

Name _____

MULTIPLE CHOICE. Choose the one alternative that best completes the statement or answers the question.

- 1) One of the most important disadvantages of the corporate form of business is: 1) _____
A) unlimited owner liability. B) ease of transferring ownership.
C) limited owner liability. D) double taxation.
- 2) An important advantage a general partner usually has is: 2) _____
A) only one person in control. B) unlimited liability.
C) larger share of profit distribution. D) limited liability.
- 3) Which statement is correct about limited partners? 3) _____
A) They can lose only one half of their initial investment.
B) They have no tax liability.
C) They take no part in running the business.
D) They have management control limited to their percent of investment.
- 4) Profit maximization: 4) _____
A) maximizes the wealth of the owners.
B) is an economic principle only.
C) is avoided because it is a long-run concept.
D) does not consider cash flow or risk.
- 5) Wealth maximization: 5) _____
A) is a long-run perspective used by financial managers for internal use only.
B) is usually discounted by bondholders.
C) takes a long-run perspective that focuses on the owners.
D) is an accounting number.
- 6) Which of the following is false? 6) _____
A) Less certain cash flows will result in lower valuation of the firm.
B) In the long run reported profits are always more important than cash flow.
C) Earlier cash inflows are generally preferable to later cash flows of similar size.
D) Risk levels will affect the valuation of the firm.
- 7) An agent has a fiduciary responsibility to the principals: 7) _____
A) for ethical obligations only. B) always.
C) never D) for legal obligations only.
- 8) In a very large corporation, the financial planner usually reports directly to the: 8) _____
A) controller. B) financial accountant.
C) treasurer. D) chief financial officer.
- 9) Which of the following would least affect the value of a firm's stock? 9) _____
A) risk associated with receiving cash flows B) cashflows
C) timing on cash flows D) number of shareholders

- 10) Cash flow is generally considered more important in finance than profits because: 10) _____
A) accountants can't agree on profit reporting.
B) profit goals involve timing issues.
C) profit doesn't pay the bills.
D) they are basically the same thing but cash flow is easier to calculate.
- 11) Larger corporate profit and cash inflows than what had been expected usually: 11) _____
A) mean a lower stock price.
B) will reduce the fluctuations of the stock price.
C) mean a higher stock price.
D) have no effect on the stock price.
- 12) Both financial managers and accountants: 12) _____
A) interpret financial statements for internal use only.
B) examine statements only for the firm they work for.
C) use financial statements.
D) work in the area of applied economics.
- 13) With respect to cash payments: 13) _____
A) you would agree to pay a larger amount if the cash payment were due in the future than if it were due right now.
B) cash earns interest in the short term only.
C) because of the time value of money, the later cash is received, the better.
D) less cash would be required if you were asked to wait for money to be received.
- 14) A principal of the firm is: 14) _____
A) the owner or owners. B) the CEO.
C) the chairman of the board. D) the agent.
- 15) Which of the following is not a problem with profit maximization as a goal? 15) _____
A) Profit maximization is an accounting principle.
B) There is not always a single definition of profit.
C) Sometimes profit and cash flow move in opposite directions.
D) Profit cannot be spent.
- 16) Which of the following would not impose constraints on the firm? 16) _____
A) worker safety laws B) environmental laws
C) civil rights laws D) company pricing decisions
- 17) The sole proprietor: 17) _____
A) is liable for all obligations of the business equal to the investment in the firm.
B) has unlimited liability relating to the business.
C) has limited liability relating to injuries on the premises.
D) has unlimited liability but avoids federal taxation.
- 18) The articles of partnership: 18) _____
A) are used primarily for limited partners to protect their investment.
B) define the terms of the partnership.
C) are required by all partnerships.
D) are usually just a formality; and rarely needed among consenting individuals.

- 19) All of the following are true about corporations with the exception of: 19) _____
A) the owners are not liable for the debts of the corporation.
B) shareholders of all corporations take an active role in the management of the business.
C) it is a form of business that results in double taxation of earnings.
D) corporations are a separate legal entity.
- 20) In a large corporation, the controller reports to the: 20) _____
A) CEO. B) financial planner.
C) chief financial officer. D) treasurer.
- 21) An agency problem could occur if: 21) _____
A) the company sells the executive jet and uses the funds to increase dividends.
B) senior executives set up a bonus system for themselves based on reported earnings per share.
C) the company announces the company will not pay for first class fares for company travel.
D) executive bonuses are tied to share price.
- 22) What is the primary reason for forming your business as a sole proprietorship? 22) _____
A) If you buy a corporate jet you will not create an agency problem.
B) It's the simplest way to start out.
C) You don't have to worry about taxes.
D) You will have unlimited liability.
- 23) Hillary Rotteneggs wishes to form a company that will specialize in toxic waste removal and storage. Which type of business form would be most advantageous? 23) _____
A) A partnership due to its low cost and diversification of ownership.
B) A corporation due to its limited liability.
C) A sole proprietorship due to its low cost and ease of formation.
D) Any of the above would be acceptable.
- 24) Which of the following is true? 24) _____
A) As the size of the expected cash flow decreases, the stock price increases.
B) As the riskiness of the cash flow increases, the stock price increases.
C) As the length of time until an expected cash flow increases, the stock price decreases.
D) All of the above are true statements.
- 25) Which of the following is false? 25) _____
A) Corporate earnings are subject to the same tax as partnership earnings.
B) Each form of business has its distinct advantages and disadvantages.
C) Agency problems are not pronounced in sole proprietorships.
D) Maximization of owner value and societal benefits are not always consistent.

ESSAY. Write your answer in the space provided or on a separate sheet of paper.

- 26) Compare and contrast the roles of the financial manager and accountant.
- 27) Why is it important for the financial manager to understand the cash flow position of the firm?
- 28) What is the fiduciary responsibility of an agent?
- 29) What is meant by double taxation?

- 30) Explain which type of business organization form affords the most control to the owner?
- 31) Why would someone choose a limited partnership share over a sole proprietorship?
- 32) How are partnerships, corporations, and proprietorships taxed?
- 33) What are the major problems with using profit maximization as a goal of the firm?
- 34) What are the constraints a firm operates under as it seeks wealth maximization?
- 35) Explain the difference between an agent and a principal.
- 36) Why must every firm have a general partner?
- 37) Why might a company report increasing earnings per share and declining cash flow per share?
- 38) How do agency problems arise? What are some examples of agency problems? What can corporations do to monitor these costs?
- 39) What is the main danger, in an agency sense, of setting up an executive bonus system based on profits?
- 40) Agency problems were not a major factor in business before the 19th century. Why not?
- 41) Why are cash flows received today worth more than cash flows received in the future? Would your answer change the interest rate was 0%? Discuss
- 42) When the degree of risk associated with future cash flows goes down, share prices go up. When the degree of risk associated with future cash flows goes up, share prices go down. Why?

MULTIPLE CHOICE. Choose the one alternative that best completes the statement or answers the question.

- 43) Junk bonds are: 43) _____
 A) bonds that have been rated investment grade.
 B) bonds that have been rated below investment grade.
 C) low interest-rate debt.
 D) very liquid.
- 44) Commercial paper is: 44) _____
 A) secured short term borrowing by corporations.
 B) the more formal term for "junk bonds".
 C) short term borrowing with a bank guarantee.
 D) unsecured borrowing by corporations.
- 45) Which of the following are traded in money markets? 45) _____
 A) corporate bonds
 B) preferred shares
 C) banker's acceptances
 D) junk bonds

- 46) A zero-coupon bond: 46) _____
A) is illegal to sell.
B) usually pays interest semi-annually.
C) makes no periodic interest payments.
D) is usually issued with a maturity of less than five years.
- 47) A dealer makes his/her money by: 47) _____
A) charging you a fixed fee per investment transaction.
B) charging you a fee based on the size of the transaction.
C) charging you a fixed percentage to manage your financial assets.
D) buying a financial security at the bid price and selling it to you at the offer price.
- 48) At auction when Treasury bills are sold: 48) _____
A) the general public can participate.
B) interest on the treasury bills will be paid semi-annually.
C) the person willing to pay the highest interest will win the auction.
D) the price will be lower than their maturity value.
- 49) If an investor anticipates that the expected inflation rate for the life of the loan will be 4% and the nominal risk-free rate they demand is 6%; their real rate of interest is: 49) _____
A) 6%. B) 10%. C) 2%. D) 4%.
- 50) A primary market is one where: 50) _____
A) only very high quality products are sold.
B) that is of primary importance for an investment manager who is managing clients stock portfolios.
C) new issues are sold.
D) trades are done through the big stock exchanges.
- 51) A secondary market is: 51) _____
A) a market that deals only in junk bonds and the stock of small companies.
B) a market that deals with less important issues.
C) where previously issued shares or bonds are sold.
D) where you go when your investment adviser can't get you a good price.
- 52) The over the counter (OTC) market is: 52) _____
A) a place lets you buy and sell stocks and bonds easily without using a broker.
B) how you can buy stocks listed on a major exchange.
C) where you go buy to buy stocks that are sold at retail outlets.
D) a network of dealers around the world who maintain inventories of securities for sale.
- 53) Commercial paper is: 53) _____
A) issued for a period greater than one year.
B) sold at a premium over par.
C) a money market instrument.
D) has a slightly lower yield than a Treasury bill of comparable maturity.

- 54) Bonds that make periodic coupon interest payments: 54) _____
A) no longer are issued.
B) qualify for the dividend tax credit.
C) are often issued by the Canadian Government.
D) are always issued at a discount to par.
- 55) Common stock: 55) _____
A) is riskier than preferred stock of the same corporation.
B) does not pay dividends as does preferred stock.
C) is usually less profitable than preferred stock.
D) is generally issued frequently.
- 56) Which of the following best describes the nominal risk-free interest rate? 56) _____
A) equal to the real rate of interest minus the sum of the inflation, maturity, default, and liquidity premiums
B) the inflation premium plus the real rate
C) the real rate of interest minus the inflation premium
D) the sum of the inflation, maturity, default, and liquidity premium
- 57) A secondary market is one where: 57) _____
A) you can trade stocks and bonds when the regular markets are closed.
B) the stock of smaller corporations trade.
C) previously issued financial instruments can be bought and sold.
D) special products like junk bonds trade.
- 58) Liquidity refers to: 58) _____
A) the price movements of the stocks of overseas shipping companies.
B) the speed at which a financial instrument can be turned into cash.
C) the extent to which the market value of a share changes.
D) the likelihood that the coupon on a bond will change.
- 59) Money market instruments are considered a good place to "park cash" because: 59) _____
A) they will always be registered in your name so you'll be sure to get your interest payments.
B) they always pay interest semiannually.
C) you should be able to convert them into cash within one business day.
D) they are all guaranteed to pay both interest and maturity value.
- 60) All of the following could be considered a financial security with the exception of: 60) _____
A) Treasury bond. B) accounts receivable.
C) banker's acceptance. D) preferred stock.
- 61) Which of the following is an example of a primary market transaction? 61) _____
A) The Royal Bank buys a T-bill through the bi-weekly Treasury auction.
B) The Royal Bank pays a dividend on its stock.
C) The investment department of the Royal Bank buys shares on the Toronto Stock Exchange.
D) The Royal Bank sells a T-bill that it owns.

- 62) Canadian capital markets are considered to be efficient because: 62) _____
A) Canada's brokerage firms have very good accounting departments.
B) there is almost no government interference.
C) financial securities can be traded easily, quickly and at a low cost.
D) you never have to pay a commission on a trade, only the spread, and this is a fixed amount.
- 63) Maturity date is: 63) _____
A) when the first coupon interest payment is due.
B) when a bond is first issued.
C) when the principal is repaid.
D) when the issuer receives the par value.
- 64) An example of a capital market security would be: 64) _____
A) a bond. B) commercial paper.
C) a banker's acceptance. D) a Treasury bill.
- 65) If you buy a 90 day, \$100,000 treasury bill that yields 3% it will cost you: 65) _____
A) more than a Government of Canada bond with 3.5% coupon maturing in 2 years.
B) more than \$100,000.
C) less than \$100,000.
D) \$100,000.
- 66) All of the following are false except: 66) _____
A) the default risk premium and the inflation risk premium are inversely related.
B) the default risk premium is the same on all types of bonds.
C) the real interest rate consists of the nominal interest rate plus risk premiums.
D) the nominal interest rate consists of the real interest rate plus risk premiums.
- 67) All of the following are false except: 67) _____
A) the yield curve will be the same for all securities with the same maturity.
B) the yield curve is based on historical data.
C) the yield curve is a graphical depiction of interest rates for securities that differ only in the time remaining to maturity.
D) the yield curve is only of interest to lenders.
- 68) Money market securities do NOT include: 68) _____
A) Treasury bills. B) negotiable certificates of deposit.
C) commercial paper. D) corporate bonds.
- 69) What will be the semi annual interest payment on a \$1,000 bond with a 5% coupon? 69) _____
A) \$2.50 B) \$50 C) \$5 D) \$25
- 70) With respect to Government of Canada bonds, all of the following are true except: 70) _____
A) the par value of a bond is returned to the bondholder on the maturity date.
B) the coupon rate is expressed as a percentage of par value.
C) face value and par value often differ due to changes in economic conditions.
D) the holder will receive the face value of the bond at maturity.

- 71) What is the annual interest payment on a bond with a 7% coupon rate and a \$1,000.00 par value? 71) _____
A) \$700.00 B) \$7.00
C) \$70.00 D) More information is needed.
- 72) Stocks that are not traded on national or regional exchanges but instead are offered for sale in a secondary market that consists of a network of dealers trading over computers are: 72) _____
A) more expensive than exchange listed stocks.
B) riskier than exchange listed stocks.
C) traded on the "over-the-counter market".
D) not liquid.

ESSAY. Write your answer in the space provided or on a separate sheet of paper.

- 73) All else constant, where would a dealer profit more on a given dollar transaction: From the spread on one T-bond transaction or the spread on one transaction of a rarely traded BBB corporate bond? Explain.
- 74) Would the default premium on an investment grade corporate bond be higher or lower than that on a junk bond? Explain.
- 75) If expected inflation is 3% and the nominal interest rate is 6%, what is the real rate of interest? If actual inflation turns out to be only 2%, explain who benefits and who loses.
- 76) Explain the difference between a dealer and a broker.
- 77) Explain how a dealer makes a profit from spread.
- 78) The more liquid the financial instrument, the wider the spread between the bid and ask price. Explain why you agree or disagree with this statement.
- 79) The economy is suffering from a recession, explain what will happen to the yield spread between a Treasury bond and a BBB rated corporate bond.
- 80) Explain how you earn a return on a Treasury bill. How is this different from the manner in which you earn a return on a Government of Canada bond?
- 81) What is commercial paper? Explain why it would have a higher return than a treasury bill.
- 82) Why are the yield curves of Government of Canada securities the most commonly used yield curves?.
- 83) What is the difference between preferred and common stock? If you want higher expected returns, which would you purchase? Which is riskier; why?
- 84) All else equal, which would offer a higher interest rate: a seven-year Treasury note or a fifteen-year Treasury bond? Explain.
- 85) There is basically no real difference between the yield on a Treasury bill and a Government of Canada bond; after all, both are backed by the Canadian government. Comment.
- 86) Why might a company prefer to issue stocks rather than debt if they need funds?

87) If security markets were not efficient, would the average price change and issue volatility be more or less pronounced? Explain.

88) Two securities of equal risk are available for investment—a money market security and a capital market security. Assuming a normal yield curve, which security should be purchased to achieve the highest potential yield? Why?

MULTIPLE CHOICE. Choose the one alternative that best completes the statement or answers the question.

89) The economy is experiencing a severe recession. The Bank of Canada will most likely: 89) _____
A) increase the reserve requirement. B) increase the discount rate.
C) buy Treasury securities. D) lower reserves at commercial banks.

90) The economy is experiencing strong economic growth. The Bank of Canada will most likely: 90) _____
A) buy Treasury securities. B) decrease the discount rate.
C) sell Treasury securities. D) decrease the Fed funds rate.

91) National commercial banks are regulated primarily by: 91) _____
A) the provincial banking authorities. B) the Bank of Canada.
C) the FDIC. D) the Bank Act

92) If a Canadian bank has more than \$5 billion in equity: 92) _____
A) it is likely that it is wholly owned by a foreign bank.
B) no one person or company has the right to own more than 20% of the bank's voting shares.
C) it will be supervised by the provinces.
D) the controlling shareholder must prove that they are financially responsible.

93) The Canada Deposit Insurance Corporation: 93) _____
A) guarantees all deposits up to \$1,000,000.
B) guarantees deposits up to \$60,000 per account.
C) is a result of the legislative change that allowed banks to sell insurance.
D) protects Canadian banks against loan losses.

94) Online banking provided by Canadian banks: 94) _____
A) can only give you access to information on your checking and savings account balances.
B) is available in bank branches only during the days they are open.
C) consists of using the Internet to link your personal computer to your bank account.
D) does not require you to have a PIN number.

95) A trust company with a portfolio of mortgages has a positive interest rate spread and interest rates are rising: 95) _____
A) the net profit margin will fall.
B) the trust company will be able to maintain the same interest rate spread.
C) the net interest margin will rise.
D) there will be no net effect on profits.

- 96) A bank needs _____ before it opens for business 96) _____
A) permission from the Prime Minister
B) a charter
C) permission from the head of the Bank of Canada
D) permission from the province in which it operates
- 97) Open market operations: 97) _____
A) refers to raising and lowering of the Bank Rate.
B) is conducted quarterly by the Bank of Canada.
C) are an attempt to manipulate the economy through changes in short-term interest rates and the money supply.
D) are used by the federal government to control interest rates.
- 98) The Target Overnight rate is: 98) _____
A) one half a percent lower than the borrowing rate.
B) the Bank Rate.
C) the rate at which the Bank of Canada wants to see institutions loan each other overnight.
D) very different than the U.S. Federal Reserve's Target Federal Funds Rate.
- 99) Which of the following is true about Credit unions? 99) _____
A) They are federally regulated.
B) Many of them have been bought by the big chartered banks.
C) They are a member owned financial institution.
D) They are the same as a trust company.
- 100) Trust companies differ from banks because: 100) _____
A) there are no real differences.
B) their deposits are not eligible for deposit insurance through the Canada Deposit Insurance corporation.
C) they can administer estates.
D) they are owned by their members.
- 101) All of the following statements are true about pension funds except: 101) _____
A) all are backed by the full faith and credit of the federal government.
B) they can fail if they are defined benefit plans.
C) they are a type of savings plan.
D) they can be sponsored by a company or the government.
- 102) If the Bank of Canada wants to increase the money supply, it could achieve this goal by: 102) _____
A) raising the target for the overnight rate. B) buying government securities.
C) selling foreign currencies. D) selling government securities.
- 103) If the Bank of Canada wishes to decrease the money supply it: 103) _____
A) sells government securities. B) prints less money at the Winnipeg mint.
C) lowers the target for the overnight rate. D) reduces the reserve requirements.

- 104) The major difference between finance companies and banks is: 104) _____
A) finance companies are always member owned.
B) there is very little difference except for size.
C) finance companies generally get their funds by borrowing from banks or by selling commercial paper.
D) finance companies make their money by charging a fixed fee on transactions and banks make most of their money by taking in money and lending it out at a higher interest rate.
- 105) Commercial Finance Companies: 105) _____
A) are mainly concerned with facilitating retail sales.
B) were developed to replace factors.
C) capped interest rates that commercial banks could pay on deposits.
D) concentrate on providing credit to other business firms.
- 106) Which of the following statements is true about life insurance companies: 106) _____
A) they work on the assumption that all of their policy holders will live a long time.
B) they always invest in short term securities because they never know when a policy holder will die.
C) they never invest in real estate.
D) their real risk is that the insured person will die sooner than expected.
- 107) In a defined benefit pension plan: 107) _____
A) the employer agrees to pay a pension but they won't agree to pay any other benefits to retirees.
B) retirement pension benefits are determined by a formula that usually considered the worker's age, salary and years of service.
C) retirement benefits depend on the total accumulation in the individual's account at the retirement date.
D) the retired employee will receive medical, dental and often life insurance benefits but possibly no monthly income.
- 108) Which of the following is NOT true about pensions funds: 108) _____
A) they will be either defined benefit or defined contribution plans.
B) they are a minor factor in the Canadian financial markets.
C) they often purchase common stock.
D) they are usually administered by trust companies.
- 109) All of the following are true about annuities with the exception of the following: 109) _____
A) they are sold to thousands of different people.
B) they can be in the form of a pension fund distribution.
C) an annuity is a series of equal payments.
D) the size of the payments you receive after you have bought the annuity will change as the prevailing interest rate changes.
- 110) If the defined contribution pension fund investments perform poorly: 110) _____
A) the retired employee will be able to buy a large annuity because interest rates are low.
B) the government of Canada guarantees all pension funds.
C) the company will have to top up its contributions so the retiree receives the expected payment based on their years of service and age.
D) the retired employee will only be able to buy a small annuity which will pay small monthly payments.

- 111) When does a financial institution NOT act as an intermediary? 111) _____
A) when it predicts and absorbs credit risk
B) when it matches suppliers of capital with demanders of capital
C) when it donates a large sum of money to a major political party
D) when it takes in small amounts of funds from many individuals to form a large pool of funds that can be used to make a single large investment
- 112) The flow of excess funds from savers to financial institutions is called: 112) _____
A) fundamental transfer. B) disintermediation.
C) monetary exchange. D) intermediation.
- 113) Which of the following is NOT true about Canadian bank regulations? 113) _____
A) The power to regulate banking was given to the federal government through Section 91 of the BNA act.
B) Banks account for over 70% of the total assets of the financial service sector.
C) If the bank has \$4 billion in equity there are no ownership limitations.
D) Historically banks were classified as Schedule I and Schedule II banks.
- 114) Property and casualty insurance companies insure against everything but: 114) _____
A) accidental death. B) weather damage.
C) theft. D) fire.
- 115) The risk that the issuer of a security may fail to make promised payments to the investor at the specified times is: 115) _____
A) business risk. B) credit risk.
C) interest rate risk. D) maturity risk.

ESSAY. Write your answer in the space provided or on a separate sheet of paper.

- 116) If you were asked to comment on the differences and similarities between a trust company and a commercial bank, how would you respond?
- 117) If the Bank of Canada wants to increase interest rates in the country why would they sell Government of Canada securities to commercial banks?
- 118) Why might a credit union member receive extra income over and above that that might be received by a client of a bank or a trust company?
- 119) How does financial intermediation often provide a better alternative to direct financing between those who have excess funds and those who need funds?
- 120) What does the term "moral suasion" mean as refers to the Bank of Canada?
- 121) Since everyone dies eventually how can life insurance companies make any money?
- 122) What is the target overnight rate of the Bank of Canada?
- 123) Explain the similarities and differences between banks and trust companies.

- 124) Interest rates are rising. An institution has a number of long term loans that are currently being financed with short term lending. Explain how this would impact on the financial institutions spread.
- 125) Why do life insurance companies use actuaries?
- 126) The Bank of Canada is concerned about an ensuing recession. What will they most likely do and how will they accomplish this?
- 127) What is the zero reserve ratio as applies to Canadian banks? Discuss.
- 128) If the Bank of Canada wants to increase the money supply they buy securities. Why?
- 129) What would happen to the standard of living if financial institutions did not exist? Why?

Answer Key

Testname: UNTITLED1

- 1) D
- 2) C
- 3) C
- 4) D
- 5) C
- 6) B
- 7) B
- 8) C
- 9) D
- 10) C
- 11) C
- 12) C
- 13) A
- 14) A
- 15) A
- 16) D
- 17) B
- 18) B
- 19) B
- 20) C
- 21) B
- 22) B
- 23) B
- 24) C
- 25) A
- 26) Accountants provide the raw materials (financial statements) which financial managers interpret. The accountant provides the data with which the financial manager works while the financial manager examines questions which are critical to the success of the firm such as: Is the asset mix correct? What are the plans for the future? The financial manager engages in the analysis of the statements provided by the accountant.
- 27) The sooner we receive cash, the sooner that we can put it to use. Understanding the cash position provides the firm with a better basis from which to make decisions. Can we increase cash inflows or collect cash sooner? Can we decrease cash outflows or pay later without being too late?
- 28) Agents are entrusted with the resources that are owned by the principals. They are in a position of trust and must always perform their obligations with the principals' best interest in mind.
- 29) A corporation pays taxes, via the corporate income tax, on its own taxable income. Any after-tax income paid by the corporation to common stockholders in the form of dividend is then taxed again on the individual tax returns of the stockholders. The Canada Customs and Revenue Agency collects taxes on the same income, first via the corporate income tax, then via the personal income tax on dividend income.
- 30) The sole proprietorship gives complete control to the owner enabling him/her to make all business decisions with respect to the business and also to reap all of the profits. However, the owner also assumes complete liability for this right.
- 31) To avoid the unlimited liability associated with a sole proprietorship, an individual might choose a limited partnership thus limiting liability although this choice would also limit upside potential since profits would have to be shared with partners.

- 32) A partnership itself is not taxed. The income only passes through the partnership to the partners where it is taxed. Corporations are double taxed. A corporation pays taxes, via the corporate income tax, on its own taxable income. Any after-tax income paid by the corporation to common stockholders in the form of dividend is then taxed again on the individual tax returns of the stockholders. Canada Customs and Revenue collects taxes on the same income, first via the corporate income tax, then via the personal income tax on dividend income. The sole proprietor is single taxed — he/she merely files a profit and loss statement for the business with their own personal tax return and the sole proprietor is responsible for any tax liability generated by the business and the tax rates are those that would apply to an individual.
- 33) Profits have a short-term orientation. High short-term profits (which may make management look good for this year) are not necessarily an indication of future profits and cash flows and thus wealth. How do we incorporate risk —perhaps we can generate some great short-term profits which would increase the risk to the firm to such an extent that next year we could actually lose all of this profit and perhaps more! Between finance and economics, there is simply no clear definition of profits. For example, the economist would like to look at opportunity costs while the accountant is only concerned with explicit expenses.
- 34) There are legal constraints such as pollution control equipment, safety standards, and civil rights laws. There are also ethical constraints—things which a manager could get away with legally but ethically are wrong; for example, the firm may be able to exploit workers within the framework of the law.
- 35) An agent is a person who has the implied or actual authority to act on behalf of another. The principals are the individuals whom the agents represent. The interests of the principals are supposed to be paramount when agents make decisions.
- 36) Someone has to be able to assume the full liability of the firm since it has chosen not to incorporate and therefore benefit from the limited liability provisions incorporation provides. Furthermore, limited partners are generally not involved in the running of the business and general partners are necessary to fulfill that role.
- 37) The business may have been overly optimistic about reporting sales (revenue) for which they still have not been paid while still having to pay cash for the expenses they built up to produce the sales. In other words, there is a mismatch between cash received and cash expended.
- 38) Agency problems occur when the interests of principals (owners) and agents (managers) diverge. Agency problems include the purchase of a corporate airplane, first-class travel, corporate country club memberships, etc. Accounting audits are a common way to monitor these costs.
- 39) Managers will be tempted to make decisions based on reported profit versus cash flow because their personal returns are tied to reported profits. The long term wealth of shareholders is based on cash flow not reported profits. Agency theory says that the goal of the managers (agents) is to maximize the wealth of the firms owners.
- 40) Agency problems were largely non-existent before the 19th century since most of the enterprises were either sole proprietorships or family partnerships. Since the owners of these businesses were directly involved in the daily operations of the firm, they directly benefited from their efforts.
- 41) Cash received today is more valuable because it could then be invested at the current interest rate and be worth more in the future. However, it is also worth more today because the further we go into the future the less sure we can be that the cash flow we expect will be what we actually get. The longer the time period the higher the probability that our assumptions regarding the cash flow will prove incorrect.
- 42) Because the less certain owners and investors are about a firm's expected future cash flows, the lower they will value those potential cash flows. In the long run, the future cash flows a company can generate will determine its value in the market.
- 43) B
- 44) D
- 45) C
- 46) C
- 47) D
- 48) D
- 49) C
- 50) C

Answer Key

Testname: UNTITLED1

- 51) C
- 52) D
- 53) C
- 54) C
- 55) A
- 56) B
- 57) C
- 58) B
- 59) C
- 60) B
- 61) A
- 62) C
- 63) C
- 64) A
- 65) C
- 66) D
- 67) C
- 68) D
- 69) D
- 70) C
- 71) C
- 72) C
- 73) They would profit more from the BBB bond transaction. The Treasury market is the most liquid in the world and as a result, the spread between the bid and ask prices is very small relative to other trades which are less liquid and the dealer needs more compensation for assuming the risk associated with the BBB bond.
- 74) The default premium would be lower on an investment grade bond. There is less risk of default; thus, the premium associated with it would be lower.
- 75) The real rate is 3%. If inflation actually turns out to be 2%, then the real return is 4% and the lender (bond investor) benefits as he/she gets paid back a higher real return on the original investment.
- 76) A dealer takes a position (buys or sells) in the security while a broker brings two parties together and charges a fee for the service. The dealer assumes more risk and more potential profit/loss.
- 77) A dealer makes a profit from buying low (bid price) and selling high (ask price).
- 78) This statement is false. The more liquid the financial instrument, the narrower the spread. A liquid instrument provides less risk for the dealer since it is easier to find a buyer. He/she will not need as much compensation for this risk as would be the case with a less liquid security.
- 79) The yield spread will increase. During a recession, there is more fear of bankruptcies and a lower-rated firm has a greater chance of default; thus, less demand means lower prices and lower prices mean higher yields on the BBB corporate bond. Treasury bonds have negligible default risk. (The nominal interest rate incorporates a default risk premium.)
- 80) You buy a Treasury bill at a discount. Your return is based on the difference between the price paid and the par value at maturity. No coupon interest is paid. A Government of Canada bond includes coupons and can be sold at a discount, par, or premium depending upon the market interest rate at time of sale. You earn a return based on the present value of all cash flows: coupon interest, reinvesting the coupon interest at market rates, and the par value at maturity.
- 81) It is a short term debt instrument issued by large corporations with strong credit ratings that functions much like treasury bills that are issued by governments. The notes are issued and traded through a network of commercial paper dealers. Most of the buyers are large institutions. Like treasury bills the commercial paper is sold at a discount from maturity. By definition, a T-bill is default free and will have no default premium built into the yield. Both instruments are short-term money market low-risk securities.

Answer Key

Testname: UNTITLED1

- 82) With Government of Canada securities it is easier to hold constant factors other than maturity. There is almost no default risk and an excellent degree of liquidity for all issues. Any differences among the interest rate on these securities can be attributed to maturity differences between the securities. If corporate securities were used the yield curve would be vulnerable to variations due to default risk premiums and in some cases liquidity premiums caused by the relatively small size of many corporate issues.
- 83) A dividend cannot be paid to common shareholders in any given year unless the preferred shareholders have been paid their fixed dividend. The holders of a corporation's common stock are the owners of the firm and get their return in the form of common stock dividends and from the potential capital gains that may be realized if the company does well and the stock price rises. Preferred stockholders will never receive more than their fixed dividend even if the company does very well. Common shareholders as owners of the firm are entitled to all residual income from the firm and there is no upper limit as to how much they can gain. However, if the firm does not do well, and the company has to declare bankruptcy the preferred shareholders rank ahead of the common shareholders, although below the debt holders, in their claim on assets.
- 84) The fifteen-year Treasury bond would generally have a higher yield reflecting the maturity premium with a normal upward sloping yield curve.
- 85) One is a short-term instrument and one is long-term. The longer term would generally have a higher yield because of the maturity risk premium. If interest rates should rise the negative effect on the price of the bond will be greater than the effect on the treasury bill.
- 86) The money raised from the sale of shares never has to be paid back. And, they have no obligation to make regular payments to the shareholders, whereas, they would have to make regular interest payments to bond holders.
- 87) Securities in an efficient market are traded easily, quickly, and at a low cost. If markets were not efficient, matching buyers and sellers would be more difficult, take longer, and cost more. Price changes and volatility would increase.
- 88) The capital market security should be purchased. Money market securities are short-term maturity (less than one year); capital market securities are long-term. Given the normal shape of the yield curve (upward sloping), the capital market security would have a higher potential return.
- 89) C
- 90) C
- 91) D
- 92) B
- 93) B
- 94) C
- 95) A
- 96) B
- 97) C
- 98) C
- 99) C
- 100) C
- 101) A
- 102) B
- 103) A
- 104) C
- 105) D
- 106) D
- 107) B
- 108) B
- 109) D
- 110) D
- 111) C
- 112) D
- 113) C

- 114) A
- 115) B
- 116) To the casual observer there appears to be little difference between trust companies and banks because both can take in deposits and make loans. However, commercial banks cannot administer estates, trusts or pension funds.
- 117) The Bank of Canada will sell securities through their traders to the large commercial banks. These sales will reduce the amounts of money that the commercial banks have available for other loans. Because there is a relative shortage of money that is available to be borrowed, corporations or individuals will be willing to pay more to get it, in other words they will be willing to pay a higher interest rate to obtain the funds they need. It will produce a classic case of supply and demand. If the supply is decreased the demand will respond by paying higher prices and in this case the higher price will be shown by a willingness to pay higher interest.
- 118) Since credit unions are owned by their members, these members are entitled to any income the credit union has after debts and expenses have been paid. This residual income may be distributed in the form of extra dividends paid on the members shares or by a rebate paid on interest paid on loans.
- 119) Financial intermediaries can help lenders and borrowers avoid denomination matching problems—if one unit needs a large sum of funds but the lending unit has only a small amount to lend, direct borrowing is difficult. The bank handles the denomination matching problem by acting as an intermediary between the units. The same principle applies to maturity matching. The intermediary can assume the risk here as they have a number of units depositing and borrowing. It is not as difficult for them to accomplish the maturity matching given the large numbers of units involved. Individual units supplying funds do not need to be as concerned about credit and default. The institution assumes the risk here (of course should the institution fail, the individual unit is at risk depending upon the insurance coverage!).
- 120) The Bank of Canada announces that it wants the economy to cool off and that they are considering increasing the overnight target rate. Financial institutions, believing rates will increase, will tend to respond by increasing, for example, their prime rates, adjusting spending forecasts and so on. In other words the Bank of Canada gets the economy to cool off without actually doing anything only by suggesting that they might do something. Since they are so large and therefore so powerful this tends to be effective.
- 121) The premiums that a policy holder pays plus the extra return that the insurance company earns on those premiums should amount to a sum that will provide enough money to pay off the policy and also provide a profit to the insurance company. Someone may die earlier than expected and their beneficiaries receive more than the value of the contributions plus investment returns. Someone else will live longer than expected and their beneficiaries will receive less than the value of the contributions plus investment returns. Although actuaries cannot say which individual person will live a longer or shorter time they can accurately predict how many of a group of 40 year old males will die in a given year.
- 122) It is the rate at which the Bank of Canada wants to see institutions loan to each other overnight. Those institutions needing funds will be charged a rate equivalent to the Bank Rate and those institutions having surplus money will be given a rate one-half a percent lower than the borrowing rate. The target overnight rate is said to be the rate halfway in between.
- 123) Both can take in deposits and make loans, but, only trust companies can administer estates and pension funds. Changes in legislation have made it possible for banks to buy and own trust companies but there are still differences in the regulations governing each entity.
- 124) The short term lenders will demand a higher rate of return but the longer term borrowers have a contract that guarantees they will pay only a fixed amount of interest on their loans until they mature. Since the financial institution will be forced to pay a higher rate to the lender or lose the account they will be forced to accept a lower spread on the loan. This is why most financial institutions try and match maturities eg. 5 year GIC's against 5 year mortgage terms. If the interest rate goes up or down they are not vulnerable because their spread doesn't change.
- 125) Actuaries calculate the price of a life insurance policy based on a person of a given age, sex, and health. This enables the insurance company to make payouts on claims, cover their expenses, and make a profit. Based on a group of 100,000 healthy forty-year old males, actuaries can tell the insurance company with a high degree of accuracy how many will die during the coming year.

Answer Key

Testname: UNTITLED1

- 126) The Bank of Canada will most likely buy securities to increase the money supply and lower the target for the overnight rate and use moral suasion to indicate they want to see interest rates fall even further from their present levels. This will encourage banks to lower their lending rates and stimulate the economy by making it easier for consumers and business to borrow funds. Buying securities increases reserves in the monetary system and when supply is increased interest rates tend to fall thereby stimulating business activity.
- 127) Canadian banks, unlike U.S. banks, are not required to have a portion of their deposits in a reserve account. If they lend out funds in excess of what they actually hold they must borrow money through the Bank of Canada.
- 128) When they buy securities they put extra funds in the hands of the financial institutions that sell them. These funds are now available to be lent out.
- 129) The standard of living would be lower. Without financial institution intermediation, those with excess funds would be less likely to invest in companies that need those funds. Business growth and development would be much slower.