Financial Management, 12e (Titman/Keown/Martin)
Chapter 2 Firms and the Financial Market

2.1 The Basic Structure of the U.S. Financial Markets

1) The principal savers in the financial markets are
A) businesses.
B) banks.
C) individuals.
D) governments.
Answer: C
Diff: 1
AACSB: 6. Reflective thinking
Question Status: New question
Objective: 2.1 Describe the structure and functions of financial markets
Keywords: financial intermediaries
Principles: Principle 2: There Is a Risk-Return Tradeoff

2) The principal participants in the financial markets are
A) businesses, banks, government.
B) borrowers, savers, financial institutions.
C) mutual funds, hedge funds, investment bankers.
D) dealers, brokers, regulators.
Answer: B
Diff: 1
AACSB: 6. Reflective thinking
Question Status: New question
Objective: 2.1 Describe the structure and functions of financial markets
Keywords: financial intermediaries
Principles: Principle 2: There Is a Risk-Return Tradeoff

3) Financial intermediaries help bring savers and borrowers together.
Answer: TRUE
Diff: 1
AACSB: 6. Reflective thinking
Question Status: Previous edition
Objective: 2.1 Describe the structure and functions of financial markets
Keywords: financial intermediaries
Principles: Principle 2: There Is a Risk-Return Tradeoff

4) Individuals are often savers because they wish to save for things such as a down payment on a home or graduate school.
Answer: TRUE
Diff: 1
AACSB: 6. Reflective thinking
Question Status: Previous edition
Objective: 2.1 Describe the structure and functions of financial markets
Keywords: financial markets
Principles: Principle 2: There Is a Risk-Return Tradeoff

5) The purpose of financial markets is to bring borrowers and savers together.
Answer: TRUE
Diff: 1
AACSB: 6. Reflective thinking
Question Status: Revised
Objective: 2.1 Describe the structure and functions of financial markets
Keywords: financial markets
Principles: Principle 2: There Is a Risk-Return Tradeoff

2.2 The Financial Marketplace: Financial Institutions

1) All of the following operate as financial intermediaries EXCEPT
A) commercial banks.
B) mutual funds.
C) insurance companies.
D) public universities.
Answer: D
Diff: 1
AACSB: 6. Reflective thinking
Question Status: Previous edition
Objective: 2.2 Distinguish between commercial banks and other financial institutions in the financial marketplace.
Keywords: financial intermediaries
Principles: Principle 3: Cash Flows Are the Source of Value

2) All of the following are true about insurance companies EXCEPT
A) They invest their reserves.
B) They may guarantee to reimburse lenders should lenders' loans go into default.
C) They participate in equipment leasing.
D) They may only invest their reserves in interest paying bank accounts under Federal law.
Answer: D
Diff: 1
AACSB: 6. Reflective thinking
Question Status: Previous edition
Objective: 2.2 Distinguish between commercial banks and other financial institutions in the financial marketplace.
Keywords: financial intermediaries
Principles: Principle 3: Cash Flows Are the Source of Value

3) Which of the following is true regarding Investment Banks?
A) As a result of the financial crisis of 2008, all stand alone Investment banks either failed, were merged into commercial banks, or became commercial banks.
B) Under the Glass-Steagal act, commercial banks were allowed to operate as Investment banks.
C) When Glass-Steagal was repealed in 1999, commercial banks and Investment banks had to be separate entities.
D) As of 2010, stand alone Investment banks are numerous.
Answer: A
Diff: 1
AACSB: 6. Reflective thinking
Question Status: Previous edition
Objective: 2.2 Distinguish between commercial banks and other financial institutions in the financial marketplace.
Keywords: financial intermediaries
Principles: Principle 3: Cash Flows Are the Source of Value

4) Each of the following is true of Mutual Funds EXCEPT
A) Funds can be classified as load or no-load funds.
B) Mutual Fund shares must be bought from or sold to the Fund by investors.
C) An index fund is the fund with the highest expenses payable by investors.
D) The NAV is the total value of stock held by the fund divided by the number of outstanding shares in the mutual fund.
Answer: C
Diff: 1
AACSB: 6. Reflective thinking
Question Status: Previous edition
Objective: 2.2 Distinguish between commercial banks and other financial institutions in the financial marketplace.
Keywords: financial intermediaries
Principles: Principle 3: Cash Flows Are the Source of Value

5) Insurance companies have a great deal of money to invest because
A) there profit margins are so high.
B) because they are reluctant to cover insurable losses.
C) because they must hold large reserves to pay potential claims.
D) insurance do not actually have large sums to invest.
Answer: C
Diff: 1
AACSB: 6. Reflective thinking
Question Status: New question
Objective: 2.2 Distinguish between commercial banks and other financial institutions in the financial marketplace.
Keywords: financial intermediaries
Principles: Principle 3: Cash Flows Are the Source of Value

6) All of the following are classified as non-bank financial intermediaries except
A) stock brokerages.
B) investment banks.
C) insurance companies.
D) hedge funds.
Answer: A
Diff: 1
AACSB: 6. Reflective thinking
Question Status: New question
Objective: 2.2 Distinguish between commercial banks and other financial institutions in the financial marketplace.
Keywords: financial intermediaries
Principles: Principle 3: Cash Flows Are the Source of Value

7) In financial markets, borrowers pay savers by giving them a return on investment.
Answer: TRUE
Diff: 1
AACSB: 6. Reflective thinking
Question Status: Previous edition
Objective: 2.2 Distinguish between commercial banks and other financial institutions in the financial marketplace.
Keywords: financial intermediaries
Principles: Principle 3: Cash Flows Are the Source of Value

8) All financial intermediaries are banks.
Answer: FALSE
Diff: 1
AACSB: 6. Reflective thinking
Question Status: Previous edition
Objective: 2.2 Distinguish between commercial banks and other financial institutions in the financial marketplace.
Keywords: financial intermediaries
Principles: Principle 3: Cash Flows Are the Source of Value

9) Mutual Funds and ETFs provide the investor a chance to diversify without having to buy shares in numerous corporations.
Answer: TRUE
Diff: 2
AACSB: 6. Reflective thinking
Question Status: Previous edition
Objective: 2.2 Distinguish between commercial banks and other financial institutions in the financial marketplace.
Keywords: financial intermediaries
Principles: Principle 3: Cash Flows Are the Source of Value

10) Private equity firms are financial intermediaries that are not traded on public capital markets.
Answer: TRUE
Diff: 1
AACSB: 6. Reflective thinking
Question Status: Previous edition
Objective: 2.2 Distinguish between commercial banks and other financial institutions in the financial marketplace.
Keywords: financial intermediaries
Principles: Principle 3: Cash Flows Are the Source of Value

11) Capital markets are markets for short term debt instruments maturing in less than one year, and money markets are markets for long term debt instruments maturing in more than one year.
Answer: FALSE
Diff: 2
AACSB: 6. Reflective thinking
Question Status: Previous edition
Objective: 2.2 Distinguish between commercial banks and other financial institutions in the financial marketplace.
Keywords: financial intermediaries
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12) Banks that are financial intermediaries generate earnings when they facilitate the transfer of money from savers to borrowers by paying savers a smaller return than they demand from borrowers.
Answer: TRUE
Diff: 2
AACSB: 6. Reflective thinking
Question Status: Previous edition
Objective: 2.2 Distinguish between commercial banks and other financial institutions in the financial marketplace.
Keywords: financial intermediaries
Principles: Principle 3: Cash Flows Are the Source of Value

13) In Financial markets, borrowers and lenders most both be located in the same country.
Answer: FALSE
Diff: 1
AACSB: 6. Reflective thinking
Question Status: Previous edition
Objective: 2.2 Distinguish between commercial banks and other financial institutions in the financial marketplace.
Keywords: financial intermediaries
Principles: Principle 3: Cash Flows Are the Source of Value

14) The difference between mutual funds and ETFs is that ETFs are traded on exchanges and mutual funds are not.
Answer: TRUE
Diff: 1
AACSB: 6. Reflective thinking
Question Status: Previous edition
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Keywords: financial intermediaries
Principles: Principle 3: Cash Flows Are the Source of Value

15) Venture capital funds play an important role in the initial financing of new businesses.
Answer: TRUE
Diff: 1
AACSB: 6. Reflective thinking
Question Status: New question
Objective: 2.2 Distinguish between commercial banks and other financial institutions in the financial marketplace.
Keywords: financial intermediaries
Principles: Principle 3: Cash Flows Are the Source of Value

16) Investment banks are similar to commercial banks except that they invest deposits in stocks and bonds rather than loans.
Answer: FALSE
Diff: 1
AACSB: 6. Reflective thinking
Question Status: New question
Objective: 2.2 Distinguish between commercial banks and other financial institutions in the financial marketplace.
Keywords: financial intermediaries
Principles: Principle 3: Cash Flows Are the Source of Value

17) Describe the costs and benefits to investors of owning Mutual Funds.
Answer: Owners of mutual fund shares get professional management of their portfolio, and get a diversified portfolio, as each mutual share is a share in the whole portfolio purchased by the mutual fund. In order to get these benefits, the investor must pay commissions upon purchase, and/or pay yearly management fees. The fees can significantly diminish the value of the shares of the mutual fund to the investor. An alternative for the investor is to buy an index fund, that is a fund that tracks an index such as the Dow Jones Industrial Average or the S & P 500. An index fund tracking the DJIA, for example, will automatically purchase stocks in the same percentage that they are used to determine the Dow Jones Industrial Average. Owning an index fund reduces costs, because there is no need to have professionals running the portfolio.
Diff: 2
AACSB: 6. Reflective thinking
Question Status: Previous edition
Objective: 2.2 Distinguish between commercial banks and other financial institutions in the financial marketplace.
Keywords: financial intermediaries
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2.3 The Financial Marketplace: Securities Markets

1) Which of the following is true about bonds?
A) They are obligations from the investor to the corporation.
B) Their interest rate always varies with the Consumer Price Index.
C) They have a fixed maturity, and they pay an amount equal to the maturity value times the coupon rate each year.
D) At maturity of the bond, the investor receives the market price of the bond.
Answer: C
Diff: 1
AACSB: 3. Analytic thinking
Question Status: Previous edition
Objective: 2.3 Describe the different securities markets for bonds and stocks.
Keywords: financial markets
Principles: Principle 4: Market Prices Reflect Information

2) Which of the following is true about Preferred Stock?
A) Preferred shareholders always have voting rights.
B) If at a time a dividend is due on preferred stock, if the company does not have the funds to pay the dividend, the right of the preferred shareholders to collect that dividend lapses.
C) Preferred dividends are not tax deductible to the corporation.
D) Like bonds, preferred stock always has a maturity date at which time the issue price must be repaid to shareholders.
Answer: C
Diff: 1
AACSB: 3. Analytic thinking
Question Status: Previous edition
Objective: 2.3 Describe the different securities markets for bonds and stocks.
Keywords: financial markets
Principles: Principle 4: Market Prices Reflect Information

3) The market for short-term debt is known as
A) the bond market.
B) the notes market.
C) the capital market.
D) the money market.
Answer: D
Diff: 1
AACSB: 3. Analytic thinking
Question Status: New question
Objective: 2.3 Describe the different securities markets for bonds and stocks.
Keywords: financial markets
Principles: Principle 4: Market Prices Reflect Information

4) Characteristics of typical bonds include all of the following EXCEPT
A) the par value.
B) the dividend rate.
C) the coupon rate
D) the maturity date.
Answer: B
Diff: 1
AACSB: 3. Analytic thinking
Question Status: New question
Objective: 2.3 Describe the different securities markets for bonds and stocks.
Keywords: financial markets
Principles: Principle 4: Market Prices Reflect Information

5) Which of the following financial instruments is not traded in the capital markets?
A) Debt with a maturity of less than one year
B) Bonds
C) Common stock
D) Preferred stock
Answer: A
Diff: 1
AACSB: 3. Analytic thinking
Question Status: New question
Objective: 2.3 Describe the different securities markets for bonds and stocks.
Keywords: financial markets
Principles: Principle 4: Market Prices Reflect Information

6) Which of the following financial instruments entails the most risk and potentially the highest returns for investors?
A) Debt with a maturity of less than one year
B) Bonds
C) Common stock
D) Preferred stock
Answer: C
Diff: 1
AACSB: 3. Analytic thinking
Question Status: New question
Objective: 2.3 Describe the different securities markets for bonds and stocks.
Keywords: financial markets
Principles: Principle 2: There Is a Risk-Return Tradeoff

7) Investors in common stock increase their wealth when the
A) the market value of the stock goes up.
B) when the stock pays a dividend.
C) when the stock pays interest on the original investment.
D) both A and B.
Answer: D
Diff: 1
AACSB: 3. Analytic thinking
Question Status: New question
Objective: 2.3 Describe the different securities markets for bonds and stocks.
Keywords: financial markets
Principles: Principle 2: There Is a Risk-Return Tradeoff

8) A security is a written instrument that represents a financial claim.
Answer: TRUE
Diff: 1
AACSB: 3. Analytic thinking
Question Status: Previous edition
Objective: 2.3 Describe the different securities markets for bonds and stocks.
Keywords: financial markets
Principles: Principle 4: Market Prices Reflect Information

9) Primary markets are always larger than secondary markets.
Answer: FALSE
Diff: 1
AACSB: 3. Analytic thinking
Question Status: Previous edition
Objective: 2.3 Describe the different securities markets for bonds and stocks.
Keywords: financial markets
Principles: Principle 4: Market Prices Reflect Information

10) ABC Corporation issued and sold 10 shares of stock to Irene Investor, a private individual. This represents a secondary market transaction.
Answer: FALSE
Diff: 2
AACSB: 3. Analytic thinking
Question Status: Previous edition
Objective: 2.3 Describe the different securities markets for bonds and stocks.
Keywords: financial markets
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11) Colin, a private individual, sold one thousand shares of stock in DEF Corporation to Colleen, also a private individual. This represents a secondary market transaction.
Answer: TRUE
Diff: 2
AACSB: 3. Analytic thinking
Question Status: Previous edition
Objective: 2.3 Describe the different securities markets for bonds and stocks.
Keywords: financial markets
Principles: Principle 4: Market Prices Reflect Information

12) Investors in securities markets do not use a financial intermediary.
Answer: TRUE
Diff: 1
AACSB: 3. Analytic thinking
Question Status: Previous edition
Objective: 2.3 Describe the different securities markets for bonds and stocks.
Keywords: financial markets
Principles: Principle 4: Market Prices Reflect Information

13) A bond matures in less than 10 years.
Answer: FALSE
Diff: 1
AACSB: 3. Analytic thinking
Question Status: Previous edition
Objective: 2.3 Describe the different securities markets for bonds and stocks.
Keywords: financial markets
Principles: Principle 4: Market Prices Reflect Information

14) Bonds are less risky than are stocks because their return is more predictable.
Answer: TRUE
Diff: 1
AACSB: 3. Analytic thinking
Question Status: Previous edition
Objective: 2.3 Describe the different securities markets for bonds and stocks.
Keywords: financial markets
Principles: Principle 4: Market Prices Reflect Information

15) Owners of common stock are the owners of the firm.
Answer: TRUE
Diff: 1
AACSB: 3. Analytic thinking
Question Status: Previous edition
Objective: 2.3 Describe the different securities markets for bonds and stocks.
Keywords: financial markets
Principles: Principle 4: Market Prices Reflect Information

16) Each year, shareholders receive a dividend equal to the firm's net earnings divided by the number of shares of common stock.
Answer: FALSE
Diff: 1
AACSB: 3. Analytic thinking
Question Status: Previous edition
Objective: 2.3 Describe the different securities markets for bonds and stocks.
Keywords: financial markets
Principles: Principle 4: Market Prices Reflect Information

17) A stock's market value is dependent on investors' expectations of future cash flows to the firm.
Answer: TRUE
Diff: 1
AACSB: 3. Analytic thinking
Question Status: Previous edition
Objective: 2.3 Describe the different securities markets for bonds and stocks.
Keywords: financial markets
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18) Preferred stock prices are solely dependent on investors' expectations of future cash flows to the corporation.
Answer: FALSE
Diff: 1
AACSB: 3. Analytic thinking
Question Status: Previous edition
Objective: 2.3 Describe the different securities markets for bonds and stocks.
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19) A company has the option to pay bond interest or not.
Answer: FALSE
Diff: 1
AACSB: 3. Analytic thinking
Question Status: Previous edition
Objective: 2.3 Describe the different securities markets for bonds and stocks.
Keywords: financial markets
Principles: Principle 4: Market Prices Reflect Information

20) There are more companies listed on NASDAQ than are listed on the New York Stock Exchange.
Answer: TRUE
Diff: 1
AACSB: 3. Analytic thinking
Question Status: Previous edition
Objective: 2.3 Describe the different securities markets for bonds and stocks.
Keywords: financial markets
Principles: Principle 4: Market Prices Reflect Information

21) Organized security exchanges do not physically occupy space.
Answer: FALSE
Diff: 1
AACSB: 3. Analytic thinking
Question Status: Previous edition
Objective: 2.3 Describe the different securities markets for bonds and stocks.
Keywords: financial markets
Principles: Principle 4: Market Prices Reflect Information

22) Established firms in need of additional capital can raise it in the secondary market.
Answer: FALSE
Diff: 1
AACSB: 3. Analytic thinking
Question Status: New question
Objective: 2.3 Describe the different securities markets for bonds and stocks.
Keywords: financial markets
Principles: Principle 4: Market Prices Reflect Information

23) The primary markets sell only stocks and bonds issued by major corporations while the secondary markets sell securities issued by newer and smaller companies.
Answer: FALSE
Diff: 1
AACSB: 3. Analytic thinking
Question Status: New question
Objective: 2.3 Describe the different securities markets for bonds and stocks.
Keywords: financial markets
Principles: Principle 4: Market Prices Reflect Information

24) Explain how securities markets provide a link between the corporation and investors.
Answer: First, the corporation sells its securities, which can be common stock, preferred stock, or debt. Since the firm receives money directly from these sales, these are primary market transactions. The firm then invests the money it receives, with the corporate purpose of maximizing the value of its shares of common stock. The corporation must then pay back its investors, and pay taxes. Any other monies can be reinvested into the firm. When these securities are traded on the market, these are secondary market transactions, and by making these trades, investors determine the market value of the securities.
Diff: 2
AACSB: 3. Analytic thinking
Question Status: Previous edition
Objective: 2.3 Describe the different securities markets for bonds and stocks.
Keywords: financial markets
Principles: Principle 4: Market Prices Reflect Information

25) Describe the tax benefits to a corporation of issuing debt rather than issuing stock.
Answer: The greatest advantage to issuing debt is that the interest payments on debt are tax deductible, and that dividend payments are not tax deductible. In addition, the interest payment is a known amount, and the required return on debt is generally lower than the investor required return on equity because the cash flows to investors are more predictable for debt than they are for equity.
Diff: 2
AACSB: 3. Analytic thinking
Question Status: Previous edition
Objective: 2.3 Describe the different securities markets for bonds and stocks.
Keywords: financial markets
Principles: Principle 4: Market Prices Reflect Information