to a mutual fund primarily because:
A) the fund requires cash to pay its taxes.
B) new investors may invest in the fund at any time.
C) the fund's shareholders may want to redeem their shares at any time.
D) a fund that is less liquid will attract more investors.
Answer: C

66) One contributing factor to the 2007-2009 financial crisis was the structuring of mortgage loans with:
A) no initial payments, offset by significantly high payments later.
B) equal payments over the life of the loan.
C) low initial payments, offset by significantly higher payments later.
D) high initial payments, offset by significantly lower payments later.
Answer: C

67) NINJA stands for
A) No interest rate, No Job, No Assets
B) No income, No Job, No Assets
C) No income, No job, Assets
D) No insider information, No Jeopardy, No Assets
Answer: B

68) Foreign currencies are traded:
A) on the Intercontinental Exchange.
B) over the counter.
C) on both the NYSE and NASDAQ.
D) only by banks in New York and London.
Answer: B

69) When Patricia sells her General Motors common stock at the same time that Brian purchases the same amount of GM stock, GM receives:
A) only the par value of the common stock.
B) the dollar amount of the transaction, less brokerage fees.
C) nothing.
D) the dollar value of the transaction.
Answer: C

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70) The main cause of the financial crisis of 2007-2009 was caused by which financial market factor?
A) Lack of understanding about who financial markets operate
B) Corporate greed
C) Agency
D) Poor economic advice
Answer: C

71) The primary distinction between securities sold in the primary and secondary markets is the:
A) previous issuance of the securities.
B) riskiness of the securities.
C) price of the securities.
D) profitability of the issuing corporation.
Answer: A

72) Which one of these is generally a key difference between U.S. and foreign commercial banks?
A) accepting investor deposits
B) providing debt financing to corporations
C) making equity investments in corporations
D) pooling and investing savings
Answer: C

73) A financial institution:
A) simply pools and invests savings.
B) raises financing by selling shares.
C) is a kind of financial intermediary.
D) invests primarily in commodities.
Answer: C

74) The 2007-2009 financial crisis was mainly caused by the following organizations.
A) US government
B) Easy money policies
C) Rating Agencies and bankers
D) All of the choices are correct.
Answer: D

75) Which one of the following is *least* liquid?
A) U.S. Treasury bonds
B) real estate
C) foreign currency
D) savings deposit
Answer: B

76) Excess cash held by a firm should be:
A) reinvested by the firm in the financial markets.
B) reinvested by the firm in projects offering the lowest rate of return.
C) distributed to bondholders in the form of extra coupon payments.
D) reinvested by the firm in projects offering rates of return higher than the cost of capital.
Answer: D

77) Which of the following functions does *not* require financial markets?
A) risk reduction by investment in diversified portfolios
B) transporting of cash across time
C) provision of liquidity
D) provision of pricing information
Answer: B

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78) Which one of these was a major cause of the deep recession and severe unemployment throughout much of Europe that followed the financial crisis of 2007-2009?
A) risk-adverse investor attitudes
B) government actions to lower government debt
C) government actions to raise interest rates
D) investor speculation
Answer: B

79) A primary market would be utilized when:
A) shares of common stock are exchanged.
B) investors buy or sell existing securities.
C) a commission must be paid on the transaction.
D) securities are initially issued.
Answer: D

80) "Balanced" mutual funds:
A) spread their investments equally over various industries.
B) charge a management fee that is proportionate to the investment return.
C) invest in both stocks and bonds.
D) spread their investments equally over a specified geographic area.
Answer: C

81) Insurance companies primarily reduce an individual's risk by:
A) spreading that risk across many individuals.
B) transporting that risk forward in time.
C) providing low-interest-rate loans.
D) providing payment services.
Answer: A

82) When corporations need to raise funds through stock issues, they rely on the:
A) primary market.
B) centralized NASDAQ exchange.
C) tertiary market.
D) secondary market.
Answer: A

83) Corporate financing comes ultimately from:
A) the issue of shares in the firm.
B) savings by households and foreign investors.
C) cash generated from the firm's operations.
D) the financial markets and intermediaries.
Answer: B

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84) Firms can often determine the current price of any commodities they use in their production process by consulting the price quotes provided by:
A) the Standard & Poor's market indexes.
B) the New York Stock Exchange.
C) the New York Mercantile Exchange.
D) their investment bank.
Answer: C

85) A share of IBM stock is purchased by an individual investor for $75 and later sold to another investor for $125. Who profits from this sale?
A) IBM and both investors
B) the first investor
C) IBM
D) the second investor
Answer: B

86) Insurance companies can usually cover the claims of policyholders because:
A) their stockholders will cover any cash shortfalls encountered by the company.
B) they issue a very limited number of policies.
C) the incidence of claims normally averages out across all policyholders.
D) they are fully insured by the U.S. government.
Answer: C

87) Which one of the following statements is *not* a characteristic of mutual funds?
A) they raise money by selling shares to investors.
B) they pool the savings of many investors.
C) they offer professional management and portfolio diversification.
D) they are always considered to be financial institutions.
Answer: D

88) A capital investment that generates a 10% rate of return is worthwhile if:
A) the expected rate of return on the stock market is 12%.
B) corporate bonds of similar risk offer 11% rates of return.
C) top-quality corporate bonds offer 10% rates of return.
D) corporate bonds of similar risk offer 8% rates of return.
Answer: D

89) How is the relationship between a bond's credit rating and its interest rate best defined?
A) logarithmic
B) direct relationship
C) unrelated
D) inverse relationship
Answer: D

90) If Apple Computer Inc. is used as the model, then new firms should expect to raise capital in which one of these orders? Start with the first money raised.
A) venture capitalists, owners, public investors, suppliers
B) owners, venture capitalists, suppliers, public investors
C) owners, suppliers, venture capitalists, public investors
D) owners, public investors, venture capitalists, suppliers
Answer: C

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91) Which one of these correctly applies to mutual funds?
A) mutual funds are a costly means of achieving portfolio diversification.
B) you can generally buy additional shares in the fund at any time.
C) funds are required to limit their annual fees and expenses to less than 1 percent of the portfolio value.
D) shareholders sell their shares to other shareholders.
Answer: B

SHORT ANSWER. Write the word or phrase that best completes each statement or answers the question.

92) What are three major types of financial markets? Describe what the main characteristics of each market are.
Answer: Equity market - stock market
Bond market - buy and sell bonds
Capital market - long term financing
Money Market - short term financing

93) Describe the difference between the primary and the secondary market.
Answer: Primary market is for the sale or NEW securities.
Secondary market is for the sale of already issued securities.

94) Describe the difference between the money and the capital market. Provide one example of each type of security that is traded in each market.
Answer: Money market - short term financing Example - commercial paper
Capital market - long term financing Example - bonds, shares

95) Describe the difference between the stock market and the fixed income market. Provide one example of each type of security that is traded in each market.
Answer: Stock market - buy and sell shares - shares
Fixed income market - debt - bonds

96) Describe what a financial intermediary is and does.
Answer: An organization that raises money from investors and provides financing for individuals, corporations and other organizations.

97) Describe what a mutual fund is.
Answer: A managed investment fund, pooling the savings of many investors and investing in a portfolio of securities.

98) What is meant by the term of liquidity why is it important?
Answer: The ability to sell or exchange and asset for cash on short notice, without a significant loss in economic value. It is important because bills are normally paid in cash as they become due. Lack of liquidity will lead to default and eventually bankruptcy.

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99) Define what cost of capital is and describe why it is important.

Answer: Cost of capital is the minimum required rate of return on capital investments. It is important because it helps an organization differentiate between investments that will increase or decrease the value of the organization.

100) Identify a minimum of four major market factors that contributed to the financial crisis of 2007-2009.

Answer: 1. The Federal Reserve for its easy money policy
2. The US government for encouraging banks to expand credit for low income housing
3. The rating agencies for providing triple-A ratings for mortgage bonds that shortly afterward went into default
4. Bankers for promoting and reselling subprime mortgages.

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