University of Central Florida (UCF) FIN3403 Business Finance Practice Exam 1 (Sample)

Study Guide

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Questions

1. Which method allows a corporation to sell securities to the public without using an investment banking firm?

   A. Private Placement

   B. Direct Sale

   C. Initial Public Offering

   D. Underwritten Offering

2. Which term is used for the difference between current assets and current liabilities?

   A. Current Ratio

   B. Working Capital

   C. Net Assets

   D. Gross Profit

3. What do you call the amount a company receives above par value from selling stock to investors?

   A. Paid-In-Capital

   B. Common Stock

   C. Capital Surplus

   D. Share Premium

4. Which of the following is a potential disadvantage of diversification?

   A. Increases overall market risk

   B. Can lead to lower returns

   C. Reduces the need for financial ratios

   D. Concentrates risk in fewer assets

5. When a firm uses a broker for its stock issue and aims to sell shares for a commission, this distribution method is known as?

   A. Firm Commitment

   B. Best Efforts

   C. Selling Group

   D. Syndicate Offering

6. Which of the following investment strategies is likely to involve a higher risk?

A. Investing in government bonds

B. Investing in blue-chip stocks

C. Investing in technology startups

D. Investing in utility stocks

7. What does it mean when an underwriter 'assumes the risk' during underwriting?

A. The underwriter guarantees all investors a profit.

B. The underwriter agrees to purchase all issued securities.

C. The underwriter takes the financial risk of selling securities at a profitable price.

D. The underwriter only markets the securities without any responsibility.

8. What do bonds represent in financial terms?

A. Ownership in a company

B. A loan made by an investor to a borrower

C. Fixed deposit accounts at banks

D. A type of equity investment

9. What term refers to the bottom line of an income statement that indicates net profit or loss?

A. Operating Income

B. Gross Profit

C. Net Income

D. Retained Earnings

10. Which of the following occurs when a company has an initial public offering?

A. Trading of existing shares begins.

B. The company issues new shares to the public.

C. Bond financing is initiated.

D. The company enters bankruptcy.

Answers

1. B
2. B
3. A
4. B
5. B
6. C
7. C
8. B
9. C
10. B

Explanations

1. Which method allows a corporation to sell securities to the public without using an investment banking firm?

A. Private Placement

B. Direct Sale

C. Initial Public Offering

D. Underwritten Offering

The method that allows a corporation to sell securities to the public without the involvement of an investment banking firm is a direct sale. In this approach, the company takes on the responsibility of marketing and selling its own securities directly to investors, often using its own resources or through digital platforms. This process can save the company on underwriting fees and can simplify the transaction, as it bypasses intermediaries that are typically involved in the sale. Private placements involve selling securities directly to a select group of investors, typically institutional ones, and do not involve a public offering. An initial public offering (IPO) is when a company first offers its shares to the public with the assistance of an investment bank. An underwritten offering is where an investment bank buys the securities from the issuer and then sells them to the public, often guaranteeing a certain amount of capital to the issuing firm. These methods contrast with a direct sale, focusing on public outreach without the intermediary service of an investment banking firm.

2. Which term is used for the difference between current assets and current liabilities?

A. Current Ratio

B. Working Capital

C. Net Assets

D. Gross Profit

The term that refers to the difference between current assets and current liabilities is working capital. Working capital is a crucial financial metric that indicates a company's short-term financial health and operational efficiency. It reflects the liquidity available to a business for its day-to-day operations. When calculating working capital, current assets include cash, accounts receivable, inventory, and other assets that are expected to be converted into cash within a year. Current liabilities, on the other hand, consist of obligations that the company needs to settle within a year, such as accounts payable and short-term debt. This calculation is important because it helps assess whether the company has enough short-term assets to cover its short-term liabilities. A positive working capital indicates that a company is in a position to pay off its short-term liabilities with its short-term assets, suggesting good financial health. In contrast, the current ratio measures the relationship between current assets and current liabilities, while net assets refer to the total assets minus total liabilities, and gross profit pertains to sales revenue minus the cost of goods sold. Each of those terms serves a different analytical purpose and cannot directly be used to represent the difference between current assets and current liabilities.

3. What do you call the amount a company receives above par value from selling stock to investors?

A. Paid-In-Capital

B. Common Stock

C. Capital Surplus

D. Share Premium

The correct term for the amount a company receives above par value from selling stock to investors is referred to as Paid-In-Capital. This term specifically designates the total amount of cash or other assets that shareholders have invested in the company above the par value of the stock. In financial contexts, par value is a nominal value assigned to shares of stock, and when shares are sold for more than this amount, the excess is classified as paid-in capital. This reflects the additional premium that investors are willing to pay over the nominal value, indicating their belief in the company's future prospects and current value. While terms like Common Stock refer to the type of shares that investors purchase, and Capital Surplus or Share Premium may be used in specific contexts, Paid-In-Capital is the standardized term that encompasses the amount received in excess of par value across a variety of equity financing scenarios. Therefore, it accurately captures the concept behind the question asked.

4. Which of the following is a potential disadvantage of diversification?

A. Increases overall market risk

B. Can lead to lower returns

C. Reduces the need for financial ratios

D. Concentrates risk in fewer assets

The notion that diversification can lead to lower returns centers on the trade-off between risk and reward in investment strategies. While diversification is generally employed to reduce risk by spreading investments across various assets, sectors, or geographical locations, it may also result in diluting the potential for higher returns an investor could achieve by concentrating their investments in a few high-performing assets. When an investor diversifies, they are essentially balancing their portfolio across a wider array of opportunities. Although this strategy reduces the impact of poor performance by any single investment, it also limits the chance to fully capitalize on a major gain from a standout asset. Hence, while the overall risk may diminish, the investor may not attain the higher return levels they might have expected from a less diversified, more focused investment strategy. In essence, the trade-off for creating a buffer against potential losses through diversification can manifest as a constraint on the overall growth of returns, particularly in buoyant market conditions where specific assets significantly outperform the market average. This understanding is crucial for investors who need to weigh the benefit of reduced risk against the potential for maximizing returns.

5. When a firm uses a broker for its stock issue and aims to sell shares for a commission, this distribution method is known as?

A. Firm Commitment

B. Best Efforts

C. Selling Group

D. Syndicate Offering

When a firm uses a broker for its stock issue and intends to sell shares for a commission, this distribution method is referred to as "Best Efforts." In a Best Efforts arrangement, the broker commits to selling as many shares as possible, but does not guarantee that the entire issue will be sold. Instead, the firm pays the broker a commission based on the number of shares sold, and the broker acts as an intermediary, attempting to place the shares with investors. This method is advantageous for the issuing firm because it bears less risk compared to other methods like Firm Commitment, where the underwriter guarantees the sale of the entire issue and provides a certain amount of capital upfront. In contrast, the Best Efforts approach allows the firm to retain some flexibility regarding the amount of capital it raises, depending on market conditions and investor interest. In summary, the Best Efforts distribution method involves a broker selling shares on behalf of the firm for a commission without guaranteeing the full sale of the issue, making it a lower-risk option for the issuer.

6. Which of the following investment strategies is likely to involve a higher risk?

A. Investing in government bonds

B. Investing in blue-chip stocks

C. Investing in technology startups

D. Investing in utility stocks

Investing in technology startups is typically associated with a higher level of risk due to several factors inherent in the nature of startups. Unlike established companies, technology startups are often in their early phases of development and may not yet have a proven business model or revenue stream. This volatility can lead to significant fluctuations in value, making the investment riskier. Additionally, many technology startups operate in highly competitive and rapidly changing markets where innovations and consumer preferences can shift quickly, further increasing uncertainty. Investors in startups may also face illiquidity, as it can be challenging to sell shares in private companies compared to publicly traded stocks. In contrast, investing in government bonds, blue-chip stocks, or utility stocks generally involves less risk. Government bonds are considered one of the safest investments due to their backing by the government. Blue-chip stocks, representing well-established companies with a history of stable earnings, tend to provide steady returns. Utility stocks, known for their consistent dividends and stable demand, also offer lower risk compared to the speculative nature of technology startups.

7. What does it mean when an underwriter 'assumes the risk' during underwriting?

A. The underwriter guarantees all investors a profit.

B. The underwriter agrees to purchase all issued securities.

C. The underwriter takes the financial risk of selling securities at a profitable price.

D. The underwriter only markets the securities without any responsibility.

When an underwriter 'assumes the risk' during underwriting, it means that the underwriter takes on the financial risk associated with the sale of securities. This involves the underwriter agreeing to purchase the securities from the issuer and then selling them to the public or to investors. If the underwriter cannot sell the securities at a profitable price, they may incur a loss. This is a key aspect of the underwriting process, as it highlights the underwriter's commitment to ensure that the issuer receives the funds they need while also aiming for a return on investment. The underwriter's assumption of risk often entails evaluating the potential market demand for the securities and pricing them appropriately to encourage investors while also ensuring the underwriter can cover their costs. This role is crucial in maintaining the overall stability of the financial markets, as underwriters help to facilitate the flow of capital between issuers and investors. In contrast, the other options do not accurately capture the essence of risk assumption in underwriting. For instance, guaranteeing profits for investors does not reflect the inherent uncertainties of market performance, while agreeing to purchase all issued securities may misrepresent the structured process of risk and profit-sharing between the underwriter and the issuer. Lastly, simply marketing the securities without any responsibility neglects the

8. What do bonds represent in financial terms?

A. Ownership in a company

B. A loan made by an investor to a borrower

C. Fixed deposit accounts at banks

D. A type of equity investment

Bonds represent a loan made by an investor to a borrower, typically a corporation or government. When an investor purchases a bond, they are essentially lending their money to the issuer of the bond in exchange for periodic interest payments and the return of the bond's face value at maturity. This relationship establishes a debt obligation, where the issuer is required to pay back the principal plus interest, which compensates the investor for the use of their funds over time. In contrast, ownership in a company relates to equity investments, where investors hold shares and have a claim on the company's assets and earnings. Fixed deposit accounts are a different type of financial product offered by banks that provide a fixed interest rate over a specified term, and are not the same as bonds. Equity investments involve taking ownership stakes in companies, which is fundamentally different from being a creditor through bonds. Understanding bonds as a debt instrument distinguishes them from other financial instruments that involve ownership or deposits.

9. What term refers to the bottom line of an income statement that indicates net profit or loss?

A. Operating Income

B. Gross Profit

C. Net Income

D. Retained Earnings

The term that refers to the bottom line of an income statement indicating net profit or loss is "Net Income." This figure represents the total earnings of a company after all expenses, taxes, and costs have been subtracted from total revenue. It is a crucial indicator of a company's profitability and is often used by investors to gauge the financial health of a business. Net Income is derived from calculating revenues minus expenses, and it reflects the amount available for shareholders after all obligations have been met. This makes it the most comprehensive measure of a company's financial performance over a specific period. In contrast, other terms like Operating Income and Gross Profit reflect different profitability levels. Operating Income accounts only for revenues and expenses associated with primary business activities, while Gross Profit is the difference between sales revenue and the cost of goods sold, not considering operational expenses or taxes. Retained Earnings represent the cumulative profits retained in the business rather than distributed as dividends, and it appears on the balance sheet rather than the income statement. Therefore, "Net Income" stands out as the definitive measure of profit or loss in an income statement.

10. Which of the following occurs when a company has an initial public offering?

A. Trading of existing shares begins.

B. The company issues new shares to the public.

C. Bond financing is initiated.

D. The company enters bankruptcy.

When a company has an initial public offering (IPO), it issues new shares to the public for the first time. This process allows the company to raise capital by selling equity to a broad base of investors. The funds raised from the IPO can be used for various purposes, such as funding expansion, paying off debt, or investing in new projects. An IPO transforms a private company into a publicly traded one, enabling it to access the capital markets for future financing. Trading of existing shares typically occurs after an IPO has taken place and the shares are available on the stock exchange, which is not the primary function of an IPO. Bond financing is unrelated to the issuance of shares, as it pertains to debt securities rather than equity. Lastly, entering bankruptcy signifies financial distress, which is the opposite of the goal of an IPO, as companies undertake IPOs to improve their financial standing and growth potential.