Foundations of Finance 9th edition Keown Test Bank

SKU: 9780134083285-TEST-BANK

Foundations of Finance, 9e **(Keown/Martin/Petty)**
Chapter 2 The Financial Markets and Interest Rates

Learning Objective 2.1

1) Common stock is considered a short-term security because it has no maturity date and a long-term security is one with a maturity date of more than one year.
Answer: FALSE
Diff: 1 Page Ref: 23
Keywords: Long-term Capital
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

2) Saving surplus units include individuals and governments, but not corporations.
Answer: FALSE
Diff: 1 Page Ref: 24
Keywords: Capital Markets, Savings Surplus Units
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

3) Individuals, corporations, and governments can be either savings deficit units or savings surplus units.
Answer: TRUE
Diff: 1 Page Ref: 24
Keywords: Capital Markets, Savings Surplus Units, Savings Deficit
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

4) A corporation needing cash sells securities to investors in the secondary market.
Answer: FALSE
Diff: 1 Page Ref: 26
Keywords: Secondary Market
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

5) Part of the U.S. Government's huge deficit is financed by foreign countries, such as China, which is a savings surplus unit.
Answer: TRUE
Diff: 1 Page Ref: 24
Keywords: Capital Markets, Savings Surplus Units
Learning Obj.: L.O. 2.1
AACSB: Diverse and multicultural work environments

6) Venture capitalists typically provide funds to high-risk startup companies but take no active role in their management.
Answer: FALSE
Diff: 1 Page Ref: 25, 26
Keywords: Venture Capitalist
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

7) Seasoned secondary offerings occur in the secondary market.
Answer: FALSE
Diff: 1 Page Ref: 26
Keywords: Seasoned Secondary Offering, Secondary Market
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

8) Capital markets are all the financial institutions that help a business raise long-term capital.
Answer: TRUE
Diff: 1 Page Ref: 23
Keywords: Capital Markets
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

9) Transactions in the futures markets involve current payments for goods which will be delivered at some future agreed upon date.
Answer: FALSE
Diff: 1 Page Ref: 27
Keywords: Futures Market
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

10) Organized stock exchanges provide the benefits of a continuous market, fair security pricing, and helping businesses raise new capital.
Answer: TRUE
Diff: 1 Page Ref: 28
Keywords: Organized Stock Exchanges
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

11) On the basis of number of shares traded, more stocks are traded over the counter than on organized exchanges.
Answer: TRUE
Diff: 1 Page Ref: 27
Keywords: Organized Stock Exchanges, Over-The-Counter Markets
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

12) Stocks listed on the New York Stock Exchange must be traded exclusively on the NYSE in order to maintain the high standards set by the exchange.
Answer: FALSE
Diff: 1 Page Ref: 28
Keywords: New York Stock Exchange, NYSE
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

13) One advantage of being listed on the NYSE is that all trades are made in an auction setting with face-to-face trading between individuals on the floor of the stock exchange.
Answer: FALSE
Diff: 1 Page Ref: 28
Keywords: New York Stock Exchange, NYSE
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

14) One advantage of organized stock exchanges is increased stock price volatility resulting from the efficient exchange of pricing information.
Answer: FALSE
Diff: 2 Page Ref: 28
Keywords: Stock Exchange, Price Volatility
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

15) Three ways that savings can be transferred through the financial markets to those in need of funds include direct transfers, indirect transfers using the investment banker, and indirect transfers using the financial intermediary.
Answer: TRUE
Diff: 1 Page Ref: 24
Keywords: Capital Markets, Direct Transfer, Indirect Transfer
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

16) Flotation costs are typically greater in the secondary market than in the primary market.
Answer: FALSE
Diff: 1 Page Ref: 26
Keywords: Flotation Costs, Secondary Market, Primary Market
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

17) Each purchase occurring in the secondary markets increases the total stock of financial assets that exist in the economy.
Answer: FALSE
Diff: 1 Page Ref: 26
Keywords: Secondary Market
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

18) The money market includes transactions in short-term financial instruments.
Answer: TRUE
Diff: 1 Page Ref: 27
Keywords: Money Market
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

19) Over-the-counter markets include all security markets, with the exception of organized exchanges.
Answer: TRUE
Diff: 1 Page Ref: 27
Keywords: Over-the-Counter Markets, Organized Exchanges
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

20) For a firm to have its securities listed on an exchange, it must meet certain requirements. These usually include measures of profitability, size, market value, and public ownership.
Answer: TRUE
Diff: 1 Page Ref: 28
Keywords: Stock Exchange, Listing Requirements
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

21) The vast majority of corporate bond business takes place over the counter.
Answer: TRUE
Diff: 1 Page Ref: 27
Keywords: Corporate Bonds, Over the Counter Markets
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

22) Financial markets exist in order to allocate savings in the economy to the demanders of those savings.
Answer: TRUE
Diff: 1 Page Ref: 27
Keywords: Financial Markets
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

23) A seasoned equity offering is the sale of additional shares by a company whose shares are already publicly traded.
Answer: TRUE
Diff: 1 Page Ref: 26
Keywords: Seasoned Equity Offering
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

24) Primary market transactions cannot be undertaken in over the counter markets.
Answer: FALSE
Diff: 2 Page Ref: 26
Keywords: Primary Market, Over the Counter Markets
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

25) Financial intermediaries issue their own indirect securities and use the proceeds to purchase the direct securities of other economic units.
Answer: TRUE
Diff: 1 Page Ref: 25
Keywords: Financial Intermediaries, Indirect Securities, Direct Securities
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

26) Cash markets are often referred to as spot markets.
Answer: TRUE
Diff: 1 Page Ref: 27
Keywords: Spot Markets, Cash Markets
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

27) Transactions in common stock occur in the money market, due to the large amount of money involved in such transactions.
Answer: FALSE
Diff: 2 Page Ref: 27
Keywords: Money Market, Common Stock
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

28) Registration of securities by the SEC indicates to investors that the risk of those securities is reasonable.
Answer: FALSE
Diff: 2 Page Ref: 28
Keywords: SEC, Registration of Securities
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

29) The process of shelf-registration is beneficial to the issuing firm because it will reduce the time needed for the firm to take an issue to market.
Answer: TRUE
Diff: 1 Page Ref: 28
Keywords: Shelf Registration, Securities
Learning Obj.: L.O. 2.1
AACSB: Analytical Thinking

30) Which of the following statements is an example of a futures market transaction?
A) An investor purchases 100 shares of IBM hoping to sell it in two years for a profit.
B) A company purchases an option to buy 1000 barrels of oil anytime between now and the end of the year.
C) A company agrees to purchase 1000 barrels of oil for delivery in six months at a price of $70 per barrel.
D) An executive has a portion of his current year salary deferred until he retires.
Answer: C
Diff: 2 Page Ref: 27
Keywords: Futures Market
Learning Obj.: L.O. 2.1
AACSB: Analytical Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

31) General Electric (GE) has been a public company for many years with its common stock traded on the New York Stock Exchange. If GE decides to sell 500,000 shares of new common stock, the transaction will be describe as
A) an initial public offering.
B) a secondary market transaction because GE common stock has been trading for years.
C) a seasoned equity offering because GE has sold common stock before.
D) a money-market transaction because GE raises new money to fund its business.
Answer: C
Diff: 2 Page Ref: 26
Keywords: Seasoned Equity Offering
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

32) Money-market instruments include
A) common stock.
B) preferred stock.
C) T-bonds.
D) T-bills.
Answer: D
Diff: 1 Page Ref: 27
Keywords: Money Market, T-bills
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

33) ExxonMobil generates about $50 billion in cash annually from its operations and invests about half of that on new exploration. Therefore, ExxonMobil is an example of a(n)
A) savings surplus unit.
B) savings deficit unit.
C) investment banker.
D) financial intermediary.
Answer: A
Diff: 1 Page Ref: 24
Keywords: Capital Markets, Savings Surplus Units
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

34) Three ways that savings can be transferred through the financial markets include all of the following EXCEPT
A) direct transfer of funds.
B) indirect transfer using the investment banker.
C) indirect transfer using the venture capital firm.
D) indirect transfer using the financial intermediary.
Answer: C
Diff: 1 Page Ref: 25
Keywords: Capital Markets, Venture Capital Firm
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

35) A wealthy private investor providing a direct transfer of funds is called
A) a venture capitalist.
B) an investment banker.
C) a financial intermediary.
D) an angel investor.
Answer: D
Diff: 1 Page Ref: 25
Keywords: Capital Markets, Angel Investor
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

36) Common examples of financial intermediaries include all of the following EXCEPT
A) Venture Capital Firms.
B) Life Insurance Companies.
C) Pension Funds.
D) Mutual Funds.
Answer: A
Diff: 1 Page Ref: 25
Keywords: Capital Markets, Financial Intermediaries
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

37) John calls his stockbroker and instructs him to purchase 100 shares of Microsoft Corporation common stock. This transaction occurs in the
A) secondary market.
B) primary market.
C) credit market.
D) futures market.
Answer: A
Diff: 1 Page Ref: 26
Keywords: Secondary Market, Primary Market
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

38) A life insurance company purchases $1 billion of corporate bonds from premiums collected on its life insurance policies. Therefore
A) the corporate bonds are indirect securities and the life insurance policies are direct securities.
B) the corporate bonds are indirect securities and the life insurance policies are indirect securities.
C) the corporate bonds are direct securities and the life insurance policies are indirect securities.
D) the corporate bonds are direct securities and the life insurance policies are direct securities.
Answer: C
Diff: 2 Page Ref: 25
Keywords: Direct Securities, Indirect Securities
Learning Obj.: L.O. 2.1
AACSB: Analytical Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

39) General Motors raises money by selling a new issue of common stock. This transaction occurs in
A) the secondary market.
B) the capital market.
C) the money market.
D) the futures market.
Answer: B
Diff: 1 Page Ref: 23, 27
Keywords: Capital Markets
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

40) Which of the following is an example of both a capital market and a primary market transaction?
A) The U.S. Government sells 3-month Treasury bills.
B) Microsoft common stock owned by an individual investor is sold to another investor.
C) Ford Motor Company sells a new issue of common stock to raise funds through a public offering.
D) No transactions occur in both primary and capital markets at the same time.
Answer: C
Diff: 2 Page Ref: 26
Keywords: Primary Market, Capital Market
Learning Obj.: L.O. 2.1
AACSB: Analytical Thinking

41) All of the following securities are sold in money markets EXCEPT
A) common stock.
B) commercial paper.
C) 3-month U.S. Treasury bills.
D) 6-month certificates of deposit.
Answer: A
Diff: 1 Page Ref: 27
Keywords: Money Market, Commercial Paper, Treasury Bills
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

42) Which of the following is an advantage of organized stock exchanges?
A) increased stock price volatility
B) screening companies to ensure only low risk stocks are sold
C) providing a continuous market
D) Only profitable companies may issue new securities on an organized exchange.
Answer: C
Diff: 1 Page Ref: 28
Keywords: Organized Stock Exchanges, Continuous Market
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

43) All of the following are benefits of organized stock exchanges EXCEPT
A) increased stock price volatility.
B) continuous markets.
C) fair security prices.
D) easier access to new capital for business expansion.
Answer: A
Diff: 1 Page Ref: 28
Keywords: Stock Exchange, Price Volatility, Continuous Markets
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

44) The stock market with the most stringent listing requirements is the
A) New York Stock Exchange (NYSE).
B) NASDAQ Stock Market.
C) American Stock Exchange (AMEX).
D) All organized exchanges have the same listing requirements in order to make trading fair for all investors.
Answer: A
Diff: 1 Page Ref: 28
Keywords: Listing Requirements, NYSE, AMEX, NASDAQ
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

45) Bill is a public accountant auditing Expo Corporation. Based on information in Expo's confidential records, Bill recommends the purchase of Expo stock to his brother.
A) Bill is involved in insider trading prohibited by the SEC.
B) Bill's brother has no direct connection to Expo Corporation and therefore his purchase of the stock is not prohibited by insider trading laws.
C) Bill is not an insider because he is not an officer or employee of Expo Corporation
D) If Bill told a non-relative who purchases Expo stock, no insider trading laws would be violated.
Answer: A
Diff: 2 Page Ref: 26
Keywords: Insider Trading, SEC, Securities Regulation
Learning Obj.: L.O. 2.1
AACSB: Analytical Thinking

46) Capital market instruments include
A) negotiable certificates of deposit.
B) corporate equities.
C) commercial paper.
D) Treasury bills.
Answer: B
Diff: 1 Page Ref: 23
Keywords: Capital Markets
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

47) An example of a primary market transaction is
A) a new issue of common stock by AT&T.
B) a sale of some outstanding common stock of AT&T by an investor.
C) AT&T repurchasing its own stock from a stockholder.
D) all of the above
Answer: A
Diff: 1 Page Ref: 26
Keywords: Primary Market
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

48) An example of a primary market transaction involving a money-market security is
A) a new issue of a security with a very short maturity.
B) a new issue of a security with a very long maturity.
C) the transfer of a previously-issued security with a very short maturity.
D) the transfer of a previously-issued security with a very long maturity.
Answer: A
Diff: 2 Page Ref: 26
Keywords: Primary Market, Money Market
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

49) An example of a secondary market transaction involving a capital market security is
A) a new issue of a security with a very short maturity.
B) a new issue of a security with a very long maturity.
C) the transfer of a previously-issued security with a very short maturity.
D) the transfer of a previously-issued security with a very long maturity.
Answer: D
Diff: 2 Page Ref: 26
Keywords: Secondary Market, Capital Market
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

50) Financial intermediaries
A) offer indirect securities.
B) include the national and regional stock exchange.
C) usually are underwriting syndicates.
D) constitute the various secondary markets.
Answer: A
Diff: 1 Page Ref: 25
Keywords: Financial Intermediaries
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

51) The telecommunications system that provides a national information linkup among brokers and dealers operating in the over-the-counter market is called
A) NCIS.
B) NSQA.
C) NASDAQ.
D) NASQ.
Answer: C
Diff: 1 Page Ref: 28
Keywords: NASDAQ, Over-the-Counter Market
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

52) Insurance companies invest in the "long-end" of the securities market by purchasing securities with longer maturities. In which of the following instruments would an insurance company be least likely to invest most of its assets?
A) corporate stocks
B) corporate bonds
C) mortgages
D) commercial paper
Answer: D
Diff: 2 Page Ref: 27
Keywords: Money Market, Commercial Paper
Learning Obj.: L.O. 2.1
AACSB: Analytical Thinking

53) Which of the following refers to all institutions and procedures that provide for transactions in short-term debt instruments generally issued by borrowers with very high credit ratings?
A) capital market
B) commercial banks
C) money market
D) stock market
Answer: C
Diff: 2 Page Ref: 27
Keywords: Money Market
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

54) Which of the following is NOT a benefit provided by the existence of organized security exchanges?
A) providing a continuous market
B) establishing and publicizing fair security prices
C) helping businesses raise new capital
D) standardization of all debt agreements
Answer: D
Diff: 2 Page Ref: 27
Keywords: Organized Security Exchange
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

55) In August 2004, Google first sold its common stock to the public at $85 per share and raised $1.76 billion. This is an example of
A) a primary market transaction.
B) a secondary market transaction.
C) a venture capital firm transaction.
D) a money-market transaction.
Answer: A
Diff: 1 Page Ref: 26
Keywords: Primary Market, Capital Market
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

56) Money-market transactions include which of the following?
A) any security that is paid for with cash
B) 30-year U.S. Treasury bonds
C) all securities paid for with the proceeds of a money-market account
D) securities that have a maturity of less than one year
Answer: D
Diff: 2 Page Ref: 27
Keywords: Money Market
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

57) Capital market transactions include which of the following?
A) any security that is purchased from a brokerage firm that is well capitalized
B) common stock of a public corporation
C) all securities that are purchased in the open market
D) U.S. Treasury bills
Answer: B
Diff: 2 Page Ref: 23, 27
Keywords: Capital Markets
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

58) Prices of securities that are traded on the organized exchanges are determined by
A) a "bid" and "ask" negotiation process amongst brokers who hold these securities in their own account.
B) the Securities Exchange Commission.
C) a continuous auction process reflecting the sentiments of buyers and sellers.
D) the sellers of the securities.
Answer: C
Diff: 2 Page Ref: 28
Keywords: Security Pricing, Continuous Auction Process, Organized Security Exchange
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

59) Prices of securities that are traded in the Over-the-Counter Markets are determined by
A) the Federal Trade Commission.
B) a continuous modified auction process.
C) the buyers of these securities.
D) a "bid" and "ask" negotiation process of broker-dealers of these securities.
Answer: D
Diff: 2 Page Ref: 28
Keywords: Over-the-Counter Market, Security Pricing, Negotiation Process
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

60) The Securities and Exchange Commission (SEC)
A) regulates only initial public offerings, or IPOs.
B) regulates only primary market transactions to ensure investors are provided with adequate and accurate information on new securities.
C) regulates both primary and secondary markets.
D) regulates initial public offerings, but not seasoned equity offerings, in the primary market.
Answer: C
Diff: 1 Page Ref: 26
Keywords: SEC, Securities and Exchange Commission, Regulation
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

61) The New York Stock Exchange (NYSE) is
A) an automated electronic trading platform.
B) an auction market with face-to-face trading on the floor of the stock exchange in addition to automated, electronic trading.
C) a hybrid market, allowing for face-to-face trading on the floor of the stock exchange in addition to automated, electronic trading.
D) primarily a futures market.
Answer: C
Diff: 1 Page Ref: 28
Keywords: New York Stock Exchange, NYSE
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

62) Explain the difference between (a) public offerings and private placements, (b) primary markets and secondary markets, (c) the money market and the capital market, and (d) organized security exchanges and over-the-counter markets.
Answer: In a public offering, securities are usually made available to the public at large by an investment-banking firm, which is a firm that specializes in helping other firms raise money. In a private placement, also called a direct placement, the securities are offered and sold directly to a limited number of investors. The firm will usually deals directly with the prospective buyers. In this setting, the investment-banking firm may act as a finder by bringing together potential lenders and borrowers.
A primary market is a market in which new, as opposed to previously issued, securities are traded. The secondary market is where currently outstanding securities are traded.
The money market refers to transactions in short-term debt instruments, with "short-term" meaning maturity periods of 1 year or less. The capital market refers to the market for long-term financial instruments. "Long-term" here means having maturity periods that extend beyond 1 year.
Organized security exchanges are tangible entities; that is, they physically occupy space (such as a building or part of a building), and financial instruments are traded on their premises. The over-the-counter markets include all security markets except the organized exchanges.
Diff: 2 Page Ref: 27
Keywords: Capital Markets
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

63) Name the benefits derived from the existence of stock exchanges.
Answer: Providing a continuous market: it may be the most important function of an organized security exchange. A continuous market provides a series of continuous security prices.
Establishing and publicizing fair security prices: An organized exchange permits security prices to be set by competitive forces. The bidding process flows from the supply and demand underlying each security. This means the specific price of a security is determined in the manner of an auction. In addition, the security prices determined at each exchange are widely publicized.
Helping business raise new capital: Because a continuous secondary market exists, it is easier for firms to float, or issue, new security offerings at competitively determined prices.
Diff: 2 Page Ref: 28
Keywords: Organized Stock Exchanges
Learning Obj.: L.O. 2.1
AACSB: Reflective Thinking

Learning Objective 2.2

1) The difference between the price the corporation gets and the public offering price is called the broker-dealer spread.
Answer: FALSE
Diff: 1 Page Ref: 29
Keywords: Investment Banker, Broker-Dealer, Spread
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

2) The need for extensive regulation of investment banking firms is limited due to the highly competitive nature of that industry.
Answer: FALSE
Diff: 1 Page Ref: 30
Keywords: Investment Banking, Concentration
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

3) The investment banker performs three basic functions: (1) underwriting, (2) distributing, and (3) advising.
Answer: TRUE
Diff: 1 Page Ref: 29
Keywords: Investment Banker
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

4) The negotiated purchase is the most prevalent method of securities distribution in the private sector.
Answer: TRUE
Diff: 1 Page Ref: 30
Keywords: Negotiated Purchase, Investment Banking
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

5) When the corporation sells securities directly to the investment public without involving an investment banker, it is called a privileged subscription.
Answer: FALSE
Diff: 1 Page Ref: 31
Keywords: Privileged Subscription, Investment Banking
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

6) An investment banker assumes underwriting risk in both negotiated purchases and privileged subscriptions with standby agreements.
Answer: FALSE
Diff: 2 Page Ref: 31
Keywords: Negotiated Purchase, Standby Agreements, Investment Banking
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

7) Investment banking firms are prohibited from selling securities due to conflicts of interest.
Answer: FALSE
Diff: 1 Page Ref: 29
Keywords: Investment Banker
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

8) The syndicate can be thought of as a wholesaler of securities and the dealer organization as a retailer of securities.
Answer: TRUE
Diff: 1 Page Ref: 29
Keywords: Syndicate, Dealer Organization, Securities
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

9) A group of investment bankers organized to distribute large securities issues is known as a syndicate.
Answer: TRUE
Diff: 1 Page Ref: 29
Keywords: Syndicate, Investment Bankers
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

10) It is common practice among the largest corporations to sell their securities directly to investors.
Answer: FALSE
Diff: 1 Page Ref: 26
Keywords: Securities, Direct Placement
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

11) The investment banker prefers to avoid a negotiated purchase because it tends to be the least profitable arrangement for the investment banker.
Answer: FALSE
Diff: 2 Page Ref: 30
Keywords: Negotiated Purchase, Investment Banking
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

12) The competitive bid purchase is largely confined to railroad, public utility, and municipal bond issues.
Answer: TRUE
Diff: 2 Page Ref: 30
Keywords: Competitive Bid Purchase
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

13) The bid price is the price that a dealer will pay for a security; the asked price is the price at which she will sell a security.
Answer: TRUE
Diff: 1 Page Ref: 32
Keywords: Bid Price, Asked Price, Securities
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

14) Because they occur in private, stricter regulations are placed on the private placement of securities.
Answer: FALSE
Diff: 2 Page Ref: 31
Keywords: Private Placements, Securities
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

15) The investment banking business is dominated by a few very large, stand-alone investment banking firms.
Answer: FALSE
Diff: 1 Page Ref: 30
Keywords: Investment Banking
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

16) Only individual investors participate in public offerings, while institutional investors participate in private placements.
Answer: FALSE
Diff: 1 Page Ref: 32
Keywords: Public Offering, Private Placement
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

17) Preferred stock is traded in the money market, while common stock is traded in the capital market.
Answer: FALSE
Diff: 1 Page Ref: 32
Keywords: Money Markets, Capital Markets
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

18) In a private placement, the securities are offered and sold to a limited number of investors.
Answer: TRUE
Diff: 1 Page Ref: 32
Keywords: Private Placements, Securities
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

19) The provisions of the Sarbanes-Oxley Act of 2002, or SOX, apply to all U.S.-based corporations, as well as to foreign corporations conducting business in U.S. markets.
Answer: FALSE
Diff: 1 Page Ref: 33, 34
Keywords: Sarbanes-Oxley, SOX
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

20) When a company repurchases its own common stock, it is likely that
A) the stock price will increase because the company views the stock as undervalued.
B) the stock price will decrease because the company is creating artificial demand for its stock.
C) the stock price will remain the same as this is simply an internal transaction.
D) the board of directors will be fired for incompetence.
Answer: A
Diff: 2 Page Ref: 30
Keywords: Common Stock, Share Repurchase
Learning Obj.: L.O. 2.2
AACSB: Analytical Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

21) Investment firms, such as Goldman Sachs, assist the transfer of capital by
A) facilitating indirect transfers from savers (investing public) to borrowers (corporations needing capital).
B) selling indirect securities to savers and using the funds to buy common stock for corporations needing funds.
C) selling direct securities.
D) selling common stock for corporate clients in the secondary market.
Answer: A
Diff: 1 Page Ref: 29
Keywords: Investment Banker, Capital Transfer
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

22) A corporation sells securities to an investment banking firm on January 1st. The next day an international oil crisis causes stock prices to drop dramatically. The corporation is immune from the drop in price of its stock due to which function of the investment banking firm?
A) hedging
B) distributing
C) reinsurance
D) underwriting
Answer: D
Diff: 2 Page Ref: 30
Keywords: Investment Banker, Underwriting
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

23) If a corporation wants a guarantee that all of its shares of stock will be sold, it should use which of the following distribution methods?
A) competitive bid purchase
B) privileged subscription with no standby agreement
C) commission or best-efforts contract
D) direct sale
Answer: A
Diff: 2 Page Ref: 30
Keywords: Investment Banking, Competitive Bid Purchase
Learning Obj.: L.O. 2.2
AACSB: Analytical Thinking

24) Reynolds, Inc. needs to raise $5 million by selling common stock. Reynolds sells 1 million shares of stock at $5 each to Goldman Sachs, who then is responsible for selling the shares to investors. This is an example of a
A) privileged subscription.
B) standby agreement.
C) negotiated purchase.
D) commission or best-efforts agreement.
Answer: C
Diff: 2 Page Ref: 30
Keywords: Negotiated Purchase, Investment Banking
Learning Obj.: L.O. 2.2
AACSB: Analytical Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

25) Spandra Electronics wants to raise money by selling stock. After talking to several investment banking firms, Spandra decides to hire Goldman Sachs to sell 5 million shares of its common stock. Goldman sells 4.5 million shares and returns the rest to Spandra. This is an example of
A) a privileged subscription with a standby agreement.
B) a commission or best-efforts agreement.
C) a privileged subscription with a standby agreement.
D) a competitive bid purchase.
Answer: B
Diff: 2 Page Ref: 31
Keywords: Commission or Best-Efforts Agreement, Investment Banking
Learning Obj.: L.O. 2.2
AACSB: Analytical Thinking

26) Activities of the investment banker include
A) assuming the risk of selling a security issue.
B) selling new securities to the ultimate investors.
C) providing advice to firms issuing securities.
D) all of the above
Answer: D
Diff: 1 Page Ref: 29, 30
Keywords: Investment Banker
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

27) The investment banker does NOT underwrite the securities to be issued in which of the following?
A) initial public offering
B) primary market transaction
C) firm commitment
D) best efforts
Answer: D
Diff: 1 Page Ref: 29
Keywords: Investment Banker, Underwriting, Best Efforts
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

28) Which of the following relationships is true regarding the costs of issuing the following securities?
A) common stock > bonds > preferred stock
B) preferred stock > common stock > bonds
C) bonds > common stock > preferred stock
D) common stock > preferred stock > bonds
Answer: D
Diff: 1 Page Ref: 31
Keywords: Cost of Capital, Securities, Common Stock, Preferred Stock, Bonds
Learning Obj.: L.O. 2.2
AACSB: Analytical Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

29) Which of the following statements about investment banking in the United States is MOST correct?
A) Investing banking is dominated by a few, very large, stand-alone investment banking firms, such as Bear Stearns.
B) The investment banking industry is dominated by large banks that are also investment bankers.
C) The top five banks involved in investment banking account for less than 25% of the industry's total market share.
D) The investment banking industry became more competitive following the financial crisis in 2007 and 2008.
Answer: B
Diff: 1 Page Ref: 29
Keywords: Investment Banking
Learning Obj.: L.O. 2.2
AACSB: Analytical Thinking

30) The investment banker performs what three basic functions?
A) underwriting, distributing, and regulating
B) underwriting, advising, and price-pegging
C) underwriting, distributing, and advising
D) underwriting, distributing, and negotiating
Answer: C
Diff: 2 Page Ref: 29
Keywords: Investment Banker
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

31) When an investment banking firm "underwrites" an issue of securities, the firm is performing which of the following?
A) agreeing to market the securities to investors for a fee
B) giving legal advice to the firm that is issuing the securities
C) offering to purchase the securities from the firm, thereby assuming the risk of resale to investors
D) agreeing to provide insurance that the firm's securities will sell for a price that is established by the firm
Answer: C
Diff: 2 Page Ref: 29
Keywords: Investment Banker, Underwriting
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

32) Investment banking firms offer to facilitate the sale of securities to the public in a variety of ways. Which of the following methods guarantees the corporation with a pre-determined price for the securities?
A) a best efforts basis
B) a commission basis
C) a competitive bid
D) an underwriting
Answer: D
Diff: 2 Page Ref: 29
Keywords: Investment Banker, Underwriting
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

33) A "Dutch auction" was used by Google to raise money in 2004. A Dutch auction involves
A) selling bonds in Europe.
B) allowing investors to submit bids saying how many shares they'd like to buy and at what price.
C) allowing investment banking firms to submit bids on how many shares they are willing to sell and at what price.
D) hiring a Dutch firm to sell a company's securities at auction.
Answer: B
Diff: 1 Page Ref: 31
Keywords: Dutch Auction, Google
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

34) Commercial banks that also provide investment banking services are called
A) conglomerate banks.
B) multi-purpose banks.
C) investment enhanced banks.
D) universal banks.
Answer: D
Diff: 1 Page Ref: 29, 30
Keywords: Universal Banks, Investment Banking
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

35) Which of the following statements concerning private placements is MOST correct?
A) Private placements do not involve investment bankers.
B) Although not selling the securities to the public, investment bankers may provide advice on the evaluation of prospective buyers and the terms of sale for private placements.
C) Private placements are limited to stocks, not bonds.
D) More than half of all private placements are sold to federal, state, or local governments or government agencies.
Answer: B
Diff: 1 Page Ref: 31, 32
Keywords: Private Placement, Investment Banking
Learning Obj.: L.O. 2.2
AACSB: Analytical Thinking

36) Which of the following is an advantage of using private placements for debt?
A) reduced costs from the elimination of the registration statement for the SEC, investment-banking underwriting fees and distribution costs
B) lower interest costs
C) fewer and less burdensome restrictive covenants
D) the possibility of future SEC registration
Answer: A
Diff: 2 Page Ref: 31, 32
Keywords: Private Placement
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

37) Which of the following statements is MOST correct concerning flotation costs?
A) Flotation costs are the same for common stock, preferred stock and bonds because they reflect mainly printing costs and legal fees.
B) Flotation costs are generally higher for bonds rather than stocks because the dollar amounts involved are much higher, allowing for economies of scale.
C) Flotation costs as a percentage of gross proceeds increase as the size of the security issue increases.
D) Flotation costs are higher for common stocks than for preferred stocks and bonds due to the higher level of risk associated with owning common stock.
Answer: D
Diff: 2 Page Ref: 33
Keywords: Flotation Costs
Learning Obj.: L.O. 2.2
AACSB: Analytical Thinking

38) Private placements are
A) limited to debt securities.
B) limited to equity securities.
C) available for both debt and equity securities, but the market is dominated by equity issues.
D) especially appealing to new, small, and medium-sized companies.
Answer: D
Diff: 1 Page Ref: 31, 32
Keywords: Private Placement
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

39) All of the following are typically advantages of private placements EXCEPT
A) speed.
B) reduced flotation costs.
C) financial flexibility.
D) the possibility of future SEC registration.
Answer: D
Diff: 1 Page Ref: 31, 32
Keywords: Private Placement
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

40) Advantages of private placements do NOT include which of the following?
A) more financing flexibility
B) lower flotation costs
C) investor protection through extensive regulation
D) funds which are available more quickly than through a public offering
Answer: C
Diff: 1 Page Ref: 31, 32
Keywords: Private Placement
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

41) Private placements usually have several advantages associated with them, but also tend to suffer from specific disadvantages. Which of the following is a disadvantage of a private placement when compared to other methods of selling new securities?
A) strictly standardized features/terms
B) higher interest costs
C) reduced flotation costs
D) avoidance of registration with the SEC
Answer: B
Diff: 2 Page Ref: 31, 32
Keywords: Private Placement
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

42) Which of the following would NOT normally be considered a "flotation cost"?
A) underwriter's spread
B) dividends
C) legal fees
D) printing and engraving expenses
Answer: B
Diff: 2 Page Ref: 33
Keywords: Flotation Costs
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

43) The costs associated with issuing securities to the public can be high. Some types of securities have greater expenses associated with them than others. Which of the following is the most costly security to issue?
A) common stock
B) corporate bonds
C) preferred stock
D) all of the above
Answer: A
Diff: 2 Page Ref: 33
Keywords: Flotation Costs
Learning Obj.: L.O. 2.2
AACSB: Analytical Thinking

44) The Sarbanes-Oxley Act of 2002, in order to protect investors, requires a higher level of accountability for which of the following groups?
A) corporate officers
B) public accountants
C) boards of directors
D) all of the above
Answer: D
Diff: 1 Page Ref: 34
Keywords: Sarbanes-Oxley Act of 2002
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

45) The Sarbanes-Oxley Act of 2002 holds all of the following groups strictly accountable in a legal sense for any instances of misconduct EXCEPT
A) company officers.
B) outside members of the board of directors.
C) lawyers.
D) investors.
Answer: D
Diff: 1 Page Ref: 34
Keywords: Sarbanes-Oxley Act of 2002
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

46) The Sarbanes-Oxley Act, or SOX
A) holds corporate advisors strictly accountable in a legal sense for any instances of misconduct.
B) pretexts the interests of shareholders by providing greater protection against accounting fraud and financial misconduct.
C) reduces the cost of financial reporting by standardizing reporting requirements.
D) accomplishes both A and B.
Answer: D
Diff: 2 Page Ref: 34
Keywords: Sarbanes-Oxley, SOX
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

47) A commitment fee is
A) an amount paid on the unused portion of a loan in a private placement.
B) an amount paid by an investment banker to ensure the sale of securities.
C) paid by investors to guarantee that a company will borrow from them.
D) paid by bondholders to secure the right to convert bonds into common stock.
Answer: A
Diff: 1 Page Ref: 33
Keywords: Commitment Fee, Private Debt Placements
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

48) What are the three major functions of an investment banker?
Answer: The investment banker performs three basic functions: (1) underwriting, (2) distributing, and (3) advising.
Underwriting: The term underwriting is borrowed from the field of insurance. It means assuming a risk. The investment banker assumes the risk of selling a security issued at a satisfactory price. A satisfactory price is one that generates a profit for the investment-banking house. A syndicate is a group of other investment bankers that is invited to help buy and resell the issue.
Distributing: Once the syndicate owns the new securities, it must get them into the hands of the ultimate investors. This is the distribution or selling function of investment banking. The investment banker may have branch offices across the United States, or it may have an informal arrangement with several security dealers who regularly buy a portion of each new offering for final sale. It is not unusual to have 300 to 400 dealers involved in the selling effort. The syndicate can properly be viewed as the security wholesaler, and the dealer organization can be viewed as the security retailer.
Advising: The investment banker is an expert in the issuance and marketing of securities. A sound investment-banking house will be aware of prevailing market conditions and can relate those conditions to the particular type of security and the price at which it should be sold at a given time.
Diff: 1 Page Ref: 29, 30
Keywords: Investment Banker
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

49) What are the five key methods by which securities are distributed to final investors?
Answer: A Negotiated Purchase: In a negotiated underwriting, the firm that needs funds makes contact with an investment banker, and deliberations concerning the new issue begin. If all goes well, a method is negotiated for determining the price the investment banker and the syndicate will pay for the securities. The negotiated purchase is the most prevalent method of securities distribution in the private sector.
A Competitive Bid Purchase: In a competitive underwriting, several underwriting groups bid for the right to purchase the new issue from the corporation that is raising funds. The firm does not directly select the investment banker. Instead, the investment banker that underwrites and distributes the issue is chosen by an auction process. The one willing to pay the greatest dollar amount per new security will win the competitive bid.
A Commission or Best-Efforts Basis: Here, the investment banker acts as an agent rather than as a principal in the distribution process. The securities are not underwritten. The investment banker attempts to sell the issue in return for a fixed commission on each security actually sold. Unsold securities are then returned to the corporation. This arrangement is typically used for more speculative issues.
A Privileged Subscription: When a new issue is marketed to a definite and select group of investors, it is called a privileged subscription. Three target markets are typically involved: (1) current stockholders, (2) employees, or (3) customers of the firm. Of these, distributions directed at current stockholders are the most prevalent. Such offerings are called rights offerings. In a privileged subscription, the investment banker may act only as a selling agent. It is also possible that the issuing firm and the investment banker might sign a standby agreement, which obligates the investment banker to underwrite the securities that are not purchased by the privileged investors.
A Direct Sale: In a direct sale the issuing firm sells the securities directly to the investing public without involving an investment banker.
Diff: 1 Page Ref: 30, 31
Keywords: Security Offerings
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

50) Within the financial markets, explain what we mean by "private placements" and name the advantages and disadvantages.
Answer: Private placements are an alternative to the sale of securities to the public or to a restricted group of investors through a privileged subscription. Any type of security can be privately placed (directly placed). The major investors in private placements are large financial institutions. Based on the volume of securities purchased, the three most important investor groups are (1) life insurance companies, (2) state and local retirement funds, and (3) private pension funds.
Private placements have advantages and disadvantages compared with public offerings.
The advantages associated with private placements are:
1. Speed: The firm usually obtains funds more quickly through a private placement than a public offering. The major reason is that registration of the issue with the SEC is not required.
2. Reduced costs: These savings result because the lengthy registration statement for the SEC does not have to be prepared, and the investment-banking underwriting and distribution costs do not have to be absorbed.
3. Financing flexibility: In a private placement, the firm deals on a face-to-face basis with a small number of investors. This means that the terms of the issue can be tailored to meet the specific needs of the company.

The following disadvantages of private placements must be evaluated.
1. Interest costs: It is generally conceded that interest costs on private placements exceed those of public issues. Whether this disadvantage is enough to offset the reduced costs associated with a private placement is a determination the financial manager must make.
2. Restrictive covenants: A firm's dividend policy, working capital levels, and the raising of additional debt capital may all be affected by burdensome provisions especially in the private placement debt contract.
3. The possibility of future SEC registration: If the lender (investor) should decide to sell the issue to a public buyer before maturity, the issue must be registered with the SEC. Some lenders, then, require that the issuing firm agree to a future registration at their option.
Diff: 1 Page Ref: 31, 32
Keywords: Private Placement
Learning Obj.: L.O. 2.2
AACSB: Reflective Thinking

Learning Objective 2.3

1) Over time, there has been a high correlation between actual rates of return on securities and the securities' standard deviations of returns.
Answer: TRUE
Diff: 1 Page Ref: 35
Keywords: Risk-Return Trade-off, Standard Deviation, Actual Return
Learning Obj.: L.O. 2.3
AACSB: Reflective Thinking

2) The rate of return available on the next best investment alternative for the saver refers to the opportunity cost of funds.
Answer: TRUE
Diff: 1 Page Ref: 34, 35
Keywords: Opportunity Cost of Funds
Learning Obj.: L.O. 2.3
AACSB: Reflective Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

3) Investors expect to receive the highest returns from government-issued securities because the government will not default on securities that it has issued.
Answer: FALSE
Diff: 2 Page Ref: 37
Keywords: Risk-Return Trade-off
Learning Obj.: L.O. 2.3
AACSB: Reflective Thinking

4) The nominal interest rate is 7% and the expected inflation rate is 2%. Based on the Fisher effect, the real rate of interest is
A) 5.0%.
B) 6.86%.
C) 5.1%.
D) 4.9%.
Answer: D
Diff: 2 Page Ref: 35
Keywords: Fisher Effect, Real Rate of Interest, Nominal Interest Rate
Learning Obj.: L.O. 2.3
AACSB: Reflective Thinking

5) A basis point is equal to
A) one percent.
B) one-tenth of one percent.
C) one-hundredth of one percent.
D) one-half of one percent.
Answer: C
Diff: 1 Page Ref: 37
Keywords: Basis Point
Learning Obj.: L.O. 2.3
AACSB: Reflective Thinking

6) The prime lending rate is the base rate on
A) mortgage loans.
B) home equity loans.
C) auto loans.
D) corporate loans.
Answer: D
Diff: 1 Page Ref: 36
Keywords: Prime Rate
Learning Obj.: L.O. 2.3
AACSB: Reflective Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

7) The real rate of return is the return earned above the
A) default risk premium.
B) risk-adjusted return.
C) inflation risk premium.
D) variability of returns measured by standard deviation.
Answer: C
Diff: 2 Page Ref: 34, 35
Keywords: Real Rate of Return, Inflation Risk Premium
Learning Obj.: L.O. 2.3
AACSB: Reflective Thinking

8) The risk premium would be greater for an investment in an oil and gas exploration in unproven fields than an investment in preferred stock because
A) oil and gas exploration investments have a greater variability in possible returns.
B) the preferred stock is more liquid.
C) the inflation rate would vary more with oil and gas exploration investments.
D) both A and B
Answer: D
Diff: 3 Page Ref: 35
Keywords: Variability of Returns, Liquidity Premium, Risk Premium
Learning Obj.: L.O. 2.3
AACSB: Analytical Thinking

9) What was the average annual rate of return on 3-month U.S. Treasury bills during the period 1990 to 2014?
A) 2.15%
B) 4.23%
C) 3.04%
D) 5.68%
Answer: C
Diff: 2 Page Ref: 34, 35
Keywords: U.S. Treasury Bills, Rate of Return
Learning Obj.: L.O. 2.3
AACSB: Reflective Thinking

10) What was the average annual rate of return on long-term government bonds (30-year Treasury bonds) during the period 1990 to 2014?
A) 4.14%
B) 5.88%
C) 5.49%
D) 7.82%
Answer: C
Diff: 2 Page Ref: 35
Keywords: Long-term Government Bonds, Rate of Return
Learning Obj.: L.O. 2.3
AACSB: Reflective Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

11) What was the average annual rate of return on long-term corporate bonds during the period 1926 to 2014?
A) 8.3%
B) 6.5%
C) 6.10%
D) 7.00%
Answer: C
Diff: 2 Page Ref: 35
Keywords: Long-term Government Bonds, Rate of Return
Learning Obj.: L.O. 2.3
AACSB: Reflective Thinking

12) What was the average annual rate of return on common stocks during the period 1926 to 2014?
A) 15.4%
B) 18.6%
C) 10.1%
D) 9.5%
Answer: C
Diff: 2 Page Ref: 34
Keywords: Small Firm Common Stocks, Rate of Return
Learning Obj.: L.O. 2.3
AACSB: Reflective Thinking

13) Over the period 1926 to 2014, the standard deviation of returns has been the greatest for which of the following?
A) Treasury bills
B) corporate bonds
C) government bonds
D) common stocks
Answer: D
Diff: 1 Page Ref: 35
Keywords: Small Firm Common Stocks, Standard Deviation
Learning Obj.: L.O. 2.3
AACSB: Reflective Thinking

14) Which of the following represents the correct ordering of returns over the period 1926 to 2014 (from lowest to highest return)?
A) Treasury bills, long-term government bonds, long-term corporate bonds, common stocks
B) common stocks, long-term government bonds, long-term corporate bonds, Treasury bills
C) Treasury bills, common stocks, long-term corporate bonds, long-term government bonds
D) long-term corporate bonds, Treasury bills, long-term government bonds, common stocks
Answer: A
Diff: 2 Page Ref: 34
Keywords: Rate of Return, Risk-Return Tradeoff
Learning Obj.: L.O. 2.3
AACSB: Analytical Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

15) Which of the following represents the correct ordering of standard deviation of returns over the period 1926 to 2014 (from highest to lowest standard deviation of returns)?
A) Treasury bills, long-term corporate bonds, long-term government bonds, common stocks
B) common stocks, long-term government bonds, long-term corporate bonds, Treasury bills
C) Treasury bills, long-term government bonds, long-term corporate bonds, common stocks
D) Treasury bills, long-term government bonds, common stocks, long-term corporate bonds
Answer: B
Diff: 2 Page Ref: 35
Keywords: Standard Deviation, Risk-Return Tradeoff
Learning Obj.: L.O. 2.3
AACSB: Analytical Thinking

16) During the period 1990 to 2014, the average yield on 3-month U.S. Treasury bills was 3.04%, the average inflation rate was 2.64%, the average yield on 30-year Treasury bonds was 5.49%, and the average return on 30-year Aaa-rated corporate bonds was 6.35%. The real risk-free short-term interest rate is
A) 0.40%.
B) 2.13%.
C) 2.97%.
D) 4.76%.
Answer: A
Diff: 2 Page Ref: 37
Keywords: Real Risk-Free Interest Rate, Inflation Risk Premium
Learning Obj.: L.O. 2.3
AACSB: Analytical Thinking

17) Which of the following securities will likely have the highest liquidity premium?
A) U.S. Treasury bond maturing in 2027
B) Bbb-rated corporate bond maturing in 2020 actively traded on a major exchange
C) Aaa-rated corporate bond maturing in 2015 not actively traded
D) U.S. Treasury bill
Answer: C
Diff: 2 Page Ref: 37
Keywords: Liquidity Premium
Learning Obj.: L.O. 2.3
AACSB: Analytical Thinking

18) Which of the following securities will likely have the highest default risk premium?
A) U.S. Treasury bond maturing in 2027
B) Bbb-rated corporate bond maturing in 2020 actively traded on a major exchange
C) Aaa-rated corporate bond maturing in 2015 not actively traded
D) U.S. Treasury bill
Answer: B
Diff: 2 Page Ref: 37
Keywords: Default Risk Premium
Learning Obj.: L.O. 2.3
AACSB: Reflective Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

19) Suppose the following rates are averages for banks in your area: interest checking accounts pay 1%, savings accounts pay 2%, and one-year certificates of deposit pay 3%. All accounts are federally insured by the FDIC. The difference in rates can be explained mainly by
A) liquidity premiums.
B) default risk premiums.
C) maturity premiums.
D) inflation risk premiums.
Answer: A
Diff: 2 Page Ref: 37
Keywords: Liquidity Premium
Learning Obj.: L.O. 2.3
AACSB: Reflective Thinking

20) Which of the following statements is false?
A) Brokers purchase securities for their own account.
B) Most corporate bond trading takes place over the counter.
C) Broker-dealers stand ready to buy and sell specific securities at selected prices.
D) none of the above
Answer: A
Diff: 2 Page Ref: 33
Keywords: Brokers, Broker-Dealers, Securities
Learning Obj.: L.O. 2.3
AACSB: Analytical Thinking

21) Examine the securities below and identify the security with the highest liquidity premium, the highest default risk premium, and the highest maturity premium.
a. 30-year U.S. Government Treasury bond maturing in 2025
b. 25-year Bbb-rated corporate bond maturing in 2030, actively traded on the New York Exchange
c. 10-year Aaa-rated corporate bond maturing in 2020, thinly traded on a regional exchange
d. 3-month U.S. Treasury bill
Answer: The 10-year Aaa-rated corporate bond has the highest liquidity premium because it is not actively traded and may be difficult to turn into cash on short notice. The Bbb-rated corporate bond has the highest default risk premium. The U.S. Government securities are virtually default risk free, and the other corporate bond is Aaa rated. The 25-year Bbb-rated corporate bond maturing in 2030 has the highest maturity premium. Although the Treasury bond had a longer maturity when issued, currently the 25-year Bbb bond has the longest time left to maturity.
Diff: 2 Page Ref: 37
Keywords: Risk Premium, Liquidity Premium, Maturity Premium
Learning Obj.: L.O. 2.3
AACSB: Reflective Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

22) Distinguish between the concepts of the inflation premium and the default-risk premium.
Answer: Inflation premium is a premium to compensate for anticipated inflation that is equal to the price change expected to occur over the life of the bond or investment instrument.
Default-risk premium is the additional return required by investors to compensate them for the risk of default. It is calculated as the difference between a U.S. Treasury bond and a corporate bond of the same maturity and marketability.
Diff: 2 Page Ref: 37
Keywords: Risk Premium
Learning Obj.: L.O. 2.3
AACSB: Reflective Thinking

23) Distinguish between the concepts of the maturity-risk premium and the liquidity-risk premium.
Answer: Maturity-risk premium is the additional return required by investors in longer-term securities to compensate them for greater risk of price fluctuations on those securities caused by interest rate changes.
Liquidity-risk premium is the additional return required by investors for securities that cannot be quickly converted into cash at a reasonably predictable price.
Diff: 2 Page Ref: 37
Keywords: Risk Premium
Learning Obj.: L.O. 2.3
AACSB: Reflective Thinking

Learning Objective 2.4

1) The term structure of interest rates usually indicates that longer terms to maturity have higher expected returns.
Answer: TRUE
Diff: 2 Page Ref: 43
Keywords: Term Structure of Interest Rates
Learning Obj.: L.O. 2.4
AACSB: Reflective Thinking

2) In response to the banking crisis and economic collapse of 2007 and 2008, the U.S. government moved to increase interest rates in order to attract foreign capital seeking high returns in U.S. banks.
Answer: FALSE
Diff: 2 Page Ref: 43
Keywords: Interest Rates, Term Structure
Learning Obj.: L.O. 2.4
AACSB: Reflective Thinking

3) A *liquidity-risk* premium is the additional return required by investors in longer-term securities to compensate them for the greater risk of price fluctuation on those securities caused by interest rate changes.
Answer: FALSE
Diff: 2 Page Ref: 38
Keywords: Nominal Rate of Interest, Inflation Premium, Real Rate of Interest
Learning Obj.: L.O. 2.4
AACSB: Reflective Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

4) A *real interest rate* is the interest rate on a fixed-income security that has no risk in an economic environment of high inflation.
Answer: FALSE
Diff: 2 Page Ref: 39
Keywords: Nominal Rate of Interest, Inflation Premium, Real Rate of Interest
Learning Obj.: L.O. 2.4
AACSB: Reflective Thinking

5) A *liquidity-risk premium* is the additional return required by investors for securities that cannot quickly be converted into cash at a reasonably predictable price.
Answer: TRUE
Diff: 1 Page Ref: 38, 39
Keywords: Nominal Rate of Return, Liquidity Premium
Learning Obj.: L.O. 2.4
AACSB: Reflective Thinking

6) Which of the following securities will likely have the highest maturity risk premium?
A) U.S. Treasury bond maturing in 2027
B) Bbb-rated corporate bond maturing in 2020 actively traded on a major exchange
C) Aaa-rated corporate bond maturing in 2015 not actively traded
D) U.S. Treasury bill
Answer: A
Diff: 2 Page Ref: 38
Keywords: Maturity Risk Premium
Learning Obj.: L.O. 2.4
AACSB: Analytical Thinking

7) The one-year interest rate is 4%. The interest rate for a two-year security is 6%. According to the unbiased expectations theory, the one-year interest rate one year from now must be equal to
A) 5.00%.
B) 8.00%.
C) 8.04%.
D) 10.00%.
Answer: C
Diff: 2 Page Ref: 45
Keywords: Term Structure of Interest Rates, Unbiased Expectations
Learning Obj.: L.O. 2.4
AACSB: Reflective Thinking

8) The one-year interest rate is 4%. The interest rate for a two-year security is 6%. The one-year interest rate one year from now is 8.34%. According to the liquidity preference theory, the risk premium for the second one-year investment is
A) 0.50%.
B) 0.34%.
C) 0.30%.
D) 1.66%.
Answer: C
Diff: 3 Page Ref: 46
Keywords: Term Structure of Interest Rates, Liquidity Preference Theory
Learning Obj.: L.O. 2.4
AACSB: Reflective Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

9) You are considering an investment in a U.S. Treasury bond but you are not sure what rate of interest it should pay. Assume that the real risk-free rate of interest is 1.0%; inflation is expected to be 1.5%; the maturity risk premium is 2.5%; and, the default risk premium for AAA rated corporate bonds is 3.5%. What rate of interest should the U.S. Treasury bond pay?
A) 8.5%
B) 6.0%
C) 5.0%
D) 2.5%
Answer: C
Diff: 2 Page Ref: 40
Keywords: Nominal Interest Rate, Real Rate, Inflation Premium, Maturity Risk Premium, Default Risk Premium
Learning Obj.: L.O. 2.4
AACSB: Analytical Thinking

10) You are considering an investment in a AAA-rated U.S. corporate bond but you are not sure what rate of interest it should pay. Assume that the real risk-free rate of interest is 1.0%; inflation is expected to be 1.5%; the maturity risk premium is 2.5%; and, the default risk premium for AAA rated corporate bonds is 3.5%. What rate of interest should the U.S. corporate bond pay?
A) 8.5%
B) 6.0%
C) 5.0%
D) 2.5%
Answer: A
Diff: 2 Page Ref: 40
Keywords: Nominal Interest Rate, Real Rate, Inflation Premium, Maturity Risk Premium, Default Risk Premium
Learning Obj.: L.O. 2.4
AACSB: Analytical Thinking

11) What is the term for a graphical representation of the relationship between interest rates and the maturities of debt securities?
A) term curve
B) maturity chart
C) yield curve
D) inflationary expectations
Answer: C
Diff: 2 Page Ref: 43
Keywords: Yield Curve, Interest Rates
Learning Obj.: L.O. 2.4
AACSB: Reflective Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

12) Which of the following is NOT a valid theory that attempts to explain the shape of the term structure of interest rates?
A) the unbiased expectations theory
B) the liquidity preference theory
C) the market segmentation theory
D) the Fisher Effect theory
Answer: D
Diff: 2 Page Ref: 45
Keywords: Expectations Theory, Liquidity Preference Theory, Market Segmentation Theory, Term Structure of Interest Rates
Learning Obj.: L.O. 2.4
AACSB: Reflective Thinking

13) A "normal" yield curve is
A) downward sloping.
B) downward sloping, then upward sloping.
C) upward sloping.
D) upward sloping, then downward sloping.
Answer: C
Diff: 2 Page Ref: 44
Keywords: Normal Yield Curve
Learning Obj.: L.O. 2.4
AACSB: Reflective Thinking

14) Which of the following premiums is NOT factored into the price of a long-term Treasury bond?
A) a real risk-free interest rate
B) a maturity premium
C) a default-risk premium
D) an inflation-risk premium
Answer: C
Diff: 1 Page Ref: 44
Keywords: Nominal Rate of Interest, Inflation Premium, Real Rate of Interest
Learning Obj.: L.O. 2.4
AACSB: Reflective Thinking

15) The _____ is the premium to compensate for the price change expected to occur over the life of the bond or investment instrument.
A) inflation-risk premium
B) maturity premium
C) real risk-free interest rate premium
D) default-risk premium
Answer: A
Diff: 1 Page Ref: 44
Keywords: Nominal Rate of Interest, Inflation Premium, Real Rate of Interest
Learning Obj.: L.O. 2.4
AACSB: Reflective Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

16) Given the anticipated rate of inflation (i) of 1.7% and the real rate of interest (R) of 1.4%, find the nominal rate of interest (r).
Answer:
r = R + i + Ri
r = .014 + .017 + (.014)(.017)
r = .031 + .000238 = .031238
r = 3.12%
Diff: 2 Page Ref: 44
Keywords: Real Rate of Interest, Inflation Premium, Nominal Rate of Interest
Learning Obj.: L.O. 2.4
AACSB: Analytical Thinking

17) Given the rate information in the table below, estimate the nominal rate for a AA-rated corporate bond. Assume a liquidity premium of 8 basis points. Identify as part of your answer the inflation risk premium, the default risk premium, the maturity premium, and the liquidity premium.

3-month T-bills	2.0%
30-year Treasury bonds	5.0%
AA-rated corp. bonds	8.0%
Inflation Rate	1.0%

Answer:
k* = 2.0% - 1.0% = 1.0%
IRP = 1.0%
DRP = 8.0% - 5.0% = 3.0%
MP = 5.0% - 2.0% = 3.0%
LP = .08% (given)
K = 1.0% + 1.0% + 3.0% + 3.0% + .08% = 8.08%
Diff: 3 Page Ref: 44
Keywords: Nominal Interest Rate, IRP, DRP, MP, LP
Learning Obj.: L.O. 2.4
AACSB: Analytical Thinking

18) An investor buys a 20-year Bbb-rated corporate bond with a nominal annual rate of return of 10%. The average inflation rate is expected to be 2%. The default risk premium is expected to be 5% and the maturity premium is 4%. Calculate the real rate of interest.
Answer:
$k_{rf} = k^* + IRP + (k^* \times IRP)$
$10\% = k^* + 2\% + (k^* \times 2\%)$
$8\% = 1.02\ k^*$
$7.84\% = k^*$
Diff: 2 Page Ref: 41
Keywords: Fisher Effect, Real Rate of Interest
Learning Obj.: L.O. 2.4
AACSB: Analytical Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

19) The current rate of return on a one-year U.S. Government security is 3%. The rate of return on a two-year U.S. Government security is 5%. According to the expectations theory, what is the return on a one-year U.S. Government security purchased one year from today?
Answer:
$1,000 × 1.03 = $1,030 at the end of year one
$1,000 × $(1.05)^2$ = $1,102.50 at the end of two years
$1,102.50 - $1,030 = $72.50 interest needed in year 2
$72.50/$1,030 = 7.04%
Diff: 3 Page Ref: 45, 46
Keywords: Expectations Theory, Term Structure of Interest Rates
Learning Obj.: L.O. 2.4
AACSB: Analytical Thinking

20) The date today is January 1, 2010. A one-year security maturing on 1/1/11 yields 3%. A two-year security maturing on 1/1/12 yields 6%. A three-year security maturing on 1/1/13 yields 11%. Calculate the expected annual return on a two-year security beginning 1/1/11 and maturing on 1/1/13.
Answer:
$1,000 × $(1.11)^3$ = $1,367.63 at the end of three years (1/1/13)
$1,000 × (1.03) = $1,030 at the end of one year (1/1/11)
$1,367.63 - $1,030 = $337.63 to be earned on two-year security from 1/1/11 to 1/1/13
$1,030 × $(1 + k)^2$ = $1,367.63
k = ($1,367.63/$1,030)$^{.5}$ - 1 = 15.23%
Diff: 2 Page Ref: 45, 46
Keywords: Expectations Theory, Term Structure of Interest Rates
Learning Obj.: L.O. 2.4
AACSB: Analytical Thinking

21) If provided the nominal rate of interest (r) of 7.4% and the anticipated rate of inflation (i) of 4.5%, what is the real rate of interest (R)?
Answer:
r = R + i + Ri
.074 = R + .045 + (.045)(R)
.074 - .045 = 1.045R
.029 = 1.045R
R = .02775 = 2.
78%
Diff: 2 Page Ref: 44
Keywords: Nominal Rate of Interest, Inflation Premium, Real Rate of Interest
Learning Obj.: L.O. 2.4
AACSB: Analytical Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank

22) Given the anticipated rate of inflation (i) of 2.13% and the real rate of interest (R) of 3.1%, find the nominal rate of interest (r).
Answer:
r = R + i + Ri
r = .031 + .0213 + (.031)(.0213)
r = .0523 + .0006603
r = .05296 = 5.3%
Diff: 2 Page Ref: 44
Keywords: Inflation Premium, Real Rate of Interest, Nominal Rate of Interest
Learning Obj.: L.O. 2.4
AACSB: Analytical Thinking

23) The yield curve in 2009 was very low, with short-term rates close to zero and long-term rates below 5 percent. What factors contributed to such low interest rates?
Answer: Answer: In response to the banking and economic crises, the U.S. Government undertook policies to reduce interest rates in an attempt to stimulate economic activity. In addition, the recession caused a decrease in the demand for borrowed funds, and investors, scared off by large declines in the stock market, moved money into safer U.S. Treasury securities. Increasing Treasury prices mean lower yields.
Diff: 2 Page Ref: 43, 44, 45
Keywords: Economic Crises, Yield Curve, Term Structure of Interest Rates
Learning Obj.: L.O. 2.4
AACSB: Reflective Thinking

24) Identify three prominent theories that attempt to explain the term structure of interest rates.
Answer: Three possible theories may explain the shape of the term structure of interest rates at any point in time:
The Unbiased Expectations Theory: The theory says that the term structure is determined by an investor's expectations about future interest rates.
The Liquidity Preference Theory: According to the theory, investors require maturity-risk premiums to compensate them for buying securities that expose them to the risks of fluctuating interest rates.
The Market Segmentation Theory: The theory implies that the rate of interest for a particular maturity is determined solely by demand and supply for a given maturity and that it is independent of the demand and supply for securities having different maturities.
Diff: 2 Page Ref: 45
Keywords: Term Structure of Interest Rates
Learning Obj.: L.O. 2.4
AACSB: Reflective Thinking

Copyright © 2017 Pearson Education, Inc.

Foundations of Finance 9th edition Keown Test Bank