FIN104 Tutorial Answers - Week 2

1. Financial Markets and Institutions. True or false? (CH2.Q3)

a. Financing for public corporations must flow through financial markets.

b. Financing for private corporations must flow through financial intermediaries.

c. Almost all foreign exchange trading occurs on the floors of the FOREX exchanges in New York and London.

d. Derivative markets are a major source of finance for many corporations.

e. The opportunity cost of capital is the capital outlay required to undertake a real investment opportunity.

f. The cost of capital is the interest rate paid on borrowing from a bank or other financial institution.

Answer:

a. False. Financing could flow through an intermediary.

b. False. Investors can buy shares in a private corporation.

c. False. There is no centralized FOREX exchange. Foreign exchange trading takes place in the over-the-counter market.

d. False. Derivative markets are not sources of financing, but markets where the financial manager can adjust the firm's exposure to various business risks.

e. False. The opportunity cost of capital is the expected rate of return that shareholders can earn in the financial markets on investments with the same risk as the firm's capital investments.

f. False. The cost of capital is an *opportunity* cost determined by expected rates of return in the financial markets. The opportunity cost of capital for risky investments is normally higher than the firm's borrowing rate.

2. **Financial Institutions. Summarize the differences between a commercial bank and an investment bank. (CH2.Q12)**

   Answer: Commercial banks accept deposits and provide financing primarily for businesses. Investment banks do not accept deposits and do not loan money to businesses and individuals. Investment banks may make bridge loans as temporary financing for a takeover or acquisition. In addition, investment banks trade many different financial contracts, such as bonds and options, while providing investment advice and portfolio management for institutional and individual investors.

3. **The Financial Crisis. True or false? (CH2.Q19)**
   a. The financial crisis was largely caused by banks taking large positions in the options and futures markets.
   b. The prime cause of the financial crisis was an expansion in bank lending for the overheated commercial real estate market.
   c. Many subprime mortgages were packaged together by banks for resale as mortgage-backed securities (MBSs).
   d. The crisis could have been much more serious if the government had not stepped in to rescue Merrill Lynch and Lehman Brothers.
   e. The crisis in the eurozone finally ended when other eurozone countries and the IMF provided a massive bailout package to stop Greece from defaulting on its debts.

   Answer:

   a. False. The financial crisis had its roots in an easy monetary policy that provided funds for banks to expand the supply of subprime mortgages to low-income borrowers.

   b. False. Subprime mortgages are for residential properties.

   c. True. Most subprime mortgages were packaged together to be resold as mortgage-backed securities (MBSs), though many banks retained exposure to these securities.

   d. False. The government arranged for Bank of America to take over Merrill but did nothing to rescue Lehman Brothers, which filed for bankruptcy protection.

   e. False. Though the massive bailout of Greece calmed the markets somewhat, concerns over Greece and other weak eurozone countries, such as Portugal, Italy, Spain, and even Ireland, remain today.

4. **Financial Statements. Henry Josstick has just started his first accounting course and has pre- pared the following balance sheet and income statement for Omega Corp. Unfortunately, although the data for the individual items are correct, he is very confused as to whether an item should go in the balance sheet or income statement and whether it is an asset or liability. Help him by rearranging the items and filling in the blanks. (CH3.Q8)**

   What is the correct total for the following?
   a. Current assets
   b. Net fixed assets
   c. Total assets
   d. Current liabilities
   e. Total liabilities
   f. Total liabilities and shareholders' equity
   g. EBIT
   h. Taxable income
   i. Net income

BALANCE SHEET			
Payables	$ 35	Inventories	$50
Less accumulated depreciation	120	Receivables	35
Total current assets		Total current liabilities	
Long-term debt	$350	Interest expense	$25
Property, plant, and equipment	520	Total liabilities	
Net fixed assets		Shareholders' equity	$90
Total assets		Total liabilities and shareholders' equity	

INCOME STATEMENT	
Net sales	$700
Cost of goods sold	580
Selling, general, and administrative expenses	38
EBIT	
Debt due for repayment	$ 25
Cash	15
Taxable income	
Federal plus other taxes	$ 15
Depreciation	12
Net income	

Answer: See answers in financial statements.

Balance Sheet			
Assets		Liabilities & Shareholders' Equity Shareholders' Equity	
Cash	15	Debt due for repayment	25
Receivables	35	Payables	35
Inventories	50	Total current liabilities	60
Total current assets	100		
		Long- term debt	350
Property, plant and equipment	520	Total liabilities	410
Less accumulated depreciation	120	Shareholders' equity	90
Net fixed assets	400		
Total assets	500	Total liabilities and shareholders' equity	500

Income Statement	
Net sales	700
Cost of goods sold	580
Selling, G & A expenses	38
Depreciation	12
EBIT	70
Interest expense	25
Taxable income	45
Taxes	15
Net Income	30