

Corporate Finance Online, 2e (Eakins/McNally)
Chapter 1 Introduction to Finance

LO1: Understand the Features of CFO

1) Section 1.1 does not contain any questions.

LO2: Understand the Four Facets of Finance

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.

Answer: C

Explanation: C) Finance is the study of the capital market and its many players.

Diff: 1

Section: 2

AACSB: Analytical Skills

Learning Outcome: 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

Answer: A

Explanation: A) The capital market matches entrepreneurs with great business ideas or concepts to people with money.

Diff: 1

Section: 2

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

3) Which of these 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?

Answer: D

Explanation: 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?

Diff: 1

Section: 2

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

4) Which one of these 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

Answer: A

Explanation: A) Most importantly, financial advisors help you make decent dough over the long haul.

Diff: 1

Section: 2

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

5) _____ 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

Answer: B

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

Diff: 1

Section: 2

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

LO3: Understand the Function of the Financial System

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

Answer: TRUE

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

Diff: 1

Section: 3.2

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

2) 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

Answer: B

Explanation: B) Financial Intermediaries include banks and thrifts, investment banks, pension, mutual, and hedge funds, and insurance companies.

Diff: 1

Section: 3.1

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

3) 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.

Answer: D

Explanation: D) The financial system transfers money from suppliers to users.

Diff: 1

Section: 3.1

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

LO4: Distinguish between Money and Capital Markets

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

Answer: TRUE

Explanation: Money Market securities mature less than 1 year from their issue date.

Diff: 1

Section: 4.1

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

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

Answer: FALSE

Explanation: T-Bills are instruments of the money market.

Diff: 1

Section: 4.1

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

3) Preferred stock pays a variable dividend.

Answer: FALSE

Explanation: Preferred stockholders receive a fixed dividend that does not change.

Diff: 1

Section: 4.2

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

4) Capital markets have maturities of one year or less.

Answer: FALSE

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

Diff: 1

Section: 4.2

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

5) 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.

Answer: E

Explanation: E) The U.S. Commerce Department is not a major player in the money market.

Diff: 1

Section: 4.1

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

6) 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

Answer: D

Explanation: D) Foreign currencies are not capital market securities

Diff: 1

Section: 4.2

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

7) Money markets are markets for

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

Answer: D

Explanation: D) In a money market, the securities are short term and highly liquid.

Diff: 1

Section: 4.1

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

- 8) 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.

Answer: D

Explanation: D) Preferred shareholders are entitled to their dividends before common shareholders.

Diff: 1

Section: 4.2

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

- 9) 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.

Answer: B

Explanation: B) Common shareholders receive a dividend at the discretion of the board.

Diff: 1

Section: 4.2

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

- 10) 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

Answer: C

Explanation: C) The players in the money market are the U.S. Treasury, Corporations, Banks, Funds, Federal Reserve, Insurance Cos, Pensions, and Banks.

Diff: 1

Section: 4.1

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

11) Shares of _____ are units of ownership interest, or equity, in a corporation.

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

Answer: B

Explanation: B) Shares of Common Stock represent ownership in a corporation

Diff: 1

Section: 4.2

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

12) _____ are long-term debt instruments business and government use to raise large sums of money.

- A) T-bills
- B) Bonds
- C) Common stocks
- D) Preferred stocks
- E) Commercial papers

Answer: B

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

Diff: 1

Section: 4.2

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

13) 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.

Answer: D

Explanation: 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.

Diff: 1

Section: 4.2

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

14) 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

Answer: D

Explanation: D) Capital markets are markets in which securities have an original maturity greater than one year.

Diff: 1

Section: 4.2

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

15) 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

Answer: A

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

Diff: 1

Section: 4.2

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

LO5: Learn the Difference between Primary and Secondary Markets

1) 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.

Answer: E

Explanation: 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.

Diff: 1

Section: 5.2

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

2) 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.

Answer: B

Explanation: B) Primary markets are for securities offered for sale for the first time.

Diff: 1

Section: 5.1

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

3) The _____ is the financial market in which securities are initially issued.

- A) private placement
- B) OTC
- C) primary market
- D) secondary market
- E) NASDAQ

Answer: C

Explanation: C) Primary markets are for securities offered for sale for the first time.

Diff: 1

Section: 5.1

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

4) In the over-the-counter market, dealers are linked with the purchasers and sellers of securities through the _____ system.

- A) NASDAQ
- B) NYSE
- C) AMEX
- D) SEC
- E) NYMEX

Answer: A

Explanation: A) NASDAQ is a computerized dealer market.

Diff: 1

Section: 5.2

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

- 5) 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.

Answer: D

Explanation: D) The over the counter market is an intangible market for unlisted securities.

Diff: 1

Section: 5.2

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

- 6) What do we call a market in which the price of a security is an accurate estimate by the market of its true value?

- A) Efficient Market
- B) Law of One Price
- C) Effective Market
- D) Primary Market
- E) Secondary Market

Answer: E

Explanation: E) One of the most important roles of the secondary market is establishing security prices.

Diff: 1

Section: 5.2

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

- 7) 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) Establishing security prices

Answer: E

Explanation: E) One of the most important roles of the secondary market is establishing security prices.

Diff: 1

Section: 5.2

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

8) _____ 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

Answer: A

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

Diff: 1

Section: 5.2

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

LO6: Learn about the Structure and Governance of Corporations

1) 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.

Answer: FALSE

Explanation: 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.

Diff: 1

Section: 6.2

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

2) 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 only

B) I and IV only

C) II and III only

D) II and IV only

E) I, II, and IV only

Answer: B

Explanation: 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.

Diff: 1

Section: 6.2

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

3) 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

Answer: B

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

Diff: 1

Section: 6.2

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

4) Agency costs pose the biggest problem for

- A) insiders.
- B) shareholders.
- C) directors.
- D) agents.
- E) executives.

Answer: B

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

Diff: 1

Section: 6.2

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

5) 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.

Answer: A

Diff: 1

Section: 6.2

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

6) 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.

Answer: C

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

Diff: 1

Section: 6.2

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

7) 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)

Answer: A

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

Diff: 1

Section: 6.1

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

8) The top of the organizational chart of organizations is

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

Answer: D

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

Diff: 1

Section: 6.2

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

9) 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.

Answer: B

Explanation: B) Aligning managers interest with shareholder interest helps prevent the principal-agent problem.

Diff: 1

Section: 6.2

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

LO7: Learn Six Important Ideas in Finance

1) 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.

Answer: TRUE

Explanation: Higher risk requires higher return.

Diff: 1

Section: 7.2

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

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

Answer: FALSE

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

Diff: 1

Section: 7.4

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

3) \$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.

Answer: C

Explanation: C) A dollar today is worth more than the promise of a dollar next year.

Diff: 1

Section: 7.1

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

4) 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.

Answer: D

Explanation: D) As the risk of an investment increases, the required return will increase.

Diff: 1

Section: 7.2

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

5) 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.

Answer: D

Explanation: D) Higher risk requires higher returns.

Diff: 1

Section: 7.2

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

- 6) 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.

Answer: E

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

Diff: 1

Section: 7.3

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers

- 7) 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.

Answer: C

Explanation: C) Information asymmetry is when information is not spread evenly among all participants.

Diff: 1

Section: 7.5

AACSB: Analytical Skills

Learning Outcome: F-01: Describe the different financial markets and the role of the financial managers