Introduction to Corporate Finance (Canadian) 5th edition Booth Solutions Manual

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Chapter 1: An Introduction to Finance

Multiple Choice Questions

1. Section: 1.1 Finance Defined
Learning Objective: 1.1
Level of difficulty: Basic
CPA: Finance
Solution: A

2. Section: 1.2 Real versus Financial Assets
Learning Objective: 1.2
Level of difficulty: Intermediate
CPA: Finance
Solution: C
Stocks are financial assets. Examples of real assets are residential structures, non-residential structures, machinery and equipment, durables, inventories, and land.

3. Section: 1.2 Real versus Financial Assets
Learning Objective: 1.2
Level of difficulty: Basic
CPA: Finance
Solution: D

4. Section: 1.2 Real Versus Financial Assets
Learning Objective 1.2
Level of difficulty: Basic
CPA: Finance
Solution:
Liquidity is typically characterized as the ability to change an asset into cash quickly. Many financial assets, for example investments such as stocks and bonds, trade on public financial markets, and their monetary value can be readily realized. In contrast, the process of converting a real asset, such as real estate, into cash is considered to be much more time consuming.

5. Section: 1.3 The Financial System
Learning Objective: 1.3
Level of difficulty: Basic
CPA: Finance
Solution: B

6. Section: 1.3 The Financial System
Learning Objective: 1.3
Level of difficulty: Intermediate
CPA: Finance
Solution: A

In the financial system, households are the primary fund providers to government and businesses.

7. Section: 1.3 The Financial System
Learning Objective: 1.3
Level of difficulty: Intermediate
CPA: Finance
Solution: C
Banks, pension funds, and insurance firms transform the nature of the underlying financial securities. However, mutual funds do not transform the nature of the underlying financial securities.

8. Section: 1.4 Financial Instruments and Markets
Learning Objective: 1.4
Level of difficulty: Intermediate
CPA: Finance
Solution: C

9. Section: 1.4 Financial Instruments and Markets
Learning Objective: 1.4
Level of difficulty: Intermediate
CPA: Finance
Solution:
A marketable asset is one that can be traded between or among investors after issuance, but before expiry. The asset's market value will also change over time while the asset is outstanding. In contrast, non-marketable assets cannot be traded between or among investors.

10. Section 1.5 The Global Financial Community
Learning Objective: 1.5
Level of difficulty: Intermediate
CPA: Finance
Solution: C

Practice Problems
Intermediate
11. Section: 1.2 Real versus Financial Assets
Learning Objective: 1.2
Level of difficulty: Intermediate
CPA: Finance
Solution:
Balance sheet:
Residential structures: $1,000 + $3,000 + $1,500 = $5,500
As there are no foreign assets or liabilities, the net worth or equity of the island is $5,500

This shows all of the assets and liabilities:

	Assets	Liabilities
Fred		
House	$1,000	
Debt to Friday		$ 500
Robinson		
House	3,000	
Debt to Friday		2,000
Friday		
House	1,500	
Loan to Fred	500	
Loan to Robinson	2,000	
Totals	$8,000	$2,500

The net worth of the economy equals total assets minus total liabilities, or $5,500.

12. Section: 1.2 The Financial System
Learning Objective: 1.3
Level of difficulty: Intermediate
CPA: Finance
Solution:
In the financial system, there are four major sectors: households, government, business, and non-residents. Within the field of finance, there are four major areas: personal finance, government finance, corporate finance, and international finance. They closely interrelate to each other. Because they are all major parts of the whole financial system, what happens in one market will affect all the other markets.

13. Section: 1.3 The Financial System
Learning Objective: 1.3
Level of difficulty: Intermediate
CPA: Finance
Solution:
Banks take in deposits and loan them out to fund borrowers. Pension funds take in pension contributions and pay out pensions to plan participants when they retire. Insurance firms take in premiums and pay out when a certain event occurs. Mutual funds pool small funds together and make large investments that small investors cannot make. Mutual funds also offer investment expertise to ordinary investors.

14. Section: 1.3 The Financial System
Learning Objective: 1.3
Level of difficulty: Intermediate
CPA: Finance

Solution:
Five main reasons why financial and market intermediaries exist are:
i) They provide anonymousness and convenience to all transaction parties.
ii) They efficiently match the needs of the participants in the financial market and aggregate all the small transactions.
iii) They have procedures for documentation of legal contracts to ensure security.
iv) The risk of non-payment is alleviated by maintaining credit ratings and by controlling other accounts.
v) Financial institutions transform the nature of the underlying financial securities.

15. Section: 1.4 Financial Instruments and Markets
Learning Objective: 1.4
Level of difficulty: Intermediate
CPA: Finance
CPA: Finance
Solution:
The two major types of secondary markets are *exchanges* or *auction markets,* and *dealer* or *over-the-counter (OTC) markets.* Exchanges have been referred to as auction markets because they involve a bidding process that takes place in a specific location (i.e., similar to an auction). OTC or dealer markets do not have a physical location, but rather consist of a network of dealers who trade directly with one another.

Challenging
16. Section: 1.4 Financial Instruments and Markets
Learning Objective: 1.4
Level of difficulty: Challenging
CPA: Finance
Solution:
Secondary market transactions are those where ownership of existing shares changes hands, but the corporations or governments who originally issued the securities receive no financing; trading takes place *between* investors. This is critical to the functioning of the primary markets, because governments and companies would not be able to raise financing if investors were unable to sell their investments if necessary.

Answers to Concept Review Questions

1.2 Real versus Financial Assets

Concept Review Questions

1. What is finance?

Finance in its broadest terms is the study of how and under what terms savings (monies) are allocated between lenders and borrowers.

2. Distinguish between real and financial assets.

Real assets represent the normal tangible things that we think of in terms of personal and business assets. Financial assets are simply what one individual has lent to another, so one person's positive financial asset is another's *negative* financial asset (or liability).

3. Which sector or sectors of the economy are net providers of financing and which are the net users of financing?

Households and non-residents are net providers of financing. Government and business are net users of financing.

1.3 The Financial System

Concept Review Questions

1. Identify and briefly describe the three main channels of savings.

In the first channel we have *direct* intermediation, where the lender provides money directly to the ultimate borrower. The second channel also represents direct intermediation between the lender and borrower, but in this case some help is needed since no one individual can come up with the full amount needed and/or because the borrower is not aware of the available lenders. The third savings channel is completely different since it represents financial intermediation, where the *financial institution* or *financial intermediary* lends the money to the ultimate borrower, but raises the money itself by borrowing directly from other individuals.

2. Distinguish between market and financial intermediaries.

A market intermediary is simply an entity that facilitates the working of markets and helps provide direct intermediation. The *financial institution* or *financial intermediary* lends the money to the ultimate borrower, but raises the money itself by borrowing directly from other individuals. In this case, the ultimate lender only has an *indirect* claim on the ultimate borrower; their *direct* claim is on the financial institution.

3. Discuss how the four most important types of financial intermediaries operate.

Chartered banks take in deposits and make loans, insurance companies take in premiums and pay off in the event of an incident happening such as a death or fire, while pension funds take in contributions and provide pension payments after plan members retire. Mutual funds pool smaller amounts from small investors and make large investments that cannot be made by small investors.

1.4 Financial Instruments and Markets

Concept Review Questions

1. Distinguish among the various types of financial assets.
The two major categories of financial securities are debt instruments and equity instruments.

2. Identify the major sources of financing used by (a) governments and (b) businesses.
Governments raise new financing via the debt markets. They issue T-bills as a source of short-term financing (i.e., less than one year), and they issue traditional bonds and Canada Savings Bonds (CSBs) for long-term financing. Businesses raise short-term financing in the form of debt through the use of loans, or by issuing commercial paper, BAs, etc. (all of which will be discussed in greater detail in later chapters). They raise long-term financing in the form of debt (i.e., through loans, by issuing bonds, or using other long-term debt instruments), or in the form of equity (i.e., by issuing common shares or preferred shares, etc.).

3. Distinguish between primary and secondary markets.
Primary markets involve the issue of new securities by the borrower in return for cash from investors (or lenders). Secondary markets provide trading (or market) environments that permit investors to buy and sell existing securities.

1.5 The Global Financial Community

Concept Review Questions

1. Explain why global financial markets are so important to Canadians.
On aggregate, if we add our foreign borrowings to the amount of direct foreign investment in Canada, it exceeded the sum of what foreigners borrowed from us and the amount that we invested directly abroad.

2. Identify and briefly describe the two major stock markets in the United States.
The New York Stock Exchange (NYSE) is the world's largest and most famous stock market. The second largest and most important stock market in the U.S. is the Nasdaq Stock Market, or Nasdaq.

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