Chapter 1

Practice Problems

1. What are the two major categories of financial securities issued by firms?
2. Who are the owners of a corporation?
3. What rule do shareholders want managers to use to make decisions?
4. What is limited liability? *Who* has it?
5. What are the three major types of decisions that firms make?
6. How does maximizing shareholder value affect society?
7. What are some societal responses to the externalities of maximizing shareholder wealth?
8. Describe the conflict between managers and shareholders. Give an example of a way to align manager and shareholder interests.
9. What is the conflict of interest between shareholders and debtholders, and what drives it?
10. Give an example of a way to align the incentives of shareholders and bondholders (i.e. an example of how the conflict can be resolved)?

Chapter 1

Practice Problems (w/ answers)

1. What are the two major categories of financial securities issued by firms? **Stocks and bonds**
2. Who are the owners of a corporation? **Shareholders**
3. What rule do shareholders want managers to use to make decisions? **Maximize shareholder wealth**
4. What is limited liability? *Who* has it? **Limited liability means that shareholders are not liable to other claimants for corporate actions. In particular, shareholders can only lose—at a maximum—their original investment.**
5. What are the three major types of decisions that firms make? **Investment, financing, and payout.**
6. How does maximizing shareholder value affect society? **It encourages companies to make goods and services that are desirable (people are willing to pay for them), in a cost efficient manner. It also encourages companies to abuse social free goods and induces monopolistic behavior.**
7. What are some societal responses to the externalities of maximizing shareholder wealth? **Regulation, consumer activism, and investor activism.**
8. Describe the conflict between managers and shareholders. Give an example of a way to align manager and shareholder interests. **Managers may prefer to engage in activities that they fully benefit from, but only bear a fraction of the cost of (e.g. golf vs. work, empire building, etc). One way to mitigate this conflict is to make managers bear a greater fraction of the cost of such waste—to make their proportional ownership of the company greater (i.e. the manager owns more shares). Firms can compensate the manager through stock options rather than through cash.**
9. What is the conflict of interest between shareholders and debtholders, and what drives it? **Shareholders prefer to engage in activities that have higher risk than debtholders would like. Limited liability drives this for the following reason. Higher risk associates with higher potential gains and losses to the firm. If the firm gains, debtholders do not participate in that gain since they are promised a fixed amount. On the other hand, equity experiences the benefits of the gains. If the firm loses, promises may not be kept to debtholders if there are insufficient resources to pay them, and they have no recourse to recover the lost amount from equity holders due to limited liability.**
10. Give an example of a way to align the incentives of shareholders and bondholders (i.e. an example of how the conflict can be resolved)? **Examples of debtholder responses designed to mitigate this conflict (though these responses are costly) include: covenants in the debt contract, secured debt (backed by specific firm resources), and convertible debt (i.e. can be converted into equity when advantageous to the debtholder).**