**CHAPTER 18**

1. Below is a balance sheet of a firm:

**Assets Liabilities and owner’s equity**

Financial assets 20 Liabilities 70

Real assets 80 Equity 30

Total 100 Total 100

Suppose that the firm makes a profit of 10 which is paid out to the shareholders.   
What happens to the balance sheet?

1. Real assets increase to 90 and equity increases to 40
2. Liabilities increase to 80 and equity falls to 20
3. Financial assets fall to 10 equity falls to 20
4. **The balance sheet remains unchanged**
5. Real assets fall to 40 and equity falls to minus 10; the firm is insolvent
6. Below is a balance sheet for a firm:

**Assets Liabilities and owner’s equity**

Financial assets 20 Liabilities 70

Real assets 80 Equity 30

Total 100 Total 100

Suppose that the firm makes a loss and has to borrow 10 from the bank to finance the operations.  
What happens to the balance sheet?

1. Real assets increase to 90 and equity increases to 40
2. **Liabilities increase to 80 and equity falls to 20**
3. Financial assets fall to 10 equity falls to 20
4. The balance sheet remains unchanged
5. Real assets fall to 40 and equity falls to minus 10; the firm is insolvent
6. Below is a balance sheet for a firm:

**Assets Liabilities and owner’s equity**

Financial assets 20 Liabilities 70

Real assets 80 Equity 30

Total 100 Total 100

Suppose that the firm makes a profit of 10 which is used to finance purchase of machines.   
What happens to the balance sheet?

1. **Real assets increase to 90 and equity increases to 40**
2. Liabilities increase to 80 and equity falls to 20
3. Financial assets fall to 10 equity falls to 20
4. The balance sheet remains unchanged
5. Real assets fall to 40 and equity falls to minus 10; the firm is insolvent
6. Below is a balance sheet for a firm:

**Assets Liabilities and owner’s equity**

Financial assets 20 Liabilities 70

Real assets 80 Equity 30

Total 100 Total 100

Suppose that 50 percent of the real assets turn out to be useless and must be written off.   
What happens to the balance sheet?

1. Real assets increase to 90 and equity increases to 40
2. Liabilities increase to 80 and equity falls to 20
3. Financial assets fall to 10 equity falls to 20
4. The balance sheet remains unchanged
5. **Real assets fall to 40 and equity falls to minus 10; the firm is insolvent**
6. To make an investment an entrepreneur/shareholder has to borrow funds and the promised repayment (including interest) is 100. The entrepreneur can choose between two projects: A and B. Project A gives 110 with certainty. Project B gives 130 with 50 percent probability and 70 with 50 percent probability. Which of the following statements is correct if the entrepreneur is risk neutral?
7. **Project A gives the highest total expected return and project B is preferred by the shareholder**
8. Project B gives the highest total expected return and project A is preferred by the shareholder
9. Project A gives the highest total expected return and it is also preferred by the shareholder
10. Project B gives the highest total expected return and it is also preferred by the shareholder
11. To make an investment an entrepreneur/shareholder has to borrow funds and the promised repayment including interest is 100. The entrepreneur can choose between two projects: A and B. Project A gives 110 with certainty. Project B gives 130 with 50 percent probability and 70 with 50 percent probability. Which of the following statements is correct?
12. Project A gives the highest total expected return and project B is preferred by the lender
13. Project B gives the highest total expected return and project A is preferred by the lender
14. **Project A gives the highest total expected return and it is also preferred by the lender**
15. Project B gives the highest total expected return and it is also preferred by the lender
16. To make an investment an entrepreneur/shareholder has to borrow funds and the promised repayment including interest is 100. The entrepreneur can choose between two projects: A and B. Project A gives 110 with certainty. Project B gives 150 with 50 percent probability and 90 with 50 percent probability. Which of the following statements is correct?
17. Project A gives the highest total expected return and project B is preferred by the shareholder
18. Project B gives the highest total expected return and project A is preferred by the shareholder
19. Project A gives the highest total expected return and it is also preferred by the shareholder
20. **Project B gives the highest total expected return and it is also preferred by the shareholder**
21. To make an investment an entrepreneur/shareholder has to borrow funds and the promised repayment including interest is 100. The entrepreneur can choose between two projects: A and B. Project A gives 110 with certainty. Project B gives 150 with 50 percent probability and 90 with 50 percent probability. Which of the following statements is correct?
22. Project A gives the highest total expected return and project B is preferred by the lender
23. **Project B gives the highest total expected return and project A is preferred by the lender**
24. Project A gives the highest total expected return and it is also preferred by the lender
25. Project B gives the highest total expected return and it is also preferred by the lender
26. Which of the following statements is most relevant?
27. Banks need bank reserves to deal with unforeseen defaults on loans
28. Banks need liquid assets to deal with unforeseen defaults on loans
29. **Banks need sufficient equity capital to deal with unforeseen defaults on loans**
30. Banks need sufficient equity capital to deal with unforeseen withdrawals of deposits
31. Which of the following statements is most relevant?
32. To deal with unforeseen defaults on loans, banks need bank reserves
33. To deal with unforeseen defaults on loans, banks need liquid assets
34. **To deal with unforeseen withdrawals of deposits, banks need liquid assets**
35. To deal with unforeseen withdrawals of deposits, banks need sufficient equity capital
36. Which factor will make a bank run less likely?
37. Deposits that can be withdrawn at short notice
38. Deposit holders are poorly informed about the situation of the bank
39. **There is deposit insurance which is backed by the government**
40. Deposit holders are poorly informed about what other deposit holders do
41. A key element of the Basel agreements is “capital requirements”. What is the point of “capital requirements”?
42. **The debts of the banks should not be too large relative to assets**
43. A certain fraction of the assets must be deposited in an account with the central bank
44. A certain fraction of assets must be held as bank reserves
45. A certain fraction of assets must be held as liquid assets
46. A certain fraction of assets must be deposited in a special account
47. The equity of the bank should not be too large relative to assets
48. What is the main reason why governments often take over large banks when they are in trouble?
49. To protect the owners of the bank because they play a central role in the financial system
50. To protect the assets of the small deposit holders who would otherwise lose their money
51. **To prevent other financial institutions and firms, who have claims on the bank, also getting in trouble**
52. To profit from buying bank shares when they are really cheap
53. To take a step towards communism