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 they are decisions that require more sophisticated thought processes, such as the purchase of a house or making retirement plans. Persons who make business decisions must understand finance because their decisions generally include an element of finance in the sense that the results of their decisions generally require some type of funding to be operationalized.

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 its 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.

1-6 Such factors as a compensation system that is based on management performance (bonuses tied to profits, stock op­tion plans) as well as the possibility of being removed from office (voted out of office, an unfriendly tender offer by another firm) serve to keep management's focus on stockhold­ers' interests. If a firm is taken over, or acquired, by another firm, generally top management is let go. To help ensure that they are not in this position, management should take steps to make the firm is operated as efficient as possible. Efficient firms generally are priced correctly in the financial markets, thus are not takeover targets.

1-7 The answer to this question depends on which action satisfies you more as the sole owner of the business. But, chances 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 16.

1-9 Corporate governance refers to the “set of rules” that a firm follows when conducting business. In general, corporate governance relates to the manner in which a firm is operated. Corporate governance affects the manner in which a firm approaches its decision-making tasks, treats its employees and customers, constructs its financial statements, and so forth. Because its governance policy affects how a company does business, corporate governance is a major factor that determines whether a firm “acts” ethically. If a firm does not have a good corporate governance policy—that is, a good set of rules to follow—then there is a chance that management might behave unethically—either intentionally or unintentionally—at some point. Firms that have good corporate governance policies generally have higher values than firms that don’t.

1-10 Firms “go international” for many reason, including to seek new markets, to get access to raw materials, to avoid political hurdles, to name a few. 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.

1-12 The general areas of study in finance include: (1) financial markets and institutions, which includes the study of the roles of banks, credit unions, and other financial organizations in the financial markets; (2) investments, which focuses on how investments are valued and selected to be included in portfolios; (3) financial services, which refers to the area of study that deals with the management of money, primarily for individuals; and (4) managerial finance, which deals with how firms make decisions about their cash flows, both inflows and outflows.

Simply stated, finance deals with how firms generate and use funds. To do a good job, people must understand how all four of the areas of finance are related. For example, publicly-traded firms raise money in the financial markets, which means financial managers must understand the financial markets. Likewise, persons who work in the financial markets must understand the needs of publicly-traded firms and of investors to ensure they are offering the right financial products.

1-13 Proprietorship, partnership, and corporation are the three principal forms of business organization. The advantages of the first two include the ease and low cost of formation. The advantages of the corporation include limited liability, indefinite life, ease of ownership transfer, and access to capital markets.

The disadvantages of proprietorships and partnerships are (1) difficulty in obtaining large sums of capital; (2) unlimited personal liability for business debts; (3) limited life; and (4) difficulty of transferring ownership. The disadvantages of a corporation are (1) double taxation of earnings and (2) setting up a corporation and filing required state and federal reports are complex and time-consuming.

1-14 Hybrid forms of business have been created over the years as the result of the needs of businesspeople and investors. The hybrid forms of business generally include the advantages of partnerships and corporations in one business. As business operations change in the future, so too will the structure of business organizations.

1-15 Ethics refers to the attitude and behavior that a firm applies when dealing with stakeholders. A firm must consider all of its stakeholders—that is, investors, customers, employees, local community, environment, and so forth—when conducting business; otherwise it will not stay in business for very long. For example, if a firm makes huge profits at the expense of its customers, then the customers will quit purchasing from the firm when they discover how they have been treated—the customers will either begin purchasing from competitors or find substitute products to purchase. As a result, although their satisfaction does not have to be maximized, the firm must find a way to keep all stakeholders happy. Likewise, if a firm focuses only on its common stockholders, other stakeholders will take appropriate actions, which could mean the death of the company. A firm that increases the value of its stock in the short run risks going out of business, because such a short-run decision is short-sighted and can be extremely harmful to long-run success of the firm.

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1-17 The corporate structure of foreign firms generally is characterized by greater concentration in ownership, which often means more involvement in ownership and operations by large lenders, such as banks and other financial institutions, and by large groups or families. In many instances, this means that banks, other financial institutions, and ownership groups can meet most or all of the financing needs of a firm. In the United States, on the other hand, banks and financial institutions are restricted in the amounts of corporate debt and stock they can own. Thus, most large U.S. firms have very dispersed ownership structures because they must raise needed funds from a large number of sources—it generally is not possible to get the large amount of funds needed from a single source or even from very few sources. “One-stop” financing outlets do not currently exist in the United States. It is argued that greater concentration in ownership breeds fewer agency-related problems, so that managers can better focus on maximizing the wealth of the firm, which are also their self-fulfilling goals. In addition, because creditors generally have a significant ownership position in the firm, it is in their best interests to make sure the firm is successful. Therefore, when financial difficulties arise, such creditors are perhaps more likely to “bail out” the company than creditors in the United States. On the other hand, many argue that the foreign ownership structures create a corporate environment in which managers can easily become entrenched; thus, it is very difficult to get rid of inefficient management. In addition, creditors might be too eager to try to save failing firms, and hence turn “good money” into a “bad money” when they should actually walk away and not compound their existing losses.

It is difficult to say which form of business organization is better—the “open” company with disperse ownership we have in the United States and Canada, or the more “closed” company with more concentrated ownership we find in Japan, Germany, and many other countries. Government regulations, the sophistication of both the financial markets and the product markets, and the culture of the country impact greatly on which type of business organization works better.

1-18 Stockholder wealth maximization is a long‑run goal. Companies, and consequently the stockholders, prosper when man­agement makes decisions that will produce long‑term increases in earnings. Actions that are continually short‑sighted often “catch up” with a firm and, as a result, it may find itself unable to compete effectively against its competi­tors. There has been much criticism in recent years that U.S. firms are too short‑run profit oriented. A prime example was the U.S. auto industry in the 1970s and early 1980s, which was accused of continuing to build large “gas guzzler” auto­mobiles because they had higher profit margins rather than retooling for smaller, more fuel‑efficient models.

1-19 (a) Agency problems should not exist in a proprietorship, because there is only one owner, who generally is the sole decision maker. The owner operates the business in a fashion that will improve his or her own welfare. Thus, the owner can do whatever makes him or her happy, even if such actions are harmful to the business.

(b) As more owners are included in a business, the likelihood of agency problems increases because the potential for conflicts as to what actions promote the best interests of all owners increases. As a result, the possibility of agency problems in a partnership is greater than in a proprietorship. And, businesses with greater numbers of partners have greater chances of experiencing agency problems.

(c) As mentioned in part (b), the greater the number of owners in a business, the greater the possibility of agency problems. Consequently, we would expect the potential for agency problems to be much greater in a corporation with 100,000 stockholders than in a partnerships with 100 partners. Similarly, we would expect the possibility of agency problems to be even greater in a corporation that is publicly traded with millions of stockholders.

1-20 The statement is not valid in every instance. Clearly, there are cases in which a firm’s stock price has declined as the result of managerial decisions that were not in the best interest of shareholders. However, the stock prices of firms are also based on external factors, including economic conditions. In a poor economy, the stock prices of most companies decline even when management is making decisions that are considered in the best interests of their shareholders.