CHAPTER 1

(readings: chapter 1 of BMA)

1. Investment and financing decisions. Read the following passage: "Companies usually buy (a) assets. These include both tangible assets such as (b) and intangible assets such as (c). To pay for these assets, they sell (d) assets such as (e). The decision about which assets to buy is usually termed the (f) or (g) decision. The decision about how to raise the money is usually termed the (h) decision."

Now fit each of the following terms into the most appropriate space: financing, real, bonds, investment, executive airplanes, financial, capital budgeting, brand names.

2. Investment and financing decisions. Which of the following are real assets, and which are financial?

a. A share of stock.
b. A personal IOU ("I wow you" document - similar to a bank check).
c. A trademark.
d. A factory.
e. Undeveloped land.
f. The balance in the firm's checking account.
g. An experienced and hardworking sales force.
h. A corporate bond.

3. Explain the differences between:

a. Real assets and financial assets.
b. Capital budgeting and financing decisions.
c. Unlimited liability and limited responsibility.

4. Which of the following statements always apply to corporations.

a. Unlimited liability.

b. Limited life.

c. Ownership can be transferred without affecting operations.

d. Managers can be fired with no effect on ownership.

5. Corporate goals. We can imagine the financial manager doing several things on behalf of the firm's stockholders. For example, the manager might:

a. Make shareholders as wealthy as possible by investing in real assets.
b. Modify the firm's investment plan to help shareholders achieve a particular time pattern of consumption.
c. Choose high- or low-risk assets to match shareholders' risk preferences.
d. Help balance shareholders' checkbooks.

But in well-functioning capital markets, shareholders will vote for only one of these goals. Which one? Why?

6. Maximizing shareholder value Ms. Espinoza is retired and depends on her investments for her income. Mr. Liu is a young executive who wants to save for the future. Both are stock-holders in Scaled Composites, LLC, which is building SpaceShipOne to take commercial passengers into space. This investment's payoff in many years away. Assume it has a positive NPV for Mr. Liu. Explain why this investment also makes sense for Ms. Espinoza.

7. Opportunity cost of capital. F&H Corp. continues to invest heavily in a declining industry. Here is an excerpt from a recent speech by F&H's CFO:

We at F&H have of course noted the complaints of a few spineless investors and uninformed security analysts about the slow growth of profits and dividends. Unlike those confirmed doubters, we have confidence in the long-run demand for mechanical encabulators, despite competing digital products. We are therefore determined to invest to maintain our share of the overall encabulator market. F&H has a rigorous CAPEX approval process, and we are confident of returns around 8% on investment. That's a far better return than F&H earns on its cash holdings. The CFO went on to explain that F&H invested excess cash in short-term U.S. government securities, which are almost entirely risk-free but offered only a 4% rate of return.

a. Is a forecasted 8% return in the encabulator business necessarily better than a 4% safe return on short-term U.S. government securities? Why or why not?
b. Is F&H's opportunity cost of capital 4%? How in principle should the CFO determine the cost of capital?

8. Ethical issues The Beyond the Page feature, "Goldman Sachs Causes a Ruckus," describes the controversial involvement of Goldman Sachs in a mortgage-backed securities deal in 2006. When this involvement was revealed, the market value of Goldman Sachs' common stock fell overnight by $10 billion. This was far more than any fine that might have been imposed. Explain.

9. Agency issues. Why might one expect managers to act in shareholders' interests? Give some reasons.