

Principles of Managerial Finance, 14e (Gitman/Zutter)
Chapter 2 The Financial Market Environment

2.1 Understand the role that financial institutions play in managerial finance.

1) A financial institution is an intermediary that channels the savings of individuals, businesses, and governments into loans or investments.

Answer: TRUE

Diff: 1

Topic: Financial Institutions

Learning Obj.: LG 1

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Analytic Skills

2) Commercial banks advise firms on major transactions such as mergers or financial restructurings.

Answer: FALSE

Diff: 1

Topic: Financial Institutions

Learning Obj.: LG 1

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Analytic Skills

3) As a key participant in financial transactions, individuals are _____.

A) net demanders of funds because they save more money than they borrow

B) net users of funds because they save less money than they borrow

C) net suppliers of funds because they save more money than they borrow

D) net purchasers of funds because they save more money than they borrow

Answer: C

Diff: 1

Topic: Financial Institutions

Learning Obj.: LG 1

Learning Outcome: F-01

Question Status: New

AACSB Tag: Analytic Skills

4) Government is typically a _____.

- A) net provider of funds because it borrows more than it saves
- B) net demander of funds because it borrows more than it saves
- C) net provider of funds because it can print money at will
- D) net demander of funds because it saves more than it borrows

Answer: B

Diff: 1

Topic: Financial Institutions

Learning Obj.: LG 1

Learning Outcome: F-01

Question Status: New

AACSB Tag: Analytic Skills

5) Government can obtain funds _____.

- A) by trading in equity market
- B) by issuing financial instruments such as futures and options
- C) through forex market
- D) by selling debt securities

Answer: D

Diff: 1

Topic: Financial Institutions

Learning Obj.: LG 1

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

6) Firms that require funds from external sources can obtain them _____.

- A) through financial institutions
- B) from central bank directly
- C) through forex market
- D) by issuing T-bills

Answer: A

Diff: 1

Topic: Financial Institutions

Learning Obj.: LG 1

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

7) Investment banks are institutions that _____.

- A) perform all activities of commercial banks and retail banks
- B) are exempted from Securities and Exchange Commission regulations
- C) engage in trading and market making activities
- D) are only limited to capital market activities

Answer: C

Diff: 1

Topic: Commercial Banks, Investment Banks, And The Shadow Banking System

Learning Obj.: LG 1

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

8) Which of the following serves as an intermediary channeling the savings of individuals, businesses, and governments into loans and investments?

- A) financial institutions
- B) financial markets
- C) Securities and Exchange Commission
- D) OTC market

Answer: A

Diff: 1

Topic: Financial Institutions

Learning Obj.: LG 1

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

9) The shadow banking system describes a group of institutions that engage in lending activities, much like traditional banks.

Answer: TRUE

Diff: 1

Topic: Commercial Banks, Investment Banks, And The Shadow Banking System

Learning Obj.: LG 1

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Analytic Skills

10) Which of the following provides savers with a secure place to invest funds and offer both individuals and companies loans to finance investments?

- A) investment banks
- B) securities exchanges
- C) mutual funds
- D) commercial banks

Answer: D

Diff: 1

Topic: Commercial Banks, Investment Banks, And The Shadow Banking System

Learning Obj.: LG 1

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

11) Which of the following assists companies in raising capital, advise firms on major transactions such as mergers or financial restructuring, and engage in trading and market making activities?

- A) investment banks
- B) securities exchanges
- C) mutual funds
- D) commercial banks

Answer: A

Diff: 1

Topic: Commercial Banks, Investment Banks, And The Shadow Banking System

Learning Obj.: LG 1

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

2.2 Contrast the functions of financial institutions and financial markets.

1) Primary and secondary markets are markets for short-term and long-term securities, respectively.

Answer: FALSE

Diff: 1

Topic: Financial Markets

Learning Obj.: LG 2

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Analytic Skills

2) Financial markets are intermediaries that channel the savings of individuals, businesses, and government into loans or investments.

Answer: FALSE

Diff: 1

Topic: Financial Markets

Learning Obj.: LG 2

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Analytic Skills

3) A public offering is the sale of a new security issue—typically debt or preferred stock—directly to an investor or group of investors.

Answer: FALSE

Diff: 1

Topic: Financial Markets

Learning Obj.: LG 2

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Analytic Skills

4) A primary market is a financial market in which pre-owned securities are traded.

Answer: FALSE

Diff: 1

Topic: Financial Markets

Learning Obj.: LG 2

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Analytic Skills

5) The Glass-Steagall Act was imposed to allow commercial and investment banks to combine and work together.

Answer: FALSE

Diff: 1

Topic: Financial Institutions and Markets

Learning Obj.: LG 2

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Analytic Skills

6) Most businesses raise money by selling their securities in a _____.

- A) public offering
- B) forex market
- C) futures market
- D) commodities market

Answer: A

Diff: 1

Topic: Financial Markets

Learning Obj.: LG 2

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

7) Which of the following is a means of selling bonds or stocks to the public?

- A) private placement
- B) public offering
- C) organized selling
- D) direct placement

Answer: B

Diff: 1

Topic: Financial Markets

Learning Obj.: LG 2

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

8) Which of the following is a forum in which suppliers and demanders of funds can transact business directly?

- A) shadow banking system
- B) financial markets
- C) commercial banks
- D) financial institutions

Answer: B

Diff: 1

Topic: Financial Markets

Learning Obj.: LG 2

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

9) The sale of a new security directly to an investor or a group of investors is called _____.

- A) arbitraging
- B) short selling
- C) a capital market transaction
- D) a private placement

Answer: D

Diff: 1

Topic: Financial Markets

Learning Obj.: LG 2

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

10) The _____ market is where securities are initially issued and the _____ market is where pre-owned securities (not new issues) are traded.

- A) primary; secondary
- B) money; capital
- C) secondary; primary
- D) primary; money

Answer: A

Diff: 1

Topic: Financial Markets

Learning Obj.: LG 2

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Analytic Skills

2.3 Describe the differences between the capital markets and the money markets.

1) The over-the-counter (OTC) market is a market for trading smaller and unlisted securities.

Answer: TRUE

Diff: 1

Topic: Financial Markets

Learning Obj.: LG 3

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

2) NASDAQ is considered an OTC market since it is not recognized by the SEC as a "listed exchange."

Answer: FALSE

Diff: 1

Topic: Financial Markets

Learning Obj.: LG 3

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Analytic Skills

3) In the OTC market, the ask price is the highest price offered by a dealer to purchase a given security.

Answer: FALSE

Diff: 1

Topic: Financial Markets

Learning Obj.: LG 3

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Analytic Skills

4) In the Eurobond market, corporations and governments typically issue bonds denominated in dollars and sell them to investors located outside the United States.

Answer: TRUE

Diff: 1

Topic: Financial Markets

Learning Obj.: LG 3

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Analytic Skills

5) Capital markets are for investors who want a safe temporary place to deposit funds where they can earn interest and for borrowers who have a short-term need for funds.

Answer: FALSE

Diff: 1

Topic: Financial Markets

Learning Obj.: LG 3

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Analytic Skills

6) Money markets are markets for long-term funds such as bonds and equity.

Answer: FALSE

Diff: 1

Topic: Financial Markets

Learning Obj.: LG 3

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

7) An efficient market is a market that establishes correct prices for the securities that firms sell and allocates funds to their most productive use as a result of the intense competition among investors.

Answer: TRUE

Diff: 1

Topic: Financial Markets

Learning Obj.: LG 3

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

8) Money markets involve the trading of securities with maturities of one year or less.

Answer: TRUE

Diff: 1

Topic: Financial Markets

Learning Obj.: LG 3

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

9) Eurocurrency deposits arise when a corporation or individual makes a deposit in a bank in a currency other than the local currency of the country where the bank is located.

Answer: TRUE

Diff: 1

Topic: Financial Markets

Learning Obj.: LG 3

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Analytic Skills

10) The Eurocurrency market is a market for short-term bank deposits denominated in U.S. dollars or other easily convertible currencies.

Answer: TRUE

Diff: 1

Topic: Financial Markets

Learning Obj.: LG 3

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Analytic Skills

11) The money market is a financial relationship created by a number of institutions and arrangements that allows suppliers and demanders of long-term funds to make transactions.

Answer: FALSE

Diff: 1

Topic: Financial Markets

Learning Obj.: LG 3

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Analytic Skills

12) The over-the-counter (OTC) market is _____.

A) a highly liquid market as compared to NASDAQ

B) a market in which low risk-high return securities are traded

C) an organized market in which all financial derivatives are traded

D) a market where smaller, unlisted securities are traded

Answer: D

Diff: 1

Topic: Financial Markets

Learning Obj.: LG 3

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

13) Which of the following is true of a primary market?

A) It is an organized market in which all financial derivatives are traded.

B) It is regulated by The Sarbanes-Oxley Act.

C) It is a market where smaller, unlisted securities are traded.

D) It is the only market in which the issuer is directly involved in the transaction.

Answer: D

Diff: 1

Topic: Financial Markets

Learning Obj.: LG 3

Learning Outcome: F-01

Question Status: New

AACSB Tag: Analytic Skills

14) Which of the following is true of a secondary market?

- A) It is a market for an unlisted company to raise equity capital.
- B) It is a market where securities are issued through private placement
- C) It is a market in which short-term money market instruments such as Treasury bills are traded.
- D) It is a market in which preowned securities are traded.

Answer: D

Diff: 1

Topic: Financial Markets

Learning Obj.: LG 3

Learning Outcome: F-01

Question Status: New

AACSB Tag: Analytic Skills

15) Which of the following is true of preferred stock?

- A) It has features of bonds and a common stock.
- B) It has a claim on assets prior to creditors in the event of liquidation.
- C) Its dividends can be paid only after paying dividends to the common stockholders.
- D) It usually has a maturity of thirty years.

Answer: A

Diff: 2

Topic: Financial Markets

Learning Obj.: LG 3

Learning Outcome: F-01

Question Status: New

AACSB Tag: Analytic Skills

16) The key securities traded in the capital markets are _____.

- A) commercial papers and Treasury bills
- B) Treasury bills and certificates of deposit
- C) stocks and bonds
- D) bills of exchange and commercial papers

Answer: C

Diff: 1

Topic: Financial Markets

Learning Obj.: LG 3

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

17) Which of the following is true of international equity markets?

- A) In the international equity market, corporations cannot raise capital through IPOs, instead they can raise capital by trading in the secondary market.
- B) In the international equity market, corporations can easily manipulate the price of the shares since it is not regulated by any regulatory bodies.
- C) In the international equity market, corporations can only sell blocks of shares to institutional investors from European Union.
- D) In the international equity market, corporations can sell blocks of shares to investors in a number of different countries simultaneously.

Answer: D

Diff: 1

Topic: Financial Markets

Learning Obj.: LG 3

Learning Outcome: F-01

Question Status: New

AACSB Tag: Analytic Skills

18) Which of the following is true of a dealer market?

- A) Buyers and sellers are never brought together directly.
- B) Brokers execute the buy or sell orders in a dealer market.
- C) It has centralized trading floors.
- D) It is a part of the broker market.

Answer: A

Diff: 2

Topic: Financial Markets

Learning Obj.: LG 3

Learning Outcome: F-01

Question Status: New

AACSB Tag: Analytic Skills

19) Which of the following is true of a securities exchange?

- A) It serves as an intermediary by channeling the savings of individuals, businesses, and governments into loans or investments.
- B) It borrows funds directly from the financial institutions.
- C) It is an association of banks who meet to buy and sell stocks and bonds.
- D) It provides a marketplace in which firms can raise funds through the sale of new securities and purchasers can resell securities.

Answer: D

Diff: 2

Topic: Financial Markets

Learning Obj.: LG 3

Learning Outcome: F-01

Question Status: New

AACSB Tag: Analytic Skills

20) A market that establishes correct prices for the securities that firms sell and allocates funds to their most productive uses is called a(n) _____.

- A) future market
- B) forex market
- C) efficient market
- D) weak-form market

Answer: C

Diff: 1

Topic: Financial Markets

Learning Obj.: LG 3

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

21) The _____ is created by a financial relationship between suppliers and demanders of short-term funds.

- A) stock market
- B) capital market
- C) forex market
- D) money market

Answer: D

Diff: 1

Topic: Financial Markets

Learning Obj.: LG 3

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Analytic Skills

22) By definition, the money market involves the buying and selling of _____.

- A) stocks and bonds
- B) short-term securities
- C) all financial instruments except derivatives
- D) secured premium notes

Answer: B

Diff: 1

Topic: Financial Markets

Learning Obj.: LG 3

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

23) Most money market transactions are made in _____.

- A) common stock
- B) marketable securities
- C) commodities market
- D) preferred stock

Answer: B

Diff: 1

Topic: Financial Markets

Learning Obj.: LG 3

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

24) The _____ is created by a number of institutions and arrangements that allow the suppliers and demanders of long-term funds to make transactions.

- A) forex market
- B) capital market
- C) money market
- D) commodities market

Answer: B

Diff: 1

Topic: Financial Markets

Learning Obj.: LG 3

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Analytic Skills

25) Long-term debt instruments used by both government and business are known as _____.

- A) preferred stocks
- B) T-bills
- C) bonds
- D) equities

Answer: C

Diff: 1

Topic: Financial Markets

Learning Obj.: LG 3

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

26) Which of the following is an example of marketable securities?

- A) U.S.Treasury bills
- B) treasury stock
- C) mortgage backed securities
- D) loans

Answer: A

Diff: 1

Topic: Financial Markets

Learning Obj.: LG 3

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

27) In a _____ market, the buyer and seller are brought together to trade securities in an organization called _____.

- A) dealer; securities market
- B) broker; over-the -counter market
- C) broker; securities market
- D) dealer; over-the-counter market

Answer: C

Diff: 1

Topic: Financial Markets

Learning Obj.: LG 3

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Analytic Skills

28) In a _____ market, the buyer and seller are not brought together to trade securities directly but instead have their orders executed on the _____.

- A) dealer; securities market
- B) broker; over-the -counter market
- C) broker; securities market
- D) dealer; over-the-counter market

Answer: D

Diff: 1

Topic: Financial Markets

Learning Obj.: LG 3

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Analytic Skills

- 29) An efficient market is one where _____.
- A) prices of stocks move up and down widely without apparent reason
 - B) prices of stocks remain low for long periods of time
 - C) prices of stocks are unaffected by market news
 - D) the price of a security is an unbiased estimate of its true value

Answer: D

Diff: 1

Topic: The Capital Market

Learning Obj.: LG 3

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

- 30) The money market is a market _____.
- A) that enables suppliers and demanders of long-term funds to make transactions
 - B) which brings together suppliers and demanders of short-term funds
 - C) where smaller, unlisted securities are traded
 - D) where all derivatives are traded

Answer: B

Diff: 2

Topic: The Capital Market

Learning Obj.: LG 3

Learning Outcome: F-01

Question Status: New

AACSB Tag: Analytic Skills

- 31) Apex Inc. issues a bond of \$1,000 which pays interest semiannually at a coupon interest rate of 8%. The maturity of the bond is 15 years. Where should this bond be traded?
- A) forex market
 - B) money market
 - C) capital market
 - D) commodities market

Answer: C

Diff: 2

Topic: The Capital Market

Learning Obj.: LG 3

Learning Outcome: F-01

Question Status: New

AACSB Tag: Reflective Thinking Skills

2.4 Explain the root causes and subsequent effects of the 2008 financial crisis and recession.

1) Securitization is the process of pooling mortgages or other types of loans and selling the claims or securities against that pool in the secondary market.

Answer: TRUE

Diff: 1

Topic: Financial Institutions and Real Estate Finance

Learning Obj.: LG 4

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Analytic Skills

2) Securitization made it harder for banks to lend money because they could not pass the risk on to other investors.

Answer: FALSE

Diff: 1

Topic: Financial Institutions and Real Estate Finance

Learning Obj.: LG 4

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Analytic Skills

3) Mortgage-backed securities are securities that represent claims on the cash flows generated by a pool of mortgages.

Answer: TRUE

Diff: 1

Topic: Financial Institutions and Real Estate Finance

Learning Obj.: LG 4

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Analytic Skills

4) Prior to the 2008 financial crisis, most investors viewed mortgage-backed securities as relatively safe investments.

Answer: TRUE

Diff: 1

Topic: Falling Home Prices And Delinquent Mortgages

Learning Obj.: LG 4

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Analytic Skills

5) Subprime mortgages are mortgage loans made to borrowers with high incomes and better than average credit histories.

Answer: FALSE

Diff: 1

Topic: Falling Home Prices And Delinquent Mortgages

Learning Obj.: LG 4

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Analytic Skills

6) Recessions associated with a banking crisis tend to be more severe than other recessions because many businesses rely on credit to operate.

Answer: TRUE

Diff: 1

Topic: Spillover Effects And The Great Recession

Learning Obj.: LG 4

Learning Outcome: F-01

Question Status: New

AACSB Tag: Analytic Skills

7) The process of pooling mortgages or other types of loans and selling the claims or securities against that pool in the secondary market is called _____.

A) valuation

B) securitization

C) private placement

D) capital restructuring

Answer: B

Diff: 1

Topic: Financial Institutions and Real Estate Finance

Learning Obj.: LG 4

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

8) The primary risk of mortgage-backed securities is _____.

A) that the prices of have high volatility

B) that the prices of housing will increase

C) that the government will not be able to meet the guarantees on the cash flows

D) that homeowners may not be able to, or choose not to, repay their loans

Answer: D

Diff: 2

Topic: Financial Institutions and Real Estate Finance

Learning Obj.: LG 4

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

9) Which of the following is true of mortgage-backed securities?

- A) Mortgage-backed securities assure a flat 15% return.
- B) Mortgage-backed securities are guaranteed by the U.S. government.
- C) Mortgage-backed securities can only be purchased by investment banks.
- D) Mortgage-backed securities represent claims on the cash flows generated by a pool of homeloans.

Answer: D

Diff: 2

Topic: Financial Institutions and Real Estate Finance

Learning Obj.: LG 4

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

10) When home prices are falling, we would expect a(n) _____.

- A) high mortgage default rates
- B) low mortgage default rates
- C) unchanged mortgage default rates
- D) higher percentage of owner home equity

Answer: A

Diff: 2

Topic: Falling Home Prices And Delinquent Mortgages

Learning Obj.: LG 4

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Reflective Thinking Skills

11) A crisis in the financial sector often spills over into other industries because when financial institutions _____ borrowing, activity in most other industries _____.

- A) increase; slows down
- B) contract; slows down
- C) increase; increases
- D) contract; increases

Answer: B

Diff: 1

Topic: Spillover Effects And The Great Recession

Learning Obj.: LG 4

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Analytic Skills

2.5 Understand the major regulations and regulatory bodies that affect financial institutions and markets.

1) The Glass-Steagall Act _____.

- A) was intended to regulate the activities in the secondary market
- B) created the Securities Exchange Commission
- C) separated the activities of commercial and investment banks
- D) was intended to regulate the activities in the primary market

Answer: C

Diff: 2

Topic: Regulations Governing Financial Institutions

Learning Obj.: LG 5

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

2) The Securities Act of 1933 focuses on regulating the sale of securities in the primary market, whereas the 1934 Act deals with the regulations governing the transactions in the secondary market.

Answer: TRUE

Diff: 1

Topic: Regulations Governing Financial Markets

Learning Obj.: LG 5

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Analytic Skills

3) The Federal Deposit Insurance Corporation (FDIC) _____.

- A) is an agency, created by the Glass-Steagall Act ,that monitors banks on a regular basis to ensure that they were safe and sound
- B) is an agency that monitors business combinations between commercial banks, investment banks, and insurance companies
- C) guarantees individuals will not lose any money held at any type of financial institution that fails
- D) guarantees individuals will not lose any money, up to a specified amount, held at any type of financial institution that fails

Answer: A

Diff: 1

Topic: Regulations Governing Financial Institutions

Learning Obj.: LG 5

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

4) The Gramm-Leach-Bliley Act _____.

- A) is created to monitor banks on a regular basis to ensure that they were safe and sound
- B) allows business combinations between commercial banks and investment banks, but not insurance companies
- C) allows business combinations between commercial banks, investment banks, and insurance companies
- D) was signed during the Great Depression because of the financial crisis

Answer: C

Diff: 1

Topic: Regulations Governing Financial Institutions

Learning Obj.: LG 5

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

5) Which of the following acts regulates the secondary market ?

- A) The Securities Act of 1933
- B) The Gramm-Leach-Bliley Act
- C) The Securities Exchange Act of 1934
- D) The Glass-Steagall Act

Answer: C

Diff: 1

Topic: Regulations Governing Financial Markets

Learning Obj.: LG 5

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

6) Which of the following acts regulates the primary market in which securities are originally issued to the public?

- A) The Securities Act of 1933
- B) The Gramm-Leach-Bliley Act
- C) The Securities Exchange Act of 1934
- D) The Glass-Steagall Act

Answer: A

Diff: 1

Topic: Regulations Governing Financial Markets

Learning Obj.: LG 5

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Analytic Skills

2.6 Discuss business taxes and their importance in financial decisions.

1) The ordinary income of a corporation is income earned through the sale of goods or services and is currently taxed subject to the individual income tax rates.

Answer: FALSE

Diff: 1

Topic: Ordinary Income

Learning Obj.: LG 6

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

2) The marginal tax rate represents the rate at which the next dollar of income is taxed.

Answer: TRUE

Diff: 1

Topic: Ordinary Income

Learning Obj.: LG 6

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Analytic Skills

3) All dividend income received by a corporation is exempted from taxation.

Answer: FALSE

Diff: 1

Topic: Ordinary Income

Learning Obj.: LG 6

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Analytic Skills

4) The marginal tax rate paid on a firm's ordinary income can be calculated by dividing its taxes by its net income.

Answer: FALSE

Diff: 1

Topic: Ordinary Income

Learning Obj.: LG 6

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

5) The average tax rate paid on the firm's ordinary income can be calculated by dividing its taxes by its taxable income.

Answer: TRUE

Diff: 1

Topic: Ordinary Income

Learning Obj.: LG 6

Learning Outcome: F-01

Question Status: New

AACSB Tag: Analytic Skills

6) Dividends received by a corporation on an investment in the common and preferred stock of another corporation, where ownership in the dividend paying corporation is less than 20%, is subject to 70 percent exclusion for tax purposes.

Answer: TRUE

Diff: 1

Topic: Ordinary Income

Learning Obj.: LG 6

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Analytic Skills

7) The tax deductibility of various expenses such as general and administrative expenses _____.

A) increases their pretax cost

B) reduces their after-tax cost

C) has no effect on their after-tax cost

D) has an unpredictable effect on their after-tax cost

Answer: B

Diff: 1

Topic: Ordinary Income

Learning Obj.: LG 6

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Analytic Skills

8) The tax liability of a corporation with ordinary income of \$105,000 is _____.

Range of taxable income		Marginal rate
\$ 0	to \$ 50,000	15%
50,000	to 75,000	25
75,000	to 100,000	34
100,000	to 335,000	39
335,000	to 10,000,000	34
10,000,000	to 15,000,000	35

A) \$42,000

B) \$35,700

C) \$23,950

D) \$24,450

Answer: D

Diff: 2

Topic: Ordinary Income

Learning Obj.: LG 6

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

9) The tax liability of a corporation with ordinary income of \$1,500,000 is _____.

Range of taxable income		Marginal rate
\$ 0	to \$ 50,000	15%
50,000	to 75,000	25
75,000	to 100,000	34
100,000	to 335,000	39
335,000	to 10,000,000	34
10,000,000	to 15,000,000	35

A) \$498,250

B) \$510,000

C) \$585,000

D) \$690,000

Answer: B

Diff: 2

Topic: Ordinary Income

Learning Obj.: LG 6

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

10) The tax liability of a corporation with ordinary income of \$1,100,000 is _____.

Range of taxable income		Marginal rate
\$ 0	to \$ 50,000	15%
50,000	to 75,000	25
75,000	to 100,000	34
100,000	to 335,000	39
335,000	to 10,000,000	34
10,000,000	to 15,000,000	35

A) \$362,250

B) \$340,000

C) \$374,000

D) \$390,000

Answer: C

Diff: 2

Topic: Ordinary Income

Learning Obj.: LG 6

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

11) Jennings, Inc. has a tax liability of \$170,000 on pretax income of \$500,000. What is the average tax rate for Jennings, Inc.?

A) 34 percent

B) 46 percent

C) 25 percent

D) 40 percent

Answer: A

Diff: 2

Topic: Ordinary Income

Learning Obj.: LG 6

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Analytic Skills

12) The average tax rate of a corporation with ordinary income of \$105,000 and a tax liability of \$24,200 is _____.

- A) 46 percent
- B) 23 percent
- C) 34 percent
- D) 15 percent

Answer: B

Diff: 2

Topic: Ordinary Income

Learning Obj.: LG 6

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

13) If a corporation sells certain capital equipment for more than its initial purchase price, the difference between the sale price and the purchase price is called a(n) _____.

- A) ordinary gain
- B) revenue gain
- C) capital gain
- D) abnormal gain

Answer: C

Diff: 1

Topic: Capital Gains

Learning Obj.: LG 6

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

14) In general, most corporate capital gains are taxed at _____ tax rate.

- A) the average
- B) the regular corporate
- C) the historic
- D) a 30 percent

Answer: B

Diff: 1

Topic: Capital Gains

Learning Obj.: LG 6

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Analytic Skills

15) Congress allows corporations to exclude from taxes 70 to 100 percent of dividends received from other corporations. Congress did this to _____.

- A) encourage corporations to invest in each other
- B) avoid double taxation on dividends
- C) eliminate most of the potential tax liability from the dividends received by the second and any subsequent corporations
- D) lower the cost of equity financing for corporations

Answer: C

Diff: 1

Topic: Ordinary Income

Learning Obj.: LG 6

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Reflective Thinking Skills

16) Corporation X needs \$1,000,000 and can raise this through debt at an annual rate of 10 percent, or preferred stock at an annual cost of 7 percent. If the corporation has a 40 percent tax rate, the after-tax cost of each is _____.

- A) debt: \$100,000; preferred stock: \$70,000
- B) debt: \$60,000; preferred stock: \$42,000
- C) debt: \$60,000; preferred stock: \$70,000
- D) debt: \$100,000; preferred stock: \$42,000

Answer: C

Diff: 2

Topic: Ordinary Income

Learning Obj.: LG 6

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Reflective Thinking Skills

17) Corporation A owns 15 percent of the stock of corporation B. Corporation B pays corporation A \$100,000 in dividends in 2002. Corporation A must pay tax on _____.

- A) \$100,000 of ordinary income
- B) \$ 30,000 of ordinary income
- C) \$ 70,000 of ordinary income
- D) \$ 70,000 of capital gain

Answer: B

Diff: 2

Topic: Ordinary Income

Learning Obj.: LG 6

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Reflective Thinking Skills

18) The dividend exclusion for corporations receiving dividends from another corporation has resulted in _____.

- A) a lower cost of equity for the corporation paying the dividend
- B) a higher relative cost of bond-financing for the corporation paying the dividend
- C) stock investments being relatively less attractive, relative to bond investments made by one corporation in another corporation
- D) stock investments being relatively more attractive relative to bond investments made by one corporation in another corporation

Answer: D

Diff: 2

Topic: Ordinary Income

Learning Obj.: LG 6

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Reflective Thinking Skills

19) Which of the following is true?

- A) The process of pooling mortgages or other types of loans and then selling claims or securities against that pool in a secondary market is called capitalization.
- B) Corporations pay taxes on all dividends received from other corporations, no matter their share of ownership.
- C) Corporations may pay taxes depending on their percentage of ownership.
- D) Capital gains are treated separately from ordinary corporate income for tax purposes.

Answer: C

Diff: 2

Topic: Ordinary Income

Learning Obj.: LG 6

Learning Outcome: F-01

Question Status: Revised

AACSB Tag: Reflective Thinking Skills

20) Meese Paper Distributors, Inc. has before-tax earnings of \$1,900,000. Calculate the amount of the total tax liability.

Range of taxable income		Marginal rate
\$	0 to \$ 50,000	15%
	50,000 to 75,000	25
	75,000 to 100,000	34
	100,000 to 335,000	39
	335,000 to 10,000,000	34
	10,000,000 to 15,000,000	35
	15,000,000 to 18,333,333	38

Answer:

Meese Paper Distributors		Tax Liability
$0.15 \times \$50,000$	=	\$ 7,500
$0.25 \times \$25,000$	=	6,250
$0.34 \times \$25,000$	=	8,500
$0.39 \times (\$335,000 - \$100,000)$	=	91,650
$0.34 \times (1,900,000 - \$335,000)$	=	<u>532,100</u>
Total tax liability	=	\$646,000

Diff: 2

Topic: Ordinary Income

Learning Obj.: LG 6

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Reflective Thinking Skills

21) During 2002, a firm has sold 5 assets described below. Calculate the tax liability on the assets. The firm pays a 40 percent tax rate on ordinary income.

Asset	Purchase Price	Sale Price
1	\$10,000	\$12,000
2	\$50,000	\$40,000
3	\$37,500	\$50,000
4	\$ 3,000	\$ 3,500
5	\$15,000	\$12,000

Answer:

Asset	Tax Liability		
1	\$ 2,000(0.40)	=	\$ 800
2	—		
3	12,500(0.40)	=	5,000
4	500(0.40)	=	200
5	—		

Diff: 2

Topic: Ordinary Income

Learning Obj.: LG 6

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Analytic Skills

22) Consider two firms, Go Debt corporation and No Debt corporation. Both firms are expected to have earnings before interest and taxes of \$100,000 during the coming year. In addition, Go Debt is expected to incur \$40,000 in interest expenses as a result of its borrowings whereas No Debt will incur no interest expense because it does not use debt financing. However, No Debt will have to pay stockholders \$40,000 in dividend income. Both firms are in the 40 percent tax bracket. Calculate the Earnings after tax for both firms. Which firm has the higher after-tax earnings? Which firm appears to have the higher cash flow? How do you account for the difference?

Answer:

	Go Debt	No Debt
Earnings before interest and taxes	\$100,000	\$100,000
Less: Interest expense	<u>40,000</u>	<u>0</u>
Earnings before taxes	\$ 60,000	\$100,000
Less: Taxes (40%)	<u>24,000</u>	<u>40,000</u>
Earnings after taxes	\$ 36,000	\$ 60,000
Less: Dividends paid	<u>0</u>	<u>40,000</u>

Go Debt has lower earnings after taxes compared to No Debt. However, from a cash outflow perspective, Go Debt paid out a total of only \$64,000 (\$40,000 in interest expenses plus \$24,000 in taxes) while No debt paid out a total of \$80,000 (\$40,000 in taxes and \$40,000 in dividends). The difference between the two is \$16,000 which is exactly the difference in taxes paid between the two firms (\$24,000 compared to \$40,000). This difference results from the fact that interest expense is a tax deductible expense.

Diff: 2

Topic: Ordinary Income

Learning Obj.: LG 6

Learning Outcome: F-01

Question Status: Previous Edition

AACSB Tag: Reflective Thinking Skills