Chapter 1 Solutions

1-1 Finance deals with decisions about money. Finance decisions deal with how money is raised and used by businesses, governments, and individuals. In business, decisions about cash inflows include for what price products should be sold, how funds should be raised when the firms has good investment opportunities, and so forth; decisions about cash outflows include what expenses must be incurred, which investments should be purchased, and so forth.

1-2 Simply stated, everyone should have a basic understanding of finance because everyone faces financial decisions daily, whether those decisions are as simple as determining how much money to carry in one’s pocket or required more sophisticated thought processes, such as the purchase of a house or making retirement plans.

1‑3 The value of a firm can be measured by the market value of its stock. Thus, the firm maximizes value/wealth by maximizing the value of it stock.

1-4 Value is measured as the present value of the cash flows that an investment is expected to generate during its life. The three factors that determine value are: (1) the amount of the future cash flows, (2) the timing of the future cash flows, and (3) investors’ required rate of return. If the amount of the cash flows increases, the cash flows are received sooner, investors’ required rate of return decreases, or any combination of these events occur, the value of an investment will increase.

1‑5 Profit maximization abstracts from (1) the timing of profits and (2) the riskiness of different operating plans. How­ever, both of these factors are reflected in stock price maximiza­tion. Thus, profit maximization would not necessar­ily lead to stock price maximization. A firm could maximize its current profit but go bankrupt in the near future by implementing “corner-cutting” measures that increase profits. Such measures might include not replacing equipment when it is worn out, decreasing the quality of the product that is manufactured and sold, reducing the number of employees, and so forth.

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1-7 The answer to this question depends on which action satisfies you more, but chance are that you would be inclined to maximize your personal satisfaction, which does not preclude you from maximizing the value of the business. No agency problem exists in a proprietorship, because there is only one owner, and he or she is the person who makes the day-to-day business decisions.

1-8 Provided that the rate of return on assets exceeds the interest rate on debt, greater use of debt will raise the expected rate of return on stockholders' equity. Also, the interest on debt is tax deductible, which provides a further advan­tage. However, (1) greater use of debt will have a negative impact on the stockholders if the Company's return on assets falls below the cost of debt, and (2) increased use of debt increases the chances of going bankrupt. The effects of the use of debt, called "financial leverage," are spelled out in detail in Chapter 17.

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1-10 Taking into account differential labor costs abroad, transportation, tax advantages, and so forth, U.S. corporations can maximize long‑run profits. There are also nonprofit behavioral and strategic considerations, such as maximizing market share and enhancing the prestige of corporate officers.

1-11 Factors that make financial decision making more complicated for firms that operate in foreign countries include differences in: currency, language, culture, governmental relations, political risk, legal structure, and economy. The general techniques and concepts applied by purely domestic firms are valid for multinational firms. These factors, however, increase the risks that multinational firms face when making financial decisions.

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