Chapter 1: An Introduction to Finance

Multiple Choice Questions

1. Section: 1.1 Real versus Financial Assets
Learning objective: 1.2
Level of Difficulty: Easy
Solution: B

2. Section: 1.1 Real versus Financial Assets
Learning objective: 1.2
Level of Difficulty: Medium
Solution: C
Net worth = Assets – Debts. Examples of real assets are residential structures, non-residential structures, machinery and equipment, durables, inventories, and land.

3. Section: 1.2 The Financial System
Learning objective: 1.3
Level of Difficulty: Easy
Solution: B

4. Section: 1.2 The Financial System
Learning objective: 1.3
Level of Difficulty: Medium
Solution: A
In the financial system, households are the primary fund providers to the government and businesses.

5. Section: 1.2 The Financial System
Learning objective: 1.3
Level of Difficulty: Medium
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: 1.3 Financial Instruments and Markets
Learning objective: 1.4
Level of Difficulty: Medium
Solution: C

Practice Problems

7. Section: 1.1 Real versus Financial Assets
Learning objective: 1.2
Level of Difficulty: Easy
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 the 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.

8. Section: 1.2 The Financial System
Learning objective: 1.3
Level of Difficulty: Medium
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.

9. Section: 1.2 The Financial System
Learning objective: 1.3
Level of Difficulty: Medium
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.

10. Section: 1.2 The Financial System
Learning objective: 1.3
Level of Difficulty: Medium
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.

11. Section: 1.2 The Financial System
Learning objective: 1.3
Level of Difficulty: Medium
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.

12. Section: 1.3 Financial Instruments and Markets
Learning objective: 1.4
Level of Difficulty: Medium
Solution: The two main types of primary market transactions are *initial public offerings* (IPOs), which are offered to the public by previously private firms, and *seasoned equity offerings* (SEOs), which are offered by firms previously listed on the stock exchange.

13. Section: 1.3 Financial Instruments and Markets
Learning objective: 1.4
Level of Difficulty: Difficult
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.