**Chapter 1: An Introduction to Finance**

**Multiple Choice Questions**

1. Section: 1.1 Finance Defined

Learning objective: 1.1

Level of Difficulty: Basic

Solution: A

2. Section: 1.2 Real versus Financial Assets

Learning objective: 1.2

Level of Difficulty: Intermediate

Solution: C

Stocks are financial assets. Examples of real assets are residential structures, non-residential structures, machinery and equipment, durables, inventories, and land.

3. Section: 1.3 The Financial System

Learning objective: 1.3

Level of Difficulty: Basic

Solution: B

4. Section: 1.3 The Financial System

Learning objective: 1.3

Level of Difficulty: Intermediate

Solution: A

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

5. Section: 1.3 The Financial System

Learning objective: 1.3

Level of Difficulty: Intermediate

Solution: C

Banks, pension funds, and insurance firms do transform the nature of their underlying financial securities. However, mutual funds do not transform the nature of the underlying financial securities.

6. Section: 1.4 Financial Instruments and Markets

Learning objective: 1.4

Level of Difficulty: Intermediate

Solution: C

7. Section 1.5 The Global Financial Community

Learning objective: 1.5

Level of Difficulty: Intermediate

Solution: C

8. Section 1.5 The Global Financial Community

Learning objective: 1.5

Level of Difficulty: Intermediate

Solution: D

**Practice Problems**

**Intermediate**

9. Section: 1.2 Real versus Financial Assets

Learning objective: 1.2

Level of Difficulty: Intermediate

Solution:

Balance sheet:

Residential structures: $1,000+ $3,000+$1,500 = $5,500

As there are no foreign assets or liabilities, the net worth or equity of the island is $5,500

To deal with Fred and Robinson’s debts:

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

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

10. Section: 1.3 The Financial System

Learning objective: 1.3

Level of Difficulty: Intermediate

Solution: In the financial system, there are mainly four major sectors: Households, Government, Business, and Non-Residents. Within the field of finance there are four major areas: personal finance, government finance, corporate finance, and international finance. They closely interrelate to each other. Because they are all major parts of the whole financial system, what happens in one market will affect all the other markets.

11. Section: 1.3 The Financial System

Learning objective: 1.3

Level of Difficulty: Intermediate

Solution: Banks take in deposits and loan them out to fund borrowers. Pension funds take in pension contributions and pay out pensions to plan participants when they retire. Insurance firms take in premiums and pay out when a certain event occurs. Mutual funds pool small funds together and make investments that small investors cannot make. Mutual funds also offer investment expertise to ordinary investors.

12. Section: 1.3 The Financial System

Learning objective: 1.3

Level of Difficulty: Intermediate

Solution: Five main reasons why financial and market intermediaries exist are:

i) They provide anonymousness and convenience to all transaction parties.

ii) They efficiently match the needs of the participants in the financial market and aggregate all the small transactions.

iii) They have procedures for documentation of legal contracts to ensure security.

iv) The risk of non-payment is alleviated by maintaining credit ratings and by controlling other accounts.

v) Financial institutions transform the nature of the underlying financial securities.

13. Section: 1.3 The Financial System

Learning objective: 1.3

Level of Difficulty: Intermediate

Solution: A “credit crunch” refers to a situation when financial intermediaries such as banks and other lenders are either unable or unwilling, in general, to offer credit to borrowers. The crunch usually arises due to a lack of confidence, leading people and other institutions to be unwilling to lend to the financial intermediary. If very few people are willing to lend to the financial intermediary, then they, in turn, will not have the funds available to lend out and the “crunch” begins.

14. Section: 1.4 Financial Instruments and Markets

Learning objective: 1.4

Level of Difficulty: Intermediate

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

**Challenging**

15. Section: 1.4 Financial Instruments and Markets

Learning objective: 1.4

Level of Difficulty: Challenging

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

**Answers to Concept Review Questions**

**1.2 Real versus Financial Assets**

***Concept review questions***

1. What is finance?

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

2. Distinguish between real and financial assets.

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

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

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

**1.3The Financial System**

***Concept review questions***

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

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

2. Distinguish between market and financial intermediaries.

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

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

Chartered banks take in deposits and make loans, insurance companies take in premiums and pay off in the event of an incident happening such as a death or fire, while pension funds take in contributions and provide pension payments after plan members retire.

**1.4 Financial Instruments and Markets**

***Concept review questions***

1. Distinguish among the various types of financial assets.

The two major categories of financial securities are debt instruments and equity instruments.

2. Identify the major sources of financing used by: (a) governments and (b) businesses.

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

3. Distinguish between primary and secondary markets.

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

**1.5 The Global Financial Community**

***Concept review questions***

1. Explain why global financial markets are so important to Canadians.

On aggregate, if we add our foreign borrowings to the amount of direct foreign investment in Canada, it exceeded the sum of what foreigners borrowed from us and the amount that we invested directly abroad.

2. Identify and briefly describe the two major stock markets in the United States.

The New York Stock Exchange (NYSE) is the world’s largest and most famous stock market. The second largest and most important stock market in the U.S. is the Nasdaq Stock Market SM, or Nasdaq.

3. Explain briefly why events in the United States affected countries around the world so drastically.

The world’s money markets and bond markets are very global in nature, with U.S. markets representing the largest and most active debt markets in the world. The U.S. also possesses the largest equity markets in the world.