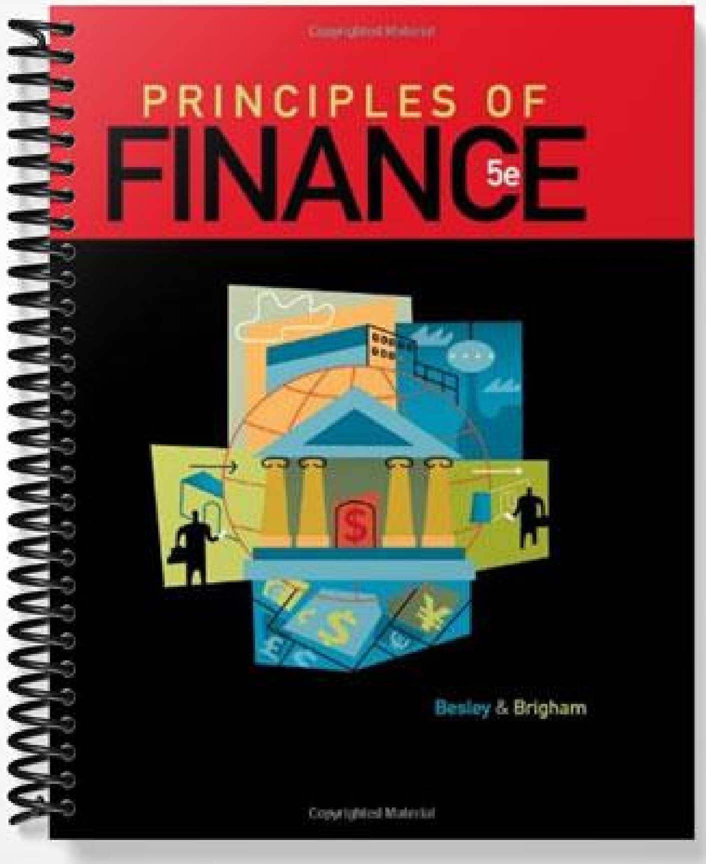
TEST BANK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CHAPTER 2—FINANCIAL ASSETS (INSTRUMENTS)

MULTIPLE CHOICE

1. Which of the following events would make it more likely that a company would choose to call its outstanding callable bonds?
   a. A reduction in market interest rates.
   b. The company's bonds are downgraded.
   c. An increase in the call premium.
   d. Answers a and b are both correct.
   e. Answers a, b, and c are all correct.

   ANS: B
   Statement b is false because a bond downgrade generally raises the cost of issuing new debt. Therefore, the callable bonds would not be called. Statement c is false since the call premium, the cost paid in excess of par, increases the cost of calling debt.

   PTS: 1 DIF: Easy TOP: Callable Bonds

2. Other things held constant, if a bond indenture contains a call provision, the yield to maturity that would exist without such a call provision will generally be ____ the YTM with it.
   a. Higher than
   b. Lower than
   c. The same as
   d. Either higher or lower, depending on the level of call premium, than
   e. Unrelated to

   ANS: B PTS: 1 DIF: Easy TOP: Call Provision

3. Of the following provisions that might be found in a bond indenture, which would tend to *reduce* the coupon interest rate on the bond in question?
   a. A subordination clause in a debenture.
   b. A call provision.
   c. A convertible feature.
   d. Having relatively few restrictive covenants.
   e. All of the above.

   ANS: C PTS: 1 DIF: Easy TOP: Bond Indenture

4. The terms and conditions to which a bond is subject are set forth in its
   a. Debenture.
   b. Underwriting agreement.
   c. Indenture.
   d. Restrictive covenants.
   e. Call provision.

   ANS: C PTS: 1 DIF: Easy TOP: Bond Indenture

5. All of the following may serve to *reduce* the coupon rate that would otherwise be required on a bond issued at par, <u>except</u> a
   a. Sinking fund.
   b. Restrictive covenant.
   c. Call provision.
   d. Change in rating from Aa to Aaa.

e. None of the above (all may reduce the required coupon rate).

ANS: C PTS: 1 DIF: Easy TOP: Bond Coupon Rate

6. Which of the following factors does *not* influence a firm's long-term financing decisions?
   a. Its target capital structure.
   b. Maturity matching considerations.
   c. Comparative costs of financing alternatives.
   d. Availability of collateral.
   e. All of the above factors may influence a firm's long-term financing decisions.

ANS: E PTS: 1 DIF: Easy TOP: Long-Term Financing

7. Common equity refers to the sum of which of the following balance sheet accounts?
   a. Common stock and retained earnings
   b. Book value, retained earnings, and common stock
   c. Common stock, additional paid-in capital, retained earnings
   d. Either answer a or c above could be correct depending on whether the firm has "par" or "no par" stock.
   e. Both b and c are correct since additional paid-in capital is equivalent to book value.

ANS: D PTS: 1 DIF: Easy TOP: Common Equity

8. The preemptive right is important to shareholders because it
   a. Allows management to sell additional shares below the current market price.
   b. Protects the current shareholders against dilution of ownership interests.
   c. Is included in every corporate charter.
   d. Will result in higher dividends per share.
   e. The preemptive right is not important to shareholders.

ANS: B PTS: 1 DIF: Easy TOP: Preemptive Rights

9. Companies can issue different classes of common stock. Which of the following statements concerning stock classes is correct?
   a. All common stocks fall into one of three classes: A, B, and C.
   b. Most firms have several classes of common stock outstanding.
   c. All common stock, regardless of class, must have voting rights.
   d. All common stock, regardless of class, must have the same dividend privileges.
   e. None of the above statements is necessarily true.

ANS: E PTS: 1 DIF: Easy TOP: Classes of Stock

10. Which of the following statements is correct?
    a. One danger a family-owned business faces when it goes public is the loss of absolute voting control of the company, because there is no way to keep new stockholders from voting.
    b. The market is less active for small companies' shares, so these stocks must be included on the SEC's list in order to inform investors of their existence. Therefore, "listed shares" as the term is generally used refers to shares of smaller as opposed to larger companies.
    c. Before a company can offer a new issue of common stock to the public, it must get approval from the SEC for the price at which the stock can be sold. If the SEC thinks the proposed price is too high, then the company's prospectus is rejected and the stock cannot be sold.
    d. The preemptive right refers to stockholders' right to elect a company's board of directors.
    e. Each of the above statements is false.

ANS: E
Different classes of stock can be issued which can keep new stockholders from voting for a certain number of years. Listed shares are those that are on an exchange. Exchanges have minimum net income and share requirements; thus these companies would be large rather than small. The SEC does not approve the price at which new securities are offered. The preemptive right gives old stockholders the right to purchase additional shares of common stock on a pro rata basis.

PTS: 1 DIF: Easy TOP: Miscellaneous

11. Which of the following statements is correct?
    a. All common stock must have full voting rights.
    b. While firms are allowed to issue different classes of common stock, the Securities and Exchange Commission (SEC) requires that each class have the same dividend privileges.
    c. The New York Stock Exchange (NYSE) allows firms with dual class stock to be listed on the exchange.
    d. In order to increase a stock's liquidity, investment bankers generally require that insiders sell some percentage of their shares after a firm has undergone an initial public offering (IPO).
    e. When a firm raises capital, investment bankers enter into a "best efforts" arrangement which guarantees that the securities will be sold.

ANS: C
Statement c is correct. For example, General Motors has several NYSE listed common classes. Statement a is false because not all common stock has full voting rights. Statement b is false since classes of common can have differing dividend policies. Statement d is false because insider sales tend to depress share prices because they are a sign that the shares are overpriced. Statement e is false because a "best efforts" arrangement does not guarantee that the securities will be sold.

PTS: 1 DIF: Easy TOP: Miscellaneous

12. An option which gives the holder the right to sell a stock at a specified price at some time in the future is called a(n)
    a. Call option.
    b. Put option.
    c. Out-of-the-money option.
    d. Naked option.
    e. Covered option.

ANS: B PTS: 1 DIF: Easy TOP: Options

13. Pure options are instruments that are
    a. Created by investors outside the firm.
    b. Bought and sold primarily by investors and speculators.
    c. Of greater importance to investors than to financial managers.
    d. All of the above.
    e. None of the above.

ANS: D PTS: 1 DIF: Easy TOP: Pure Options

14. Your Aunt Agatha purchased a call option a few months ago. Today is the expiration date, so she must decide whether to exercise the option. Which of the following statements is correct? Do not consider brokers' commissions in your answer.
    a. Aunt Agatha doesn't need to make a decision about exercising the option today; in fact, it would be better if she waited until after the option expires.
    b. Aunt Agatha should exercise the option if the price of the stock is less than the exercise, or

strike, price.
c. Aunt Agatha should exercise the option if the price of the stock is greater than the exercise, or strike, price.
d. Aunt Agatha should exercise the option, regardless of the current stock price.
e. None of the above.

ANS: C PTS: 1 DIF: Easy TOP: Options

15. Which of the following are generally considered advantages of term loans over publicly issued bonds?
a. Lower flotation costs.
b. Speed, or how long it takes to bring the issue to market.
c. Flexibility, or the ability to adjust the bond's terms after it has been issued.
d. All of the above.
e. Only answers b and c above.

ANS: D PTS: 1 DIF: Easy TOP: Term Loans

16. Eurodebt is the term used to designate
a. Debt sold by a foreign borrower that is denominated in the currency of the country where it is sold.
b. European bank loans that are denominated in the new Euro currency.
c. Debt that is denominated in a currency that is different than the currency of the country in which it is sold.
d. Equity instruments of one country that are sold in another country.
e. The certificates that represent ownership in foreign companies that are sold in the United States.

ANS: C PTS: 1 DIF: Moderate
TOP: International Debt Instruments

17. An American Depository Receipt (ADR) represents
a. Debt sold by a foreign borrower that is denominated in the currency of the country where it is sold.
b. Stock of foreign companies that is sold directly to investors in the United States.
c. Equity instruments of one country that are sold in another country.
d. The certificates that represent ownership in foreign companies that are sold in the United States.
e. Certificates representing ownership in stocks of foreign companies that are held in trust by a bank located in the country the stock is traded.

ANS: E PTS: 1 DIF: Moderate
TOP: International Debt Instruments

18. Which of the following types of debt protect a bondholder against an increase in interest rates?
a. Floating rate debt.
b. Bonds that are redeemable ("putable") at par at the bondholders' option.
c. Bonds with call provisions.
d. All of the above.
e. Only answers a and b above.

ANS: E PTS: 1 DIF: Moderate TOP: Types of Debt

19. Assume the securities are all issued by the same firm. From the *investor's* standpoint, rank the following securities in order of increasing risk (the number of the least risky security is placed first, or to the left, in the answer set).

(1) Preferred stock.
(2) Income bonds.
(3) Convertible preferred stock.
(4) Mortgage bonds.

a. 1, 2, 3, 4
b. 4, 1, 2, 3
c. 4, 1, 3, 2
d. 4, 2, 1, 3
e. 4, 2, 3, 1

ANS: D PTS: 1 DIF: Moderate TOP: Types of Securities

20. Companies A and B recently established a new jointly owned subsidiary, ABBA Corporation. ABBA now requires $100 million of capital. A and B will supply $40 million of common equity, $20 million each. The remaining $60 million will be raised by using some combination of debt and preferred stock. Which of the following statements is *most correct*?
    a. The interest rate on the debt would be *higher* if ABBA uses $60 million of debt and $0 preferred than it would be if ABBA uses $30 million of debt and $30 million of preferred.
    b. Because 70 percent of preferred stock dividends received are excluded from a corporation's taxable income, (1) most preferred stock is owned by corporations, and (2) frequently a company's bond interest rate is *higher* than its preferred stock dividend yield.
    c. If ABBA's preferred stock were made convertible into its common, the preferred would have a *lower* dividend yield than if the preferred were nonconvertible.
    d. All of the above statements are true.
    e. Only answers a and b above are true.

ANS: D PTS: 1 DIF: Moderate TOP: Types of Financing

21. A company is planning to raise $1,000,000 to finance a new plant. Which of the following statements is correct?
    a. If debt is used to raise the million dollars, the cost of the debt would be lower if the debt is in the form of a fixed rate bond rather than a floating rate bond.
    b. If debt is used to raise the million dollars, the cost of the debt would be lower if the debt is in the form of a bond rather than a term loan.
    c. If debt is used to raise the million dollars, but $500,000 is raised as a first mortgage bond on the new plant and $500,000 as debentures, the interest rate on the first mortgage bond would be lower than it would be if the entire $1 million were raised by selling first mortgage bonds.
    d. The company would be especially anxious to have a call provision included in the indenture if its management thinks that interest rates are almost certain to rise in the foreseeable future.
    e. All of the above statements are false.

ANS: C PTS: 1 DIF: Moderate TOP: Types of Financing

22. Which of the following statements is correct?
    a. Because bonds can generally be called only at a premium, meaning that the bondholder will enjoy a capital gain, including a call provision (other than a sinking fund call) in the indenture increases the value of the bond and lowers the bond's required rate of return.
    b. You are considering two bonds. Both are rated double A (AA), both mature in 20 years, both have a 10 percent coupon, and both are offered to you at their $1,000 par value. However, Bond X has a *sinking fund* while Bond Y does not. This probably is not an equilibrium situation, as Bond X, which has the sinking fund, generally would be expected

to have a *higher* yield than Bond Y.

c. A sinking fund provides for the orderly retirement of a debt (or preferred stock) issue. Sinking funds generally force the firm to call a percentage of the issue each year. However, the call price for sinking fund purposes is generally higher than the call price for refunding purposes.
d. Zero coupon bonds are bought primarily by pension funds and other tax exempt investors because they avoid the tax that non-tax exempt investors must pay on the accrued value each year.
e. All of the above statements are false.

ANS: D PTS: 1 DIF: Moderate TOP: Miscellaneous

23. Which of the following statements is correct?
 a. Once a firm declares bankruptcy, it is liquidated by the trustee, who uses the proceeds to pay bondholders, unpaid wages, taxes, and lawyer fees.
 b. A firm with a sinking fund payment coming due would generally choose to buy back bonds in the open market, if the price of the bond exceeds the sinking fund call price.
 c. Income bonds pay interest only when the amount of the interest is actually earned by the company. Thus, these securities cannot bankrupt a company and this makes them riskier to investors than regular bonds.
 d. One disadvantage of zero-coupon bonds is that issuing firms cannot realize the tax savings from issuing debt until the bonds mature.
 e. Other things held constant, callable bonds should have a lower yield to maturity than noncallable bonds.

ANS: C

Statement a is false because bankrupt firms often are reorganized rather than liquidated. Statement b is false because the firm would prefer the less expensive option of calling the bonds—which in this case is the sinking fund call price. Statement d is false because interest expense accrues for tax purposes, so firms can realize the tax savings from issuing debt. Statement e is false because callable bonds will sell for a higher yield than noncallable bonds, if all other things are held constant.

PTS: 1 DIF: Moderate TOP: Miscellaneous

24. The sale of new common stock at a price greater than par value will affect which balance sheet accounts? (Choose the most complete answer.)
 a. Common stock, paid-in capital, retained earnings.
 b. Assets, common stock, paid-in capital.
 c. Liabilities, common equity.
 d. Common stock, retained earnings.
 e. Common stock, paid-in capital.

ANS: B PTS: 1 DIF: Moderate TOP: Common Stock

25. Which of the following statements is *false*?
 a. When a corporation's shares are owned by a few individuals who are associated with or are the firm's management, we say that the firm is "closely held."
 b. A publicly owned corporation is simply a company whose shares are held by the investing public, which may include other corporations and institutions as well as individuals.
 c. Going public establishes a true market value for the firm and ensures that a liquid market will always exist for the firm's shares.
 d. When stock in a closely held corporation is offered to the public for the first time the transaction is called "going public" and the market for such stock is called the new issue market.

ANS: C PTS: 1 DIF: Moderate TOP: Miscellaneous

26. Which of the following statements concerning common stock and the investment banking process is *false*?
    a. The preemptive right gives each existing common stockholder the right to purchase his or her proportionate share of a new stock issue.
    b. If a firm sells 1,000,000 new shares of Class B stock, the transaction occurs in the *primary* market.
    c. Listing a large firm's stock is often considered to be beneficial to stockholders because the increases in liquidity and status probably outweigh the additional costs to the firm.
    d. Stockholders have the right to elect the firm's directors, who in turn select the officers who manage the business. If stockholders are dissatisfied with management's performance, an outside group may ask the stockholders to vote for it in an effort to take control of the business. This action is called a *margin call*.
    e. A large issue of new stock could cause the stock price to fall. This loss is called "market pressure," and it is treated as a flotation cost because it is a cost associated with the new issue.

ANS: D PTS: 1 DIF: Moderate TOP: Miscellaneous

27. Which of the following statements concerning preferred stock is correct?
    a. Preferred stock generally has a higher component cost to the firm than does common stock.
    b. By law in most states, all preferred stock issues must be cumulative, meaning that the cumulative, compounded total of all unpaid preferred dividends must be paid before dividends can be paid on the firm's common stock.
    c. From the issuer's point of view, preferred stock is less risky than bonds.
    d. Preferred stock, because of the current tax treatment of dividends, is bought mostly by individuals in high tax brackets.
    e. Unlike bonds, preferred stock cannot have a convertible feature.

ANS: C PTS: 1 DIF: Moderate TOP: Preferred Stock

28. Which of the following statements is correct?
    a. One of the advantages of common stock financing is that there is no dilution of owners' equity, as there is with debt.
    b. If the market price of a stock falls below its book value, the firm can be liquidated, with the book value proceeds then distributed to the shareholders. Thus, a stock's book value per share sets a floor below which the stock's market price is unlikely to fall.
    c. The preemptive right gives a firm's preferred stockholders preference to assets over common stockholders in the event the firm is liquidated.
    d. The steeper the demand curve for a firm's stock, the higher will be its flotation costs when it sells a new issue of common stock, other things held constant.
    e. All of the above statements are false.

ANS: D PTS: 1 DIF: Moderate TOP: Miscellaneous

29. Which of the following statements is correct?
    a. If the demand curve for a firm's stock is relatively flat, the firm will have a more difficult time raising a large amount of new equity funds for expansion than would be true if the demand curve were steeper.
    b. Flotation costs to raise a given amount of funds would, typically, be smaller under a best-efforts arrangement than with an underwritten offering, and the corporation is also more certain of getting the needed funds under a best-efforts offering. This is why best-efforts deals are most common.

c. Par value is not necessarily the actual price at which stock is issued by the firm, but it does constitute the maximum legal liability per share in the event of bankruptcy. Thus, if a firm sold $5 par stock to investors at $30 per share, in the event of bankruptcy the firm would have to pay the stockholders no more than $5 per share.
d. The preemptive right gives current stockholders the right to purchase, on a pro rata basis, any additional shares sold by the firm. This right protects current stockholders against both dilution of control and dilution of value.
e. One of the legal rights that often goes with common stock is the preemptive right. This is the right of present stockholders to purchase their "proportional share" of all new securities that might be issued by the firm, including common and preferred stock, and all types of debt.

ANS: D PTS: 1 DIF: Moderate TOP: Miscellaneous

30. Which of the following statements is correct?
a. A floating rate bond has an advantage over a fixed rate bond because its price is more stable and this makes a floating rate preferred bond more suitable as a liquid asset.
b. Convertible preferred stock would likely appeal more to income-oriented investors because they can convert their capital gains into bond income simply by converting their preferred stock into bonds.
c. One advantage of preferred stock from an issuer's perspective is that it has a lower after-tax cost than that of debt.
d. One principal advantage of preferred stock is that preferred stockholders have a legal enforceable right to their stock dividend, thus, preferred stock is generally less risky than unsecured debt.
e. Because of the 70% dividend exclusion rule for preferred stock dividends, the higher a company's tax bracket, the more likely it is to issue preferred stock.

ANS: A PTS: 1 DIF: Moderate TOP: Miscellaneous

31. Which of the following statements is correct?
a. A warrant is basically a long-term option that enables the holder to sell common stock back to the firm at an agreed upon price, at a specified time in the future.
b. Generally, warrants are distributed along with preferred stock in order to make the preferred stock less risky.
c. If a company issuing coupon paying debt wanted to reduce the cash outflows associated with the coupon payments, it could issue warrants with the debt to accomplish this.
d. One of the disadvantages of warrants to the issuing firm is that they can be detachable and can be traded separately from the debt with which they are issued.
e. Warrants are attractive to investors because when they are issued with stock, investors receive dividends on the warrants they own as well as on the underlying stock.

ANS: C PTS: 1 DIF: Moderate TOP: Warrants (from footnote)

32. A firm plans to sell $100 million of 20-year bonds to raise capital for expansion. Which of the following provisions, if it were included in the bond's indenture, would tend to *raise* the coupon interest rate over what it would be if the provision were not included?
a. A call provision under which the firm may call the bonds for redemption after 5 years.
b. Provision for a sinking fund, where a set percentage of the bonds must be called for redemption at par each year.
c. A restrictive covenant which states that the firm's current ratio must always exceed 2.0.
d. A pledge of real property as security for the bonds.
e. A provision under which the bondholders may, at their option, turn the bond in to the company and receive the bond's face value; that is, the bond is redeemable at par at the holder's option.

ANS: A PTS: 1 DIF: Hard TOP: Bond Indenture

33. Listed below are some provisions that are often contained in bond indentures:

1. Fixed assets may be used as security.
2. The bond may be subordinated to other classes of debt.
3. The bond may be made convertible.
4. The bond may have a sinking fund.
5. The bond may have a call provision.
6. The bond may have restrictive covenants in its indenture.

Which of the above provisions, each viewed alone, would tend to *reduce* the yield to maturity investors would otherwise require on a newly issued bond?

a. 1, 2, 3, 4, 5, 6
b. 1, 2, 3, 4, 6
c. 1, 3, 4, 5, 6
d. 1, 3, 4, 6
e. 1, 4, 6

ANS: D PTS: 1 DIF: Hard TOP: Bond Indenture

34. Which of the following statements is *false*?

a. Any bond sold outside the country of the borrower is called an international bond.
b. Foreign bonds and Eurobonds are two important types of international bonds.
c. Foreign bonds are bonds sold by a foreign borrower but denominated in the currency of the country in which the issue is sold.
d. The term Eurobond specifically applies to any foreign bonds denominated in U.S. currency.
e. None of the above.

ANS: D PTS: 1 DIF: Moderate TOP: International Bond Markets

35. Rollincoast Incorporated issued BBB bonds two years ago that provided a yield to maturity of 11.5 percent. Long-term risk-free government bonds were yielding 8.7 percent at that time. The current risk premium on BBB bonds versus government bonds is half what it was two years ago. If the risk-free long-term governments are currently yielding 7.8 percent, then at what rate should Rollincoast expect to issue new bonds?

a. 7.8%
b. 8.7%
c. 9.2%
d. 10.2%
e. 12.9%

ANS: C

Calculate the previous risk premium, RP_{BBB}, *and new* RP_{BBB}:
$RP_{BBB} = 11.5\% - 8.7\% = 2.8\%$.
New $RP_{BBB} = 2.8\%/2 = 1.4\%$.

Calculate new YTM on BBB bonds:
$YTM_{BBB} = 7.8\% + 1.4\% = 9.2\%$.

PTS: 1 DIF: Easy TOP: Risk Premium on Bonds

36. NOPREM Inc. is a firm whose shareholders don't possess the preemptive right. The firm currently has 1,000 shares of stock outstanding, the price is $100 per share. The firm plans to issue an additional 1,000 shares at $90.00 per share. Since the shares will be offered to the public at large, what is the amount per share that old shareholders will lose if they are excluded from purchasing new shares?
a. $90.00
b. $5.00
c. $10.00
d. $0
e. $2.50

ANS: B
Calculate current and new market value of firm after new stock issue

1,000 shares × $100 per share =		$100,000
Plus 1,000 new shares @ $90 each	+	90,000
New firm market value		$190,000

Calculate new market share price
$190,000/2,000 shares = $95.00 per share

Dilution Old shareholders lose $100 – $95 = $5.00 per share.

PTS: 1 DIF: Easy TOP: New Issues and Dilution

37. B & O Railroad's convertible debentures were issued at their $1,000 par value in 2008. At any time prior to maturity on February 1, 2028, a debenture holder can exchange a bond for 25 shares of common stock. What is the conversion price, P_c?
a. $25
b. $1,000
c. $40
d. $1,025
e. $50

ANS: C
P_c = Par value/Shares received = $1,000/25 = $40.

PTS: 1 DIF: Easy TOP: Conversion Price

38. An investor purchased a call option that allows her to purchase 100 shares of Dell Computer common stock for $45 per share any time during the next six months. The current market price of Dell's stock is $42.50. If the price of Dell increases to $50 and the investor decides to exercise it, what will be the gain or loss that results from the exercise? Ignore taxes and commissions.
a. $500 gain
b. $250 loss
c. $750 gain
d. $250 gain
e. None of the above.

ANS: A
Gain = 100($50 – $45) = $500

PTS: 1 DIF: Easy TOP: Options

39. An investor purchased a call option that allows her to purchase 100 shares of Dell Computer common stock for $45 per share any time during the next six months. The price she paid for the option was $2.50 per share, or $250 total, and the current market price of Dell's stock is $42.50. If the price of Dell increases to $50 and the investor decides to exercise it, what will be the gain or loss that results from the option position that was held? Ignore taxes and commissions.
a. $500 gain
b. $250 loss
c. $750 gain
d. $250 gain
e. None of the above.

ANS: D
Gain = 100($50 – $45) –$250 = $250

PTS: 1 DIF: Easy TOP: Options

40. An investor purchased a call option that allows her to purchase 100 shares of Dell Computer common stock for $45 per share any time during the next six months. The price she paid for the option was $2.50 per share, or $250 total, and the current market price of Dell's stock is $42.50. If the price of Dell increases to $44.50 and the investor decides to exercise it, what will be the gain or loss that results from the option position that was held? Ignore taxes and commissions.
a. $200 gain
b. $300 loss
c. $50 loss
d. $450 loss
e. None of the above.

ANS: B
Loss = 100($44.50 – $45.00) –$250 = –$300

PTS: 1 DIF: Easy TOP: Options

41. Sharon has a convertible bond with a face value of $1,000 that can be converted into 40 shares of common stock of Mountain Ice Corporation. If the current price of the stock is $20, what is the conversion price of the bond?
a. $20
b. $50
c. $800
d. $500
e. None of the above.

ANS: E
Conversion price = $1,000/40 = $25

PTS: 1 DIF: Easy TOP: Convertible Bond

42. A(n) ____ is generally obtained from a bank or insurance company and the borrower agrees to make a series of payments consisting of interest and principal.
a. putable bond
b. bankers acceptance
c. income bond
d. term loan
e. certificate of deposit

ANS: D PTS: 1 DIF: Easy TOP: Term Loans

43. A(n) ____ is a bond that pays no annual interest but is sold at a discount below par, thus providing compensation to investors in the form of capital appreciation.
a. coupon bond
b. income bond
c. convertible bond
d. zero coupon bond
e. callable bond

ANS: D PTS: 1 DIF: Easy TOP: Zero Coupon Bond

44. A protective feature on preferred stock that requires preferred dividends previously not paid to be disbursed before any common stock dividends can be paid is called what?
a. cumulative dividends
b. callable dividends
c. putable dividends
d. historical dividends
e. paid dividends

ANS: A PTS: 1 DIF: Easy TOP: Cumulative Dividends

45. Preferred stockholders generally are given the right to vote for directors if
a. the preferred stock is participating preferred stock.
b. the directors are elected under the cumulative method.
c. the common stockholders do not vote in new directors with a clear majority.
d. the company cannot pay its interest payments.
e. the company has not paid the preferred dividend for a specified period.

ANS: E PTS: 1 DIF: Moderate TOP: Preferred Stock

46. A ____ is a financial instrument which gives the owner the right but not the obligation to sell shares of stock at a specified price during a particular time period.
a. convertible security
b. call option
c. warrant
d. put option
e. callable security

ANS: D PTS: 1 DIF: Easy TOP: Put Options

47. A French firm is buying $1,000,000 of optical cable from a firm in the United States. The French firm will pay for the cable in thirty days. To protect itself from changes in the exchange rate between the Euro and dollar, the French firm enters into a futures contract to purchase $1,000,000 at a price of $1.25/€. How many Euros will it cost the French firm to purchase $1,000,000 using the futures contract?
a. €125,000,000
b. €2,500,000
c. €1,250,000
d. €1,000,000
e. €800,000

ANS: E
Cost of $1,000,000 = $1,000,000/1.25$/€ = €800,000

PTS: 1 DIF: Moderate TOP: Futures

48. Which of the following is **NOT** an example of a financial asset?
   a. convertible bond
   b. certificate of deposit
   c. preferred stock
   d. inventory
   e. mutual fund

   ANS: D   PTS: 1   DIF: Easy   TOP: Financial Asset

49. Corporations issue and purchase a variety of financial securities for all of the following reasons ***EXCEPT***
   a. raise capital
   b. hedge against risk
   c. alter the capital structure of the firm
   d. all of the above are reasons to issue or purchase financial securities

   ANS: D   PTS: 1   DIF: Moderate   TOP: Financial Securities

50. Which of the following is **NOT** a source of equity on a firm's balance sheet?
   a. additional paid-in capital
   b. retained earnings
   c. common stock
   d. property, plant, and equipment

   ANS: D   PTS: 1   DIF: Moderate   TOP: Common Equity

51. Which of the following is **NOT** a type of debt?
   a. commercial paper
   b. certificate of deposit
   c. term loan
   d. preferred stock

   ANS: D   PTS: 1   DIF: Easy   TOP: Debt

52. A ____ is an agreement to between two firms where one firm agrees to sell some of its financial assets to another and then buy the financial assets back from that firm at a later time
   a. buy back
   b. call option
   c. repurchase agreement
   d. put option

   ANS: C   PTS: 1   DIF: Easy   TOP: Repurchase Agreement

53. Which of the following is **not** an advantage of a term loan over public debt offerings?
   a. speed
   b. low issuance costs
   c. significantly lower interest rates
   d. flexibility

   ANS: C   PTS: 1   DIF: Easy   TOP: Term Loans

54. The income that an investor earns from municipal bonds is
   a. exempt from federal, state, and local taxes.
   b. generally exempt from federal taxes, but most states impose local taxes.
   c. generally exempt from state and local taxes, but taxed federally.

d. fully taxed by federal, state, and local authorities.

ANS: B PTS: 1 DIF: Easy TOP: Municipal Bonds

55. Stock repurchases might be undertaken when
   a. the firm has excess cash but no "good" investment opportunities
   b. the price of the firm's stock is undervalued
   c. the firm wants to increase the proportion of its assets that are financed with debt
   d. management wants to gain more ownership control of the firm-by repurchasing the stock of other investors
   e. All of the above are reasons stock repurchases might be undertaken

ANS: E PTS: 1 DIF: Easy TOP: Stock Repurchases

56. Bond ratings of ____ and higher are considered investment grade.
   a. AAA
   b. AA
   c. A
   d. BBB

ANS: D PTS: 1 DIF: Easy TOP: Bond Ratings

TRUE/FALSE

1. Under a term loan the borrower agrees to make a series of amortized payments on specific dates. Although speed and flexibility are two advantages of term loans, such loans typically have high issuance costs.

ANS: F PTS: 1 DIF: Easy TOP: Term Loans

2. Typically, debentures have higher interest rates than mortgage bonds primarily because the mortgage bonds are backed by assets while debentures are unsecured.

ANS: F PTS: 1 DIF: Easy TOP: Mortgage Bonds

3. A call provision gives bondholders the right to demand, or "call for," repayment of a bond. Typically, calls are exercised if interest rates rise, because when rates rise the bondholder can get the principal amount back and reinvest it elsewhere at higher rates.

ANS: F PTS: 1 DIF: Easy TOP: Call Provision

4. Many bond indentures allow the company to acquire bonds for a sinking fund either by purchasing bonds in the market or by a lottery administered by the trustee for the purchase of a percentage of the issue through a call at face value.

ANS: T PTS: 1 DIF: Easy TOP: Sinking Fund

5. Issuing zero coupon bonds might appeal to a company that is considering investing in a long-term project that will not generate positive cash flows for several years.

ANS: F PTS: 1 DIF: Easy TOP: Zero Coupon Bond

6. Several types of futures contracts are available to hedge against price changes in such items as gold, agricultural products, and so forth.

ANS: T PTS: 1 DIF: Easy TOP: Futures

7. A junk bond is a high risk, high yield debt instrument typically used to finance a leveraged buyout or a merger, or to provide financing to a company of questionable financial strength.

ANS: T PTS: 1 DIF: Easy TOP: Junk Bonds

8. Because junk bonds are such high-risk instruments, the returns on such bonds aren't very high and the existence of this market detracts from social welfare.

ANS: F PTS: 1 DIF: Easy TOP: Junk Bonds

9. There is an inverse relationship between bond ratings and the required return on a bond. The required return is lowest for AAA rated bonds, and required returns increase as the ratings get lower (worse).

ANS: T PTS: 1 DIF: Easy TOP: Bond Ratings

10. In the event of bankruptcy, debtholders have a prior or first claim to a firm's income and assets over the claims of both common and preferred stockholders. However, in bankruptcy all debtholders are treated equally as a single class of claimants.

ANS: F PTS: 1 DIF: Easy TOP: Bankruptcy

11. Par value is not necessarily the actual price at which common stock is issued by the firm, but it does constitute the maximum legal liability per share in the event of bankruptcy.

ANS: F PTS: 1 DIF: Easy TOP: Par Value

12. The additional paid-in capital account represents the difference between a stock's par value and the funds actually received from the sale of new common stock.

ANS: T PTS: 1 DIF: Easy TOP: Additional Paid-In Capital

13. A proxy is a document giving one party the authority to act for another party, typically the power to vote shares of common stock. A proxy can be an important tool relating to control of the firm.

ANS: T PTS: 1 DIF: Easy TOP: Proxy

14. Classified stock is one can be used to meet special needs of a firm, such as when owners of a start-up firm need capital but don't want to relinquish control of the firm.

ANS: T PTS: 1 DIF: Easy TOP: Classified Stock

15. Founders' shares is a type of classified stock where the shares are owned by the firm's founders and they retain the sole voting rights to those shares but have restricted dividends for a specified time period.

ANS: F PTS: 1 DIF: Easy TOP: Founders Shares

16. If a firm's stockholders are given the *preemptive right*, this means that a group of stockholders can call for a meeting to replace the management. Without the preemptive right, dissident stockholders would have to seek to oust management through a *proxy fight*.

ANS: F PTS: 1 DIF: Easy TOP: Preemptive Rights

17. Companies can have different types of *preferred stock*, such as Class A or Class B, with each type having different rights and privileges, but by law there can be only one class of *common stock*.

ANS: F PTS: 1 DIF: Easy TOP: Classes of Stock

18. When a corporation's shares are owned by a few individuals who are associated with the firm's management, we say that the firm is "closely held."

ANS: T PTS: 1 DIF: Easy TOP: Closely Held Corporation

19. A publicly owned corporation is simply a company whose shares are held by the investing public, which may include other corporations and institutions.

ANS: T PTS: 1 DIF: Easy TOP: Public Corporation

20. The "preferred" feature of preferred stock means that it normally will generate a higher total return for the stockholder than common stock.

ANS: F PTS: 1 DIF: Easy TOP: Preferred Stock

21. An option is a contract which gives its holder the right to buy (sell) an asset at a predetermined price within a specified period of time.

ANS: T PTS: 1 DIF: Easy TOP: Options

22. The exercise price is the price that must be paid for a share of common stock when it is bought by exercising a warrant.

ANS: T PTS: 1 DIF: Easy TOP: Exercise Price

23. The striking price is different from the exercise price and deals with convertibles rather than with warrants.

ANS: F PTS: 1 DIF: Easy TOP: Striking Price

24. The owner of a convertible bond owns, in effect, both a bond and a call option.

ANS: T PTS: 1 DIF: Easy TOP: Convertibles

25. A convertible debenture cannot be worth more than its conversion value or less than its bond value.

ANS: F PTS: 1 DIF: Easy TOP: Convertibles

26. Convertible securities are bonds or preferred stocks that, under specified terms and conditions, can be exchanged for common stock at the option of the holder.

ANS: T PTS: 1 DIF: Easy TOP: Convertibles

27. Firms generally do not call their convertibles unless their conversion value is greater than their call price.

ANS: F PTS: 1 DIF: Easy TOP: Convertibles

28. LIBOR is an acronym for London Interbank Offer Rate, which is an average of interest rates offered by London banks to U.S. corporations.

ANS: F PTS: 1 DIF: Easy TOP: LIBOR

29. A Eurodollar is a U.S. dollar deposited in a bank outside the United States.

ANS: T PTS: 1 DIF: Easy TOP: Eurodollars

30. The Eurodollar market is essentially a long-term market; most loans and deposits have maturities of longer than one year.

ANS: F PTS: 1 DIF: Easy TOP: Eurodollar Market

31. The interest rate paid on Eurodollar deposits depends on the particular bank's lending rate and on rates of return available on U.S. money market instruments.

ANS: F PTS: 1 DIF: Moderate TOP: Eurodollar Interest Rates

32. Although common stock represents a riskier investment to an individual than do bonds, in the sense of exposing the firm to the risk of bankruptcy, bonds represent a riskier method of financing to a corporation than does common stock.

ANS: F PTS: 1 DIF: Moderate TOP: Types of Financing

33. An indexed bond has its value tied to an inflation index. As inflation increases the value of the bond increases and the issuer is responsible for the accumulated value which may become much greater than the original face value.

ANS: F PTS: 1 DIF: Moderate TOP: Indexed Bond

34. Income bonds pay interest only when the amount of the interest is actually earned by the company. Thus, these securities cannot bankrupt a company and this makes them safer than regular bonds.

ANS: F PTS: 1 DIF: Moderate TOP: Income Bonds

35. A putable bond can be redeemed at par value at the holder's option. Usually, the put option can be exercised only if the issuer takes some specific action, such as significantly increasing debt.

ANS: F PTS: 1 DIF: Moderate TOP: Putable Bonds

36. Restrictive covenants are designed so as to protect both the bondholder and the issuer even though they may constrain the actions of the firm's managers. Such covenants are contained in the bond's indenture.

ANS: T PTS: 1 DIF: Moderate TOP: Restrictive Covenants

37. A zero coupon bond's value increases over time at a compounded (or exponential) rate, not at a constant (or linear) rate. The corporate issuer reports the annual increase as interest expense, and the owner of the bond reports the increase as interest income and pays taxes on it each year.

ANS: T PTS: 1 DIF: Moderate TOP: Zero Coupon Bond

38. One of the disadvantages to a firm in issuing zero coupon bonds is that the tax shield associated with the bonds' appreciation cannot be claimed until the bond matures.

ANS: F PTS: 1 DIF: Moderate TOP: Zero Coupon Bond

39. "Treasury zeros" are Treasury bonds that have been split or "stripped" into a zero coupon discount Treasury certificate and a series of interest payments (the coupon payments). These bonds are safer than corporate zeros and thus, are very popular with institutional investors such as pension fund managers.

ANS: T PTS: 1 DIF: Moderate TOP: Treasury Zeros

40. From a social welfare perspective, common stock is a desirable form of financing in part because it involves no fixed charge payments. Its inclusion in a firm's capital structure makes the firm less vulnerable to the consequences of unanticipated declines in sales and earnings than if only debt were available.

ANS: T PTS: 1 DIF: Moderate
TOP: Common Stock and Social Welfare

41. A proxy fight involves a battle by a shareholder or group of shareholders who seek to change the investment policy of the firm. If the proxy group is successful, current management retains control of the firm but the proxy group dictates what investments the firm makes.

ANS: F PTS: 1 DIF: Moderate TOP: Proxy Fight

42. Preferred stockholders have priority over common stockholders with respect to earnings. Dividends must be paid on preferred stock before they can be paid on common stock. In exchange for this priority to dividends, preferred stockholders give up their priority claims to common stockholders in the event of bankruptcy.

ANS: F PTS: 1 DIF: Moderate TOP: Preferred Stock

43. As with common stock, preferred stock always has a par value, and also, like common stock, the par value is unimportant in the event of liquidation. However, the preferred stock dividend does depend on the par value and the dividend is usually stated as a percentage of par.

ANS: F PTS: 1 DIF: Moderate TOP: Preferred Stock

44. Preferred stock can provide a financing alternative for some firms when market conditions are such that those firms can issue neither pure debt nor common stock at reasonable cost.

ANS: T PTS: 1 DIF: Moderate TOP: Preferred Stock

45. A real asset is intangible, because it represents a promise that future cash flows will be paid to the owner.

ANS: T PTS: 1 DIF: Easy TOP: Financial Asset

46. A financial asset is tangible; it is a physically observable and touchable item.

ANS: F PTS: 1 DIF: Easy TOP: Financial Asset

47. Corporations often issue financial instruments such as debt and equity to raise the funds needed to purchase real assets.

ANS: T PTS: 1 DIF: Easy TOP: Financial Instruments

48. Current liabilities are liabilities that must be paid during the next twelve months.

ANS: T PTS: 1 DIF: Easy TOP: Current Liabilities

49. Retained earnings are the difference between the value of newly issued stock and its par value.

ANS: F PTS: 1 DIF: Easy TOP: Additional Paid-In Capital

50. Retained earnings are a balance sheet account that indicates the total amount of earnings the firm has not paid out as dividends throughout its history.

ANS: T PTS: 1 DIF: Easy TOP: Retained Earnings

51. The balance sheet item common equity represents the sum of the firm's common stock, paid-in capital, and retained earnings, which equal the common stockholders' total investment in the firm stated at book value.

ANS: T PTS: 1 DIF: Easy TOP: Common Stock

52. A firm that issues "no-par" stock will not have a separate common stock and additional paid-in capital account on their balance sheet, it will be consolidated into a single account called common stock.

ANS: F PTS: 1 DIF: Moderate TOP: Common Stock

53. Discounted securities are debt instruments that pay periodic interest payments and sell at par value when issued. The interest payments generate a positive return for the purchaser of discounted securities.

ANS: F PTS: 1 DIF: Easy TOP: Discounted Securities

54. The par value of a share of common stock represents the minimum price at which new shares can be sold. All new issues of common stock must have a par value equal to the current market price of the share.

ANS: F PTS: 1 DIF: Moderate TOP: Par Value

55. T-bills are issued electronically with face values ranging from $1,000 to $5 million and with maturities of 4, 13, 26, or 52 weeks at the time of issue.

ANS: T PTS: 1 DIF: Moderate TOP: Types of Debt