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Solutions Manual for Fundamentals of Corporate Finance 6th Parrino

SOLUTIONS MANUAL SAMPLE PREVIEW

PUBLISHER
Wiley

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2025

RESOURCE TYPE
Solutions Manual

ISBN
9781394243853

Solutions Manual for Fundamentals of Corporate Finance 6th Edition by Parrino, Bates, Gillan, Kidwell

ISBN: 9781394243853

Chapter 1: The Financial Manager and the Firm

Annotated Lecture Outline

Learning Objective 1.1: Identify the key financial decisions facing the financial manager of any business.

The financial manager faces three basic decisions (1) which productive assets the firm should buy (capital budgeting decisions), (2) how the firm should finance the productive assets purchased (financing decisions), and (3) how the firm should manage its day-to-day financial activities (working capital decisions). The financial manager should make these decisions in a way that maximizes the current value of the firm's stock.

THE ROLE OF THE FINANCIAL MANAGER

a. The financial manager is responsible for making decisions that are in the best interests of the firm's owners.
    i. The decisions made by a financial manager or owner should be one and the same.
    ii. The financial manager should make decisions that maximize the value of the owners' stock.
    iii. This helps maximize the owners' wealth, which is the economic value of the assets the owner possesses.

STAKEHOOLDERS

a. A stakeholder is someone other than an owner who has a claim on the cash flows of the firm.
    i. Stakeholders include managers, who want to be paid salaries and performance bonuses.
    ii. Other employees who want to be paid wages.
    iii. Suppliers who want to be paid for goods and services.
    iv. Creditors who want to be paid interest and principal.
    v. Government which wants the firm to pay taxes.

IT'S ALL ABOUT CASH FLOWS

a. Productive assets are long-term assets.
    i. Productive assets can be tangible and intangible assets.
b. Capital budgeting is the decision making process through which the firm purchases productive assets.

        i. Capital budgeting is one of the most important decision processes in a firm.
   c. Financing decisions determine the ways in which firms obtain and manage long-term financing to acquire and support their productive assets.
   d. The two basic sources of funds are debt and equity.
   e. Residual cash flows is cash that remains after a firm meets its obligations.
        i. A firm can pay a cash dividend, repurchase shares, or reinvest in the business.
   f. A firm is unprofitable if it fails to generate sufficient cash inflows to pay operating expenses.
        i. Firms that are unprofitable over time will be forced into bankruptcy.

THREE FUNDAMENTAL DECISIONS IN FINANCIAL MANAGEMENT

   a. Capital budgeting decisions.
        i. Identifying the productive assets the firm should buy.
   b. Financing decisions.
        i. Determining how the firm should finance or pay for assets.
   c. Working capital management decisions.
        i. Determining how day-to-day financial matters should be managed so that the firm can pay its bills, and how surplus cash should be invested.

CAPITAL BUDGETING DECISIONS

   a. A capital budget is a list of the productive (capital) assets that management wants to purchase over a budget cycle.
   g. Process addresses which productive assets the firm should purchase and how much money the firm can afford to spend.
        i. Capital budgeting has a large impact on a firm's success or failure.

FINANCING DECISIONS

   a. Financing decisions determine how firms raise cash to pay for their investments.
   b. A major advantage of debt financing is that interest payments are tax deductible for many corporations.
        i. Debt financing increases a firm's risk because it creates a contractual obligation.
   d. Equity has no maturity, and there are no guaranteed payments to equity investors.
   e. The mix of debt and equity on the balance sheet is known as a firm's capital structure.
   f. Capital markets are financial markets where equity and debt instruments with maturities greater than one year are traded.

WORKING CAPITAL MANAGEMENT DECISIONS

a. Management must decide how to manage a firm's current assets, such as cash, inventory, and accounts receivable.
b. Management must decide how to manage the firm's current liabilities, such as trade credit and accounts payable.
c. The dollar difference between a firm's current assets and its current liabilities is called its net working capital.
d. The mismanagement of working capital can cause a firm to default on its debt and go into bankruptcy.
e. A firm's profitability can also be affected by its inventory level.
    i. A financial calculator is an ordinary calculator that has preprogrammed future value and present value algorithms.
    ii. A calculator can help eliminate computation errors and save time.

Learning Objective 1.2: Identify common forms of business organization in the United States and their respective strengths and weaknesses.

Businesses in the United States are commonly organized as a sole proprietorship, a general or limited partnership, a corporation, or a limited liability partnership or company. Most large firms elect to organize as C-corporations because of the ease of raising money; the major disadvantage is double taxation. Smaller companies tend to organize as sole proprietorships or partnerships. The advantages of these firms of organization include ease of formation and taxation at the personal income tax rate, The major disadvantage is the owners' unlimited personal liability. Limited liability partnerships and companies and S-corporations provide owners of small businesses, who make the business decisions, with limited personal liability.

SOLE PROPRIETORSHIPS

a. A sole proprietorship is a business that is owned by a single person.
    i. Life is limited to the period that the owner (proprietor) is associated with the business.
    ii. Simples and least expensive form of business to set up and is the least regulated.
    iii. One advantage of this type of structure is that the proprietor does not have to share decision making with anyone.
    iv. Disadvantages include the amount of equity capital that can be raised to finance the business, more costly to transfer ownership, and the proprietor must provide all the equity capital and manage the business.

PARTNERSHIPS

a. A partnership consists of two or more owners who have joined together legally to manage a business.

b. To form a partnership, the owners (partners) enter into an agreement that details how much capital each partner will invest in the partnership, what their management roles will be, how key management decisions will be made, and how profits will be divided.
c. Partnerships are more costly to form.
d. A key disadvantage of a general partnership is that all partners have unlimited liability.
    i. The problem of unlimited liability can be avoided in a limited partnership because limited partners can generally only lose the amount of money that they have invested in the business.

CORPORATIONS

a. A corporation is a legal entity authorized under a state charter.
    i. Can sue and be sued.
    ii. Can enter into contracts.
    iii. Borrow money.
    iv. Own assets.
b. Starting a corporation is more costly than starting a sole proprietorship.
    i. Requires writing articles of incorporation and by-laws that conform to the laws of the state of incorporation.
c. Corporate form of organization has several advantages.
    i. Shares can be sold to raise capital from investors who are not involved in the business.
    ii. Stockholders have limited liability because corporations are legal person that take actions in their own names,
    iii. Stockholders have limited liability for debts and other obligations.
d. An s-corporation is a form of corporation that can be used by private businesses.
    i. Can only have one class of stock and cannot have more than one hundred stockholders.
    ii. Stockholders cannot be corporations or nonresident alien investors.

LIMITED LIABILITY PARTNERSHIPS AND COMPANIES

a. Limited liability partnerships (LLP, combines some of the limited liability characteristics of a corporation with the tax advantage of a partnership.
    i. Partners are not personally liable for any other partner's malpractice or professional misconduct.
b. A limited liability company (LLC) provides limited liability to owners.

Learning Objective 1.3: Describe the typical organization of the financial function in a large corporation.

In a large corporation, the financial manager generally has the rank of vice president and goes by the title of chief financial officer. The CFO reports directly to the firm's CEO. Positions reporting directly to the CFO generally include the treasurer, the risk manager, the controller, and the internal auditor. The audit committee of the board of directors is also important in the financial function. The committee hires the external auditor for the firm, and the internal auditor, external auditor, and compliance and ethics director all report to the audit committee.

MANAGING THE FINANCIAL FUNCTION

a. Financia managers are concerned with a firm's investments, financing, and working capital management decisions.
b. The senior financial manager is the top executive in the firm.
    i. Usually has the rank of vice president or senior vice president.
    ii. Goes by the title chief financial officer.

ORGANIZATIONAL STRUCTURE

a. The chief executive officer (CEO) has the final decision-making authority among all the firm's executives.
    i. The CEO's most important responsibilities are to set the strategic direction.
b. The treasurer looks after the collection and disbursement of cash. value factor.
    i. Invests cash to earn interest.
    ii. Raises new capital
    iii. Manages foreign exchange transactions.
    iv. Oversees pension fund managers.
c. The controller is the firm's chief accounting officer.
    i. Staff prepares financial statements.
    ii. Maintains the financial and cost accounting systems.
    iii. Works closely with the external auditors.
d. The internal auditor is responsible for identifying and assessing major risks.

EXTERNAL AUDITOR

a. Virtually every large corporation hires a licensed certified public accounting (CPA) firm, to provide an independent annual audit of the firm's financial statements.

THE AUDIT COMMITTEE

a. The audit committee is a powerful subcommittee of the board of directors.
    i. Responsible for overseeing the accounting function and the firm's financial statements.
    ii. Conducts investigations of significant fraud.
    iii. The external auditor reports to the audit committee.

THE COMPLIANCE AND ETHICS DIRECTOR

a. Oversees three mandated programs.
    i. Compliance program that ensures that the firm complies with the federal and state laws and regulations.
    ii. An ethics program that promotes ethical conduct among executives and other employees.
    iii. A compliance hotline, which must include a whistleblower program.

<u>Learning Objective 1.4: Explain why maximizing stockholder value is the appropriate goal for management and discuss the alternative goals of stockholder value maximization and stockholder welfare maximization.</u>

Maximizing stockholder value is an appropriate goal because it forces management to focus on decisions that will generate the greatest amount of wealth for stockholders. Since the value of a share of stock (or any asset) is determined by its cash flows, management's decisions must consider the size of the cash flow (larger is better), the timing of the cash flow (sooner is better), and the riskiness of the cash flow (given equal returns, lower risk is better). Stakeholder value maximization instead argues that managers should maximize the wealth of all of the company's stakeholders including customers, employees, and suppliers. However, in maximizing stockholder value, managers must make decisions that account for the interest of all stakeholders-if stakeholders do not work with the company, it can interrupt the company's operations and destroy stockholder value. The alternative of stockholder value maximization argues managers should value shareholders' desire for broad environmental or societal benefits. The idea is that shareholder welfare is a combination of the stockholder's value in the company plus the value the stockholder places on these broader benefits. While this view recognizes that stockholders are increasingly asking companies to address such issues, it would be challenging for managers to implement this as a corporate goal given the wide range of environmental and social issues that a company's stockholders are interested in, and the difficulty of determining how shareholders value those issues. Any number of changes that are observed over time in physical and social sciences follow a compound growth rate pattern. The future value formula can be used in calculating these growth rates.

THE GOAL OF THE FIRM

a. The goal of the firm is to try to keep costs as low as possible and maximize sales or market share.

WHAT SHOULD MANAGEMENT MAXIMIZE?

a. To avoid the risk of bankruptcy, a firm should focus on keeping costs as low as possible.

i. Keep wages low and avoid borrowing.
ii. Maximize market share.

WHY NOT MAXIMIZE PROFITS?

a. The goal for decision making that seems reasonable is profit maximization.
    i. One problem with profit maximization is that it is hard to pin down what is meant by "profit."
    ii. Profits may not necessarily be the same as cash flows.
    iii. Does not distinguish between getting a dollar sometime in the future.
    iv. Ignores the uncertainty. Or risk, associated with cash flows.

MAXIMIZE STOCKHOLDER VALUE

a. Maximize stockholder value is an appropriate goal for management to maximize the current value of the firm's stock.
b. The financial manager's goal is to maximize stockholder value.

MAXIMIZE STOCKHOLDER WELFARE

a. Company operations may have a negative impact on the community or environment.
b. Shareholders may be willing to give up some value to avoid negative effects.
c. By reducing negative effects, the firm produces, corporate managers will maximize stockholder welfare.
d. Other investors have the view that environmental and social issues that go unaddressed by individual companies are potential risk factors for their overall profit.

MANAGEMENT DECISIONS AFFECT STOCK PRICES?

a. The value of an asset is determined by the future cash flow it is expected to generate.
b. Cash flows are affected by how efficient management is in making products, the quality of the products, management's sales, and market skills.
c. Over time, management makes a series of decisions when executing the firm's strategy that affects the firm's cash flow and the price of the firm's stock.

Learning Objective 1.5: Discuss why financial managers are focusing more on their firm's environmental, social, and governance (ESG) strategies. Describe ESG frameworks, ESG disclosure standards, and ESG rating systems.

Environmental, social, and governance issues have assumed increased importance for financial managers as corporate stockholders and stakeholders have placed more emphasis on the role of business in society. In response, corporate managers are paying more attention to environmental issues (the E in ESG) and social issues (the S in ESG). E issues include biodiversity, greenhouse gas emissions, and toxic pollution, amongst others. Social issues include diversity, equity and *inclusion, human rights in supply chains, and workplace conditions amongst others. In the past, the disclosure of company performance on these issues has been very different across companies and mostly voluntary. However, this is starting to change with the development of ESG disclosure standards and with regulators in some countries adopting rules requiring companies to report on various ESG issues. Financial data providers have also filled the gap on company ESG performance by developing their own ESG scoring or ratings system. However, incorporating the many different elements of ESG into a single number can be challenging, and different rating agencies can score the same company very differently.*

ENVIRONMENTAL, SOCIAL, AND GOVERNANCE (ESG) ISSUES

a. Corporate ESG is being emphasized more by both investors and stakeholders.
b. ESG considerations have the potential to influence the value of a company's stock.

THE ORIGINS OF ESG

a. In 2004, the Secretary-General of the United Nations, reached out to large investors around the world inviting them to participate in developing guidelines and recommendations on how to better incorporate environmental, social, and governance considerations into asset management.
b. Over time the term ESG has evolved to encompass a broad range of topics that are important to society.
    i. Stockholders regularly submit proposals to be voted on at annual meetings asking companies to address how their operations impact a variety of factors including biodiversity, climate change, human rights, treatment of animals in the food industry, and water use.
c. More recently, ESG policies have come under scrutiny by both academic and practitioners.

ESG FRAMEWORKS

a. There are many different ESG frameworks, reporting standards, and ratings systems.
b. There are three ESG developments introduced through the United Nations (UN).
    i. Principles of Responsible Investment (PRI), provides guiding principles for investors when incorporating ESG into their investment process.
    ii. Sustainable Development Goals (SDGs), provides peace and prosperity for people and the planet.
    iii. Paris Climate Accord develops and implement plans to reduce greenhouse gas emissions.

DISCLOSURE STANDARDS

a. There have been moves to mandate and standardize ESG disclosures.

      i. The European Union (EU) has introduced the Corporate Reporting Initiative (GRI) and the Sustainability Accounting Standards Board (SASB).

b. GRI standards emphasize disclosures related to the economic, environmental, and social impacts of companies from a sustainable development perspective.
c. The SASB standards focus on industry specific ESG disclosures the SASB considers financially relevant for each of seventy-seven different industry classifications.
d. The differences between the disclosure standards pose a challenge for those interested in corporate ESG performance.

ESG RATING SYSTEMS

a. The rising interest in ESG and the development of ESG disclosure standards, investors and stakeholders have looked for ways to more easily access companies' ESG performance.
    i. The financial services industry has responded by collecting and aggregating ESG performance information to provide ESG ratings or scoring systems.
b. There are many ESG data providers and ratings systems including firms that just focus on very specific issues.
c. The SASB standards focus on industry specific ESG disclosures the SASB considers financially relevant for each of seventy-seven different industry classifications.

Learning Objective 1.6: Discuss how agency conflicts affect the goal of maximizing stockholder value and how corporate governance mechanisms can limit agency conflicts.

In most large corporations, there is a significant degree of separation between management and ownership. As a result, stockholders have little control over corporate managers, and management may thus be tempted to pursue its own self- interest rather than maximizing the value of the owners' stock. The resulting conflicts give rise to agency costs. Ways of reducing agency costs include developing compensation agreements that link employee compensation to the firm's performance and having independent boards of directors monitor management.

AGENCY CONFLICTS AND CORPORATE GOVERNANCE:SEPARATION OF OWNERSHIP AND CONTROL

a. In a large corporation, ownership is often spread over a large number of small stockholders who may have little control over management.
b. Managers may make decisions that benefit their own interests rather than those of stockholders.
c. In Smaller firms, owners and managers are usually one and the same, and there is no conflict of interest between them.

OWNERSHIP AND CONTROL

a. As the owner of a pizza parlor, you have decided your goal is to maximize the value of the business and thereby the value of your ownership interest.
    i. There is no conflict of interest in your dual roles as owner and manager because your personal and economic self-interest is tied to the success of the pizza parlor.
    ii. The restaurant has succeeded because you have worked hard and have focused on customer satisfaction.
b. You decide to hire a college student to manage the restaurant.
    i. Now that ownership and management are separated, managers may be tempted to pursue goals that are in their own self-interest rather than the interests of the owners.

AGENCY RELATIONSHIPS

a. An agency relationship arises whenever one party, called the principal, hires another party, called the agent, to perform some service on behalf of the principal.
b. The relationship between stockholders and management is an agency relationship.
c. In these types of relationships, there are chances of agency conflicts.

DO MANAGERS REALLY WANT TO MAXIMIZE STOCK PRICE?

a. In most large corporations, especially those that are publicly traded, there is a significant degree of separation between ownership and management.
b. Large corporations can have more than one million stockholders.

ALIGNING THE INTEREST OF MANAGERS AND STOCKHOLDERS

a. If the link between stockholder and manager goals is weak, there are a number of corporate governance mechanisms available to better align the behavior of managers with the goals of stockholders.
    i. Board of directors
    ii. Management compensation
    iii. Managerial labor market
    iv. Other managers
    v. Large stockholders
    vi. Stockholder voting rights
    vii. The takeover market
    viii. Legal and regulatory environment

BOARD OF DIRECTORS

a. The board of directors has a legal responsibility to represent stockholders' interests.

   i. Duties include hiring and firing the CEO, setting their compensation, and monitoring their performance.
   ii. Approves major decisions concerning the firm.

MANAGEMENT COMPENSATION

a. The most effective means of aligning the interests of the managers with those of the stockholders is a well-designed compensation (pay) package that rewards managers.
   i. This type of pay plan is effective because a manager will quickly internalize the benefits and costs of making good and bad decisions.
b. Most corporations have management compensation plans that tie compensation to the performance of the firm.
   i. A base salary
   ii. A bonus based on accounting performance
   iii. Some compensation that is tied to the firm's stock price

MANAGERIAL LABOR MARKET

a. The managerial labor market provides managers with incentives to act in the interests of stockholders.
b. Individuals who are top performers have better alternatives than to work for such firms.

OTHER MANAGERS

a. Competition among managers within firms also helps provide incentives for each manager to act in the interests of stockholders.
b. Managers compete to attain the CEO position and in doing so try to attract the board of directors' attention by acting in the stockholders' interests.

LARGE STOCKHOLDERS

a. Large stockholders, those with a significant interest in the firm, have enough money at stake and enough power to make it worthwhile for them to monitor managers and try to influence their decisions.
b. For firms that are publicly traded, many of the large stockholders are institutional investors, such as mutual funds, large commercial banks, or hedge funds.

STOCKHOLDER VOTING

a. Stockholder voting is a key corporate governance mechanism that has the potential to limit agency problems.
   i. Stockholders vote on the annual election of directors, new equity issuance, large acquisitions, and the sale of the company.
b. Dual class stock refers to companies that have multiple classes of stock outstanding with each class having different voting rights.
c. Class A stock is usually owned by early investors, founders, and insiders.

d. Class B stock is owned by the public who usually have one vote per share.

THE TAKEOVER MARKET

a. The market for takeovers provides incentives for managers to act in the interests of stockholders.
b. The possibility that a firm may be discovered by shareholder activists provides incentives for managers to perform well.

THE LEGAL AND REGULATORY ENVIRONMENT

a. Federal and state statutes make it illegal for managers to steal corporate assets.
b. One of the most significant reform measures to date is the Sarbanes-Oxley Act, which focuses on:
    i. Reducing agency costs in corporations
    ii. Restoring ethical conduct within the business sector
    iii. Improving the integrity of the accounting reporting system within firms.
c. These regulations require all public corporations to implement five overarching strategies.
    i. Ensure greater board independence.
    ii. Establish internal accounting controls.
    iii. Establish compliance programs.
    iv. Establish an ethics program.
    v. Expand the audit committee's oversight powers.

Learning Objective 1.7: Explain why ethics is an important topic in the study of corporate finance.

If we lived in a world without ethical norms, we would soon discover that it would be difficult to do business. As a practical matter, the law and market forces provide important incentives that foster ethical behavior in the business community, but they are not enough to ensure ethical behavior. An ethical culture is also needed. In an ethical culture, people have a set of moral principles-a moral compass-that helps them identify ethical issues and make ethical judgements without being told what to do.

THE IMPORTANCE OF ETHICS IN BUSINESS

a. Large stockholders, those with a significant interest in the firm, have enough money at stake and enough power to make it worthwhile for them to monitor managers and try to influence their decisions.
b. For firms that are publicly traded, many of the large stockholders are institutional investors, such as mutual funds, large commercial banks, or hedge funds.

BUSINESS ETHICS

a. Ethics describes a society's idea about what actions are right and wrong.
    i. Ethical values are not moral absolutes, and they can and do vary across societies.
b. Ethical rules include considering the impact of our actions on others, being willing to sometimes put the interest of others first and realizing that we must follow the same rules we expect others to follow.

ARE BUSINESS ETHICS DIFFERENT FROM EVERYDAY ETHICS?

a. Those that argue that ethics do not matter in business are mistaken.
b. Corruption in business creates inefficiencies in an economy, inhibits the growth of capital markets, and slows the rate of economic growth.

TYPES OF ETHICAL CONFLICTS IN BUSINESS

a. Most problems involve agency costs, conflicts of interest, and informational asymmetry.

AGENCY COSTS

a. Agents can be bound legally and ethically to act in the interest of the principal.
b. For firms that are publicly traded, many of the large stockholders are institutional investors, such as mutual funds, large commercial banks, or hedge funds.

CONFLICTS OF INTEREST

a. A conflict of interest can arise when an agent's interests are different from those of the principal.
b. Conflicts of interest are usually resolved by complete disclosure.

INFORMATION ASYMMETRY

a. Information asymmetry exists when one party in a business transaction has information that is unavailable to the other parties in the transaction.
b. Society imposes both market-based and legal solutions for transactional information asymmetries.

THE IMPORTANCE OF AN ETHICAL BUSINESS CULTURE

a. The legal system and market forces substantial costs on individuals and institutions that engage in unethical behavior.
b. Incentives for ethical behavior include financial losses, legal fines, jail time, and bankruptcy.
c. An ethical business culture means that people have a set of principles to help them identify moral issues and make ethical judgments.

SERIOUS CONSEQUENCES

a. In the past, the business community and legal authorities often dismissed corporate scandals, and the consequences for white-collar crime were minimal.
    i. This is no longer true today.

Before You Go On Questions and Answers

Section 1.1

1. **What are the three basic types of financial decisions managers must make?**

   The three basic decisions each business must make are the capital budgeting decision, the financing decision, and the working capital management decision. These decisions determine which productive assets to buy, how to pay for or finance these purchases, and how to manage the day-to-day financial matters so the company can pay its bills.

2. **Explain why you would make an investment if the value of the expected cash flows exceeds the cost of the project.**

   You would accept an investment project whose cash flows exceed the cost of the project because such projects will increase the value of the firm, making the owners wealthier. Most people start a business to increase their wealth. Remember that the cost of capital (time value of money) will affect the decision about whether to invest.

3. **Why are capital budgeting decisions among the most important decisions in the life of a firm?**

   The capital budgeting decisions are considered the most important in the life of the firm because these decisions determine which productive assets the firm purchases, and which assets generate most of the firm's cash flows. Furthermore, capital budgeting decisions are long-term decisions and if you make a mistake in selecting a productive asset, you are stuck with the decision for a long time.

Section 1.2

1. **Why are many businesses operated as sole proprietorships or partnerships?**

Many businesses elect to operate as sole proprietorships or partnerships because of the small operating scale and capital base of their firms. Both of these forms of business organization are fairly easy to start and impose few regulations on the owners.

2. **What are some advantages and disadvantages of operating as a public corporation?**
The main advantages of operating as a public corporation are the access to the public securities markets (which makes it easier to raise large amounts of capital) and the ease of ownership transfer. All the shareholders have to do is to call their broker to buy or sell shares of stock. Since a public corporation usually has many shares outstanding, large blocks of securities can be purchased or sold without an appreciable impact on the price of the stock. The major disadvantage of corporations is the tax situation. Not only must the corporation pay taxes on its income, but the owners of the corporation get taxed again when dividends are paid to them. This is referred to as double taxation. In addition to taxes, public corporations are subject to stringent reporting requirements, and the incentives may convince managers to focus on shorter-term profitability rather than longer-term wealth creation.

3. **Explain why professional partnerships such as physicians' groups organize as limited liability partnerships.**
Professional partnerships such as physicians' groups desire to organize as limited liability partnerships (LLPs) to take advantage of the tax arrangements of partnerships combined with the advantages of the limited liability of a corporation. By operating as an LLP, the partnership is able to avoid a potential financial disaster resulting from the misconduct of one partner.

Section 1.3

1. **What are the major responsibilities of the CFO?**
The major responsibilities of a CFO include analysis and recommendations for financial decisions. The CFO, who reports directly to the CEO, focuses on managing all aspects of the firm's finances and works with the CEO on strategic issues. The CFO also interacts with staff in other functional areas on a regular basis related to financial issues that affect the business.

2. Identify the financial officers who typically report to the CFO and describe their duties.

The financial officers discussed in the chapter who report to the CFO are the controller, the treasurer, the risk manager, and the internal auditor.

The controller is the firm's chief accounting officer, and thus prepares the financial statements and taxes. This position also requires close cooperation with external auditors. The treasurer's responsibility is the collection and disbursement of cash, investing excess cash, raising new capital, managing foreign exchange, and overseeing the company's pension fund management. This individual also assists the CFO in handling important Wall Street relationships. The risk manager monitors and manages the firm's risk exposure in financial and commodity markets and the firm's relationships with insurance providers. Finally, the internal auditor is responsible for conducting risk assessment and performing audits of high-risk areas.

3. Why does the internal auditor report to both the CFO and the audit committee of the board of directors?

The internal auditor reports to the CFO on a day-to-day basis but is ultimately accountable for reporting any accounting irregularities to the board of directors. The dual reporting system serves as a check to ensure that there are no discrepancies in the company's financial statements.

Section 1.4

1. Why is profit maximization an unsatisfactory goal for managing a firm?

Profit maximization is not a satisfactory goal when managing a firm because it is rather difficult to define profits since accountants can apply and interpret the same accounting principles differently. Also, profit maximization does not define the size, the uncertainty, and the timing of cash flows; it ignores the time value of money concept.

2. Explain why maximizing the market price of a firm's stock is an appropriate goal for the firm's management.

Maximizing the current market price of a firm's stock is an appropriate goal for the firm's management because it is an unambiguous objective and is easy to measure for a firm whose stock is publicly traded. One can simply look at the value of the company's stock on any given day to determine whether the market price went up or down. Maximizing the market value of the stock is not inconsistent with maximizing the value of claims to the firm's other stakeholders. In maximizing the value of the stock, managers must make decisions that account for the interests of all stakeholders. This is also true for firms without publicly traded stocks. In these cases, the statement can be interpreted as maximizing the current value of owner's equity.

3. **Explain the alternative goals of stakeholder value maximization and stockholder welfare maximization.**

   Stakeholder value maximization is the idea that corporate management should focus on the value or wealth of the company's stakeholders including managers, other employees, suppliers, creditors, and the government in addition to that of stockholders. Stockholder welfare maximization is the idea that stockholders are focused on their overall well-being and happiness (or welfare). As such, they are willing to give up some stockholder value to avoid the negative effects that companies have on the environment or society (e.g., pollution or carbon emissions that led to global warming). If so, then corporate managers should maximize stockholder welfare.

4. **What is the fundamental determinant of an asset's value?**

   The fundamental determinant of an asset's value is the future cash flows the asset is expected to generate including the size, timing, and riskiness of these cash flows. Other factors that may help determine the price of an asset are internal decisions, such as the company's expansion strategy, as well as external stimulants, such as the state of the economy.

Section 1.5

1. **What are some of the environmental issues that have been the focus of shareholder proposals?**

   Bio-diversity, greenhouse gas emissions, climate change, water use.

2. **What is the overall purpose of the Sustainable Development Goals (SDGs)?**

To provide "(…) peace and prosperity for people and the planet, now and into the future." Specific goals include ending poverty, improving health and education, reducing inequality, spurring economic growth, while addressing climate change and the preservation of oceans and forests.

3. What is an ESG rating?

An ESG rating is a summary measure of a company's overall performance on ESG issues.

Section 1.6

1. What are agency conflicts?

An agency conflict occurs when the goals of the principals or the stockholders are not aligned with the goals of the agents or the company management. Management is often more concerned with pursuing its own self-interest, and so the maximization of shareholder value is pushed to the side.

2. What are shareholder activists or corporate raiders?

Shareholder activists or corporate raiders can make the company more efficient by keeping top managers on their toes. Top managers know that if the company's performance declines and its stock slips, it makes itself vulnerable to takeovers by corporate raiders who are just waiting to temporarily acquire a company, turn it around, and sell it for profit. Therefore, the role of the corporate raiders is twofold: first, the fear of takeovers pushes managers to do a better job, and second, if managers are not performing up to expectations, the company can be rescued and restructured into becoming a strong performer. However, the threat of a corporate raider could result in an incentive conflict for managers, inducing them to focus on short-term profitability over long-term value creation.

3. List the three main objectives of the Sarbanes-Oxley Act.

The three main goals of the Sarbanes-Oxley Act are to reduce agency costs in corporations, to restore ethical conduct within the business sector, and to improve the integrity of accounting reporting systems within firms.

4. **List two other regulations that have been adopted since the passage of the Dodd-Frank Act.**

   One regulation is the "say-on-pay" rule where stockholders have a non-binding vote on the company's compensation policies. Another is the requirement that companies adopt "clawback" polices to recover compensation from executives if it was based on misstated financials.

Section 1.7

1. **What is a conflict of interest in a business setting?**

   Conflict of interest in the business setting refers to a conflict between an individual's personal or institutional gain and the obligation to serve the interest of another party. For example, the chapter discussed the problem that arises when the real estate agent helping you buy a house is also the listing agent.

2. **How would you define an ethical business culture?**

   An ethical business culture means that people have a set of principles, or a moral compass, which helps them identify moral issues and then make ethical judgments without being told what to do.

Self-Study Problems and Solutions

1.1 Give an example of a capital budgeting decision and a financing decision.

Solution:

Capital budgeting involves deciding in which productive assets the firm should invest, such as buying a new plant or investing in the renovation of an existing facility. Financing decisions determine how a firm will raise capital. Examples of financing decisions include the decision to borrow from a bank or issue debt in the public capital markets.

LO: 1.1

Level: Basic

1.2 What is the appropriate decision criterion for financial managers to use when selecting a capital project?

Solution:

Financial managers should select a capital project only if the value of the project's expected future cash flows exceeds the cost of the project. In other words, managers should only make investments that will increase firm value, and thus increase the stockholders' wealth.

LO: 1.1

Level: Basic

1.3 What are some of the things that managers do to manage a firm's working capital?

Solution:

Working capital management is the day-to-day management of a firm's short-term assets and liabilities. Working capital can be managed by maintaining the optimal level of inventory, managing receivables and payables, deciding to whom the firm should extend credit, and making appropriate investments with excess cash.

LO: 1.1

Level: Basic

1.4 Which one of the following characteristics does not pertain to corporations?

a. Can enter into contracts

b. Can borrow money

c. Are the easiest type of business to form

d. Can be sued

e. Can own stock in other companies

Solution:

The answer that does *not* pertain to corporations is: c. Are the easiest type of business to form.

LO: 1.2

Level: Basic

1.5 List three alternative goals for corporate managers. Which goal do we focus on in this textbook?

Solution:

The three alternatives are stockholder value maximization, stakeholder value maximization, and stockholder welfare maximization (you might also mention profit maximization). We focus on stockholder value maximization in the textbook.

LO: 1.4

Level: Basic

1.6 What is the Paris Climate Accord?

Solution:

The Paris Climate Accord is an international treaty where the countries signing the agreement have committed to the goal of limiting global warming to less than 2 degrees Celsius above levels in the 1850–1900 “pre-industrial” period.

LO: 1.5

Level: Basic

1.7 What is an ESG disclosure standard?

Solution:

An ESG disclosure standard provides a guide for companies on which ESG items to report and how to report them.

LO: 1.5

Level: Basic

1.8 What is an ESG rating?

Solution:

An ESG rating is a score by an ESG-ratings agency that capture a company’s overall performance on environmental, social, and governance issues.

LO: 1.5

Level: Basic

1.9 What is the corporate governance role of the board of directors?

The role of the board of directors is to hire (and fire if necessary) senior management, set compensation policy, and monitor and advise management as they run the company.

1.10 What are the main components of a typical executive compensation package?

Solution:

The three main components of a typical executive compensation package are: base salary, bonus based on accounting performance, and compensation tied to the firm's stock price.

LO: 1.6

Level: Basic

Discussion Questions and Answers

1.1 Describe the cash flows between a firm and its stakeholders.

Cash flows are generated by a firm's productive assets that were purchased through either issuing debt or raising equity. These assets generate revenues through the sale of goods and services. A portion of this revenue is then used to pay wages and salaries to employees, pay suppliers, pay taxes, and pay interest on the borrowed money. The leftover money, residual cash, is then either reinvested back in the business or is paid out to stockholders in the form of dividends.

LO: 1.1

Level: Basic

Bloomcode: Comprehension

AACSB: Analytic

IMA: Corporate Finance

AICPA: Industry/Sector Perspective

1.2 What are the three fundamental decisions the financial manager is concerned with, and how do they affect the firm's balance sheet?

The primary financial management decisions every company faces are capital budgeting decisions, financing decisions, and working capital management decisions. Capital budgeting addresses the question of which productive assets to buy; thus, it affects the asset side of the balance sheet. Financing decisions focus on raising the money the firm needs to buy productive assets. These decisions are typically accomplished by issuing long-term debt and equity, which affect both the long-term debt and stockholders' equity components of the balance sheet. Finally, working capital decisions involve how firms manage their current assets and liabilities. The focus here is to ensure that a firm has enough money to pay its bills, and that any excess money is invested to earn a return. These decisions affect current assets and current liabilities on the balance sheet.

LO: 1.1

Level: Basic

Bloomcode: Comprehension

AACSB: Analytic

IMA: Decision Analysis

AICPA: Decision Modeling

1.3 What is the difference between stockholders and stakeholders?

Stockholders, also referred to as shareholders, are the owners of the company. A stakeholder, on the other hand, is anyone with a claim on the assets of the firm, including, but not limited to, shareholders. Stakeholders include the firm's employees, suppliers, creditors, and the government.

LO: 1.1

Level: Basic

Bloomcode: Analysis

AACSB: Analytic

IMA: Corporate Finance

AICPA: Industry/Sector Perspective

1.4 Suppose that several accountants wants to start an accounting business. What organizational form would they most likely choose, and why?

Most lawyers, accountants, and doctors form what are known as limited liability partnerships. This formation combines the tax advantages of partnerships with the limited liability of corporations.

LO: 1.2

Level: Basic

Bloomcode: Application

AACSB: Analysis

IMA: Business Economics

AICPA: Industry/Sector Perspective

1.5 Why would the owners of a business choose to form a corporation even though they will face double taxation?

Because of the benefits, such as limited liability and access to large amounts of capital at relatively low cost in the public markets. These benefits outweigh the cost of double taxation (as well as the higher costs associated with forming a corporation).

LO: 1.2

Level: Basic

Bloomcode: Comprehension

AACSB: Analytic

IMA: Business Economics

AICPA: Industry/Sector Perspective

1.6 Explain why profit maximization is not the best goal for a company. What is a better goal?

Although profit maximization appears to be the logical goal for any company, it has many drawbacks. First, profit can be defined in a number of different ways, and variations in net income for similar firms can differ widely. Second, accounting profits do not exactly equal cash flows. Third, profit maximization does not account for timing and ignores risk associated with cash flows. An appropriate goal for financial managers is to maximize the current value of the firm’s stock in the open market.

LO: 1.4

Level: Intermediate

Bloomcode: Comprehension

AACSB: Analytic
IMA: Performance Measurement
AICPA: Strategic/Critical Thinking

1.7 Explain what is meant by stockholder value maximization.

Managers should focus on maximizing the current value of the firm's stock in order to maximize the wealth of the stockholders—the firm's owners who have a claim on the firm's residual cash flow. In focusing on this goal managers focus on (1) the size of the expected cash flows, (2) the timing of the cash flows, and (3) the riskiness of the cash flows that the firm can produce.

LO: 1.4
Level: Intermediate
Bloomcode: Comprehension
AACSB: Analytic
IMA: Performance Measurement
AICPA: Strategic/Critical Thinking

1.8 Explain what is meant by stakeholder value maximization.

The idea that corporate management should focus on the value or wealth of the company's stakeholders including managers, other employees, suppliers, creditors, and the government as all of these groups contribute to the value that managers can produce for stockholders.

LO: 1.4
Level: Intermediate
Bloomcode: Comprehension
AACSB: Analytic
IMA: Performance Measurement
AICPA: Strategic/Critical Thinking

1.9 If company managers do not treat their stakeholders well, what could happen to stockholder value?

If stakeholders stop doing business with a firm it could interrupt the firm's operations and destroy stockholder value. For example, if employees go on strike or a supplier refuses to provide raw materials to a manufacturing company the company will be unable to produce or sell goods to customers.

LO: 1.4

Level: Intermediate

Bloomcode: Comprehension

AACSB: Analytic

IMA: Performance Measurement

AICPA: Strategic/Critical Thinking

1.10 Explain what is meant by stockholder welfare maximization? Why might this corporate objective be difficult for managers to implement?

Stockholder welfare maximization is the idea that stockholders get a sense of well-being or happiness (welfare) from company operations that benefit society or the environment (or negative welfare from company operations that harm society or the environment) and are willing to give up some value for this. As a result, managers should consider stockholder welfare and not just stockholder value. The challenge in implementing this is that stockholders value many different environmental and societal issues, and it is not clear how management can address, or measure, all such issues.

LO: 1.4

Level: Intermediate

Bloomcode: Comprehension

AACSB: Analytic

IMA: Performance Measurement

AICPA: Strategic/Critical Thinking

1.11 What are some of the major external and internal factors that affect a firm's stock price? What is the difference between the two general types of factors?

External factors that affect the firm's stock price are: (1) economic shocks, such as natural disasters or wars, (2) the state of the economy, such as the level of interest rates, and (3) the business environment, such as taxes, antitrust laws, or regulations. External factors are variables over which management has no control. Internal factors that affect the stock price can be controlled by management to some degree, because they are firm specific, such as financial management decisions, product quality and cost, marketing and sales, research and development, and the line of business management has selected to enter. Finally, perhaps the most important internal variable that determines the stock price is the expected stream of cash flows: their magnitude, timing, and riskiness.

LO: 1.4

Level: Basic

Bloomcode: Comprehension

AACSB: Analytic

IMA: Strategic Marketing

AICPA: Measurement

1.12 Why are corporate managers increasing their focus on environmental, social, and governance (ESG) strategies?

As companies become larger and more influential in society, politicians, and people around the world, including investors, are becoming more concerned about the potential negative effects that companies can have on the environment and society. This puts pressure on corporate managers to address such issues.

LO: 1.5

Level: Intermediate

Bloomcode: Comprehension

AACSB: Analytic

IMA: Performance Measurement

AICPA: Strategic/Critical Thinking

1.13 What are the three main ESG frameworks discussed in the text?

The Principles of Responsible Investment (PRI); Sustainable Development Goals (SDGs) and the Paris Climate Accord. All three provide a set of goals on environmental and social issues that many companies contribute to by way of their operations.

LO: 1.5

Level: Basic

Bloomcode: Comprehension

AACSB: Analytic

IMA: Performance Measurement

AICPA: Strategic/Critical Thinking

1.14 What do investors that sign on to the Principles of Responsible Investment (PRI) agree to do?

The Principles of Responsible Investment (PRI) signatories commit to following several principles for investors when incorporating ESG into their investment process.

LO: 1.5

Level: Basic

Bloomcode: Comprehension

AACSB: Analytic

IMA: Performance Measurement

AICPA: Strategic/Critical Thinking

1.15 What are the advantages and disadvantages of environmental, social, and governance (ESG) disclosure standards?

The advantages are that they provide guidance for companies in terms of what ESG issues to report and how to report them. The standardization allows users to assess and compare ESG performance. The disadvantage is that different frameworks focus on different issues and the specific focus of a given framework may be of limited use for some users.

LO: 1.5

Level: Intermediate

Bloomcode: Comprehension

AACSB: Analytic

IMA: Performance Measurement

AICPA: Strategic/Critical Thinking

1.16 What are the advantages and disadvantages of ESG ratings?

The advantage of ESG ratings is that they summarize a firm's overall ESG performance into a single number that is easy to understand. The disadvantage is that it is hard to combine a wide range of ESG issues into a single number. Another disadvantage is that ESG ratings agencies can score the same company very differently depending on their focus which might confuse ratings users when reading about a company's ESG performance.

LO: 1.5

Level: Intermediate

Bloomcode: Comprehension

AACSB: Analytic

IMA: Performance Measurement

AICPA: Strategic/Critical Thinking

1.17 Give an example of a conflict of interest in a business setting, other than the one involving the real estate agent discussed in the chapter text.

For example, imagine a situation in which you are a financial officer at a growing software company and your firm has decided to hire outside consultants to formulate a global expansion strategy. Coincidentally, your spouse works for one of the major consulting firms that your company is considering hiring. In this scenario, you have a conflict of interest, because instinctively, you might be inclined to give the business to your spouse's firm, since it may benefit your family's financial situation, regardless of whether or not it makes the best sense for your firm.

LO: 1.6

Level: Intermediate

Bloomcode: Application

AACSB: Analytic

IMA: Business Economics

AICPA: Industry/Sector Perspective

1.18 Identify the sources of agency costs. What are some of the corporate governance mechanisms that can limit agency costs?

Agency costs are the costs that result from conflicts of interest between an agent and a principal. They can either be direct, such as lavish dinners or trips, or indirect, which are usually missed investment opportunities. A company can control these costs using corporate governance mechanisms such as linking management compensation to the company's performance and by establishing an independent board of directors. Outside corporate governance factors that contribute to the minimization of agency costs are the threat of shareholder activists or corporate raiders that can pressure corporate management or take over a company that is not performing up to expectations and the competitive nature of the managerial labor market.

LO: 1.6

Level: Basic

Bloomcode: Comprehension

AACSB: Analytic

IMA: Business Economics

AICPA: Industry/Sector Perspective

1.19 What is the Sarbanes-Oxley Act, and what is its focus? Why does it focus on these areas?

The Sarbanes-Oxley Act is an act of Congress that was passed in 2002. This act was passed in the aftermath of several corporate scandals that occurred at the turn of the century. The act focuses on (1) reducing agency costs in corporations, (2) restoring ethical conduct within the business sector, and (3) improving the integrity of accounting reporting systems within firms. Failures in these areas led to the corporate scandals that preceded the passage of Sarbanes-Oxley.

LO: 1.6

Level: Basic

Bloomcode: Knowledge

AACSB: Analytic

IMA: FSA

AICPA: Legal/Regulatory Perspective

1.20 What is the purpose of a compensation "clawback" policy?

A clawback policy recovers compensation from executives paid based on financial statements that later have to be "materially restated." The goal is to discourage executives from misreporting the firm's accounting numbers in order to increase their pay, as any compensation they earn as a result would ultimately be "clawed back" from them.

LO: 1.6

Level: Basic

Bloomcode: Knowledge

AACSB: Analytic

IMA: FSA

AICPA: Legal/Regulatory Perspective

1.21 What types of issues do stockholders vote on?

Stockholders vote on a wide range of issues including the board of directors, compensation for executives, the issuance of new equity, major asset sales and purchases amongst others.

LO: 1.6

Level: Basic

Bloomcode: Knowledge

AACSB: Analytic

IMA: FSA

AICPA: Legal/Regulatory Perspective

1.22 What is dual class stock?

Dual class stock refers to companies that have multiple classes of stock each with different voting rights, usually 10 votes per share for Class A stock (owned by company insiders) and 1 vote per share for Class B stock (held by the public).

LO: 1.6

Level: Basic

Bloomcode: Knowledge

AACSB: Analytic

IMA: FSA

AICPA: Legal/Regulatory Perspective

Questions and Problems and their Solutions

BASIC

1.1 Capital: What are the two basic sources of funds for all businesses?

Solution:

The two basic sources of funds for all businesses are debt and equity.

LO: 1.1

Bloomcode: Knowledge

AACSB: Analytic

IMA: Investment Decisions; Corporate Finance

AICPA: Resource Management

1.2 Management role: What is net working capital?

Solution:

Net working capital is the difference between a firm's total current assets and its total current liabilities.

LO: 1.1

Bloomcode: Knowledge

AACSB: Analytic

IMA: Corporate Finance

AICPA: Resource Management

1.3 Cash flows: Explain the difference between profitable and unprofitable firms.

Solution:

A profitable firm is able to generate enough cash flows from productive assets to cover its operating expenses, taxes, and payments to creditors. Unprofitable firms fail to do this, and therefore may be forced to declare bankruptcy, or close the business.

LO: 1.1

Bloomcode: Analysis

AACSB: Analytic

IMA: Cost Management

AICPA: Measurement

1.4 Management role: What three major decisions are of most concern to financial managers?

Solution:

Financial managers are most concerned with the capital budgeting decisions, the financing decisions, and the working capital management decisions.

LO: 1.1

Bloomcode: Comprehension

AACSB: Analytic

IMA: FSA

AICPA: Resource Management

1.5 Cash flows: What is the appropriate decision rule for a firm considering undertaking a capital project? Give a real-life example.

Solution:

A firm should undertake a capital project only if the value of its future cash flows exceeds the cost of the project. For example, a financial manager would not invest $10,000,000 in a new production line if the net present value of future cash flows from that line are expected to be only $9,000,000. That would be like throwing $1,000,000 away.

LO: 1.1

Bloomcode: Application

AACSB: Analytic

IMA: Decision Analysis

AICPA: Problem Solving and Decision Making

1.6 **Management role:** What is a firm's capital structure, and why is it important?

Solution:

Capital structure shows how a company is financed; it is the mix of debt and equity on the liability and stockholders' equity side of the balance sheet. It is important because it affects the risk and the value of the company. In general, companies with higher debt-to-equity proportions are often considered riskier, because debt comes with legal obligations to make periodic payments to creditors and to repay the principal at the end, whereas equity does not require periodic payments nor a repayment of the invested amount.

LO: 1.1

Bloomcode: Comprehension

AACSB: Analytic

IMA: Corporate Finance

AICPA: Industry/Sector Perspective

1.7 **Management role:** What are some of the working capital decisions that a financial manager faces?

Solution:

The financial manager must make working capital decisions regarding the level of inventory to hold, the terms of granting credit (accounts receivable), and decide the firm's policy on paying accounts payable.

LO: 1.1

Bloomcode: Comprehension

AACSB: Analytic

IMA: Decision Analysis

AICPA: Strategic/Critical Thinking

1.8 **Organizational form:** What are the common forms of business organization discussed in this chapter?

Solution:

The common forms of business organization discussed are sole proprietorship, partnership, corporation, limited liability company (LLC), and limited liability partnership (LLP).

LO: 1.2

Bloomcode: Knowledge

AACSB: Reflective Thinking

IMA: Business Economics

AICPA: Industry/Sector Perspective

1.9 **Organizational form:** What are the advantages and disadvantages of a sole proprietorship?

Solution:

Advantages:

- It is the easiest business organization to start.
- It is the least regulated.
- Owners keep all the profits and do not have to share decision-making authority with anyone.
- All income is taxed as personal income, which is usually in a lower tax bracket than corporate income.

Disadvantages:

- The proprietor has an unlimited liability for all business debt and financial obligations of the firm.
- The amount of capital that can be invested in the firm is limited by the proprietor's wealth.
- It is difficult to transfer ownership (requires sale of the business).

LO: 1.2

Bloomcode: Comprehension

AACSB: Analytic

IMA: Business Economics

AICPA: Industry/Sector Perspective

1.10 **Organizational form:** What is a partnership, and what is the biggest disadvantage of this form of business organization? How can this disadvantage be avoided?

Solution:

A partnership consists of two or more owners legally joined together to manage a business. The major disadvantage to partnerships is that all partners have unlimited liability for the organization's debts and legal obligations no matter what stake they have in the business. One way to avoid this is to form a limited liability partnership (LLP) in which only general partners have unlimited liability and limited partners are only responsible for business obligations up to the amount of capital they have invested in the partnership.

LO: 1.2

Bloomcode: Comprehension

AACSB: Analytic

IMA: Business Economics

AICPA: Industry/Sector Perspective

1.11 **Organizational form:** Who are the owners in a corporation, and how is their ownership represented?

Solution:

The owners of a corporation are its stockholders or shareholders, and the evidence of their ownership is represented by shares of common stock. Other types of ownership do exist and include preferred stock.

LO: 1.2

Bloomcode: Comprehension

AACSB: Analytic

IMA: Business Economics

AICPA: Industry/Sector Perspective

1.12 **Organizational form:** Explain what is meant by stockholders' limited liability.

Solution:

Limited liability for a stockholder means that the stockholder's legal liability extends only to the capital contributed or the amount invested.

LO: 1.2

Bloomcode: Comprehension

AACSB: Analytic

IMA: Business Economics

AICPA: Strategic/Critical Thinking

1.13 Organizational form: What is double taxation?

Solution:

Double taxation occurs when earnings are taxed twice. The owners of a C-corporation are subject to double taxation—first at the corporate level when the firm's earnings are taxed and then again at a personal level when they receive dividends.

LO: 1.2

Bloomcode: Comprehension

AACSB: Analytic

IMA: Business Economics

AICPA: Industry/Sector Perspective

1.14 Organizational form: What is the form of business organization taken by most large companies and why?

Solution:

Most large companies prefer to operate as public corporations because large amounts of capital can be raised in public markets at a relatively low cost.

LO: 1.2

Bloomcode: Comprehension

AACSB: Analytic

IMA: Business Economics

AICPA: Industry/Sector Perspective

1.15 Finance function: What is the primary responsibility of the board of directors in a corporation?

Solution:

The board of directors of a corporation is responsible for serving the interests of stockholders in managing the corporation. It is possible that the interest of managers may deviate from those of the stockholders. The board's objective is to monitor and correct any management decisions that might not be in the best interest of the stockholders. For example, board duties include hiring and firing the CEO, setting CEO pay, and monitoring the investment decisions of managers.

LO: 1.3

Bloomcode: Comprehension

AACSB: Analytic

IMA: Business Economics

AICPA: Resource Management

1.16 Finance function: All public companies must hire a certified public accounting firm to perform an independent audit of their financial statements. What exactly does the term *audit* mean?

Solution:

An independent CPA firm that performs an audit of a firm ensures that the financial information reported fairly presents the financial condition of the business. The audit seeks to improve the accounting reporting integrity by ensuring that generally accepted accounting principles (GAAP) have been adhered to consistently year after year and are not applied in a manner that distorts the firm's performance.

LO: 1.3

Bloomcode: Comprehension

AACSB: Analytic

IMA: FSA; Reporting

AICPA: Risk Analysis; Reporting

1.17 Firm's goal: What are some of the drawbacks to setting profit maximization as the main goal of a company?

Solution:

Drawbacks include:

- It is difficult to determine what is meant by "profit."
- It does not address the size and timing of cash flows—it does not account for the time value of money.
- It ignores the uncertainty or risk of cash flows.

LO: 1.4

Bloomcode: Comprehension

AACSB: Analytic

AICPA: Strategic/Critical Thinking

IMA: Corporate Finance

1.18 Firm's goal: What is the appropriate goal of financial managers? How do managers' decisions affect how successful the firm is in achieving this goal?

Solution:

The appropriate goal of financial managers should be to maximize the current value of the firm's stock price. Managers' decisions affect the stock price in many ways as the value of the stock is determined by the future cash flows the firm can generate. Managers can impact the cash flows by, for example, selecting what products or services to produce, what type of assets to purchase, or what advertising campaign to undertake.

LO: 1.4

Bloomcode: Comprehension

AACSB: Analytic

AICPA: Strategic/Critical Thinking

IMA: Decision Analysis

1.19 Firm's goal: What is stakeholder value maximization?

Solution:

The idea that corporate management should focus on the value or wealth of the company's stakeholders including managers, other employees, suppliers, creditors, and the government as all of these groups contribute to the value that managers can produce for stockholders.

LO: 1.4
Bloomcode: Comprehension
AACSB: Analytic
AICPA: Strategic/Critical Thinking
IMA: Corporate Finance

1.20 Firm's goal: What is stockholder welfare maximization?

Solution:

Stockholder welfare maximization is the idea that stockholders are focused on their overall well-being and happiness (or welfare), and they are willing to give up some stockholder value to avoid the negative effects that companies have on the environment or society (e.g., pollution or carbon emissions that led to global warming). As a result, corporate managers should maximize stockholder welfare.

LO: 1.4
Bloomcode: Comprehension
AACSB: Analytic
AICPA: Strategic/Critical Thinking
IMA: Corporate Finance

1.21 Firm's goal: What are the major factors that affect a firm's stock price?

Solution:

There are both internal and external factors affecting the stock price. These include the characteristics of the firm, the state of the economy, economic shocks, the business environment, expected cash flows (magnitude, timing and risk), and current market conditions.

LO: 1.4

Bloomcode: Comprehension

AACSB: Analytic

AICPA: Strategic/Critical Thinking

IMA: Corporate Finance

1.22 ESG: What is the goal of ESG disclosure standards?

Solution:

The goal of disclosure standards is to provide guidance for companies in terms of what and how to report their ESG performance and thus allow users to assess and compare company ESG performance.

LO: 1.5

Bloomcode: Comprehension

AACSB: Analytic

AICPA: Strategic/Critical Thinking

IMA: Corporate Finance

1.23 ESG: Why might different ESG ratings agencies assign very different ESG scores to the same company?

Solution:

Different ratings agencies focus on different aspects of ESG, they measure those aspects of ESG in a variety of ways and use diverse processes when developing an overall ESG rating.

LO: 1.5

Bloomcode: Comprehension

AACSB: Analytic

AICPA: Strategic/Critical Thinking

IMA: Corporate Finance

1.24 ESG: Stockholders who submit environmental shareholder proposals to companies would most likely want managers to pursue which corporate goal? Explain your answer.

Solution:

They would want managers to purse a corporate goal of stockholder welfare maximization—that is, take into consideration shareholder desire to do good for the environment even if it is at the expense of stockholder value.

LO: 1.5

Bloomcode: Comprehension

AACSB: Analytic

AICPA: Strategic/Critical Thinking

IMA: Corporate Finance

1.25 Agency conflicts: What is an agency relationship, and what is an agency conflict? How can agency conflicts be reduced in a corporation?

Solution:

Agency relationships develop when a principal hires an agent to perform some service or to represent the firm. An agency conflict arises when the agent's interests and behaviors are different from those of the principal. Agency conflicts can be reduced through the following three mechanisms: management compensation, control of the firm, and the board of directors.

LO: 1.6

Bloomcode: Comprehension

AACSB: Analytic

IMA: Business Economics

AICPA: Industry/Sector Perspective

1.26 Firm's goal: What can happen if a firm is poorly managed, and its stock price falls substantially below its maximum potential price?

Solution:

If the stock price falls below its maximum potential price, it attracts corporate raiders, who look for fundamentally sound, but poorly managed companies, they can buy, turn around, and sell for a handsome profit.

LO: 1.4

Bloomcode: Comprehension

AACSB: Analytic

IMA: Corporate Finance

AICPA: Strategic/Critical Thinking

1.27 **Agency conflicts:** What are some of the regulations that pertain to the boards of directors that were put in place to reduce agency conflicts?

Solution:

Some of the regulations include:

- The majority of board members must be outsiders.
- A separation of the CEO and chairperson of the board positions is recommended.
- The firm is required to have a code of ethics approved by the board.

LO: 1.6

Bloomcode: Comprehension

AACSB: Analytic

IMA: FSA

AICPA: Legal/Regulatory Perspective

1.28 **Agency conflicts:** What are some of the regulations that pertain to executive compensation that were put in place to reduce agency conflicts?

Solution:

Some of the regulations include:

- The introduction of compensation clawback polices to “claw back” compensation awarded to executives based on misstated financial reports.
- Giving shareholders a (non-binding) vote or “say-on-pay” so they can express how satisfied they are with the firm’s compensation policies.

LO: 1.6

Bloomcode: Comprehension

AACSB: Analytic

IMA: FSA

AICPA: Legal/Regulatory Perspective

1.29 Agency conflicts: How does stockholder voting function as a corporate governance mechanism?

Solution:

Managers have to consider whether or not the issue to be voted on is in stockholders' interests before it goes to a vote—if it is likely to fail managers may not even raise the issue as having a proposal voted down makes them look bad. Second, if an issue does go to a vote shareholders have the final say and can vote it down if it is not in their best interest.

LO: 1.6

Bloomcode: Comprehension

AACSB: Analytic

IMA: FSA

AICPA: Legal/Regulatory Perspective

1.30 Agency conflicts: What are the advantages and disadvantages of dual class stock?

Solution:

The advantage of dual class stock is that it gives management the flexibility to run the company without interference from outsiders if that is needed to drive long term value. The disadvantage is that the wedge between Class A stockholders' ownership stake and their voting power exacerbates agency conflicts and negates stockholder voting as a corporate governance mechanism.

LO: 1.6

Bloomcode: Comprehension

AACSB: Analytic

IMA: FSA

AICPA: Legal/Regulatory Perspective

1.31 Business ethics: How can a lack of business ethics negatively affect the performance of an economy? Give an example.

Solution:

A lack of business ethics can lead to corruption, which, in turn, creates inefficiencies in an economy, inhibits the growth of capital markets, and slows the rate of overall economic growth. For example, the Russian economy has had a relatively difficult time attracting foreign investment since the fall of the Soviet Union due, in part, to weak ethics and corruption in the business community and local and national governments. Lower foreign investment has led to slower overall economic growth than the country might otherwise have enjoyed.

LO: 1.7

Bloomcode: Comprehension

AACSB: Analytic

IMA: Business Economics

AICPA: Industry/Global Perspective

1.32 Business ethics: What are some ways to resolve a conflict of interest.

Solution:

One way to resolve a conflict of interest is by complete disclosure. As long as both parties are aware of the fact that, for example, both parties in a contract negotiation are represented by the same firm, disclosure is sufficient. Another way to avoid a conflict of interest is for the company to remove itself from serving the interest of one of the parties. This is, for example, the case with accounting firms not being allowed to serve as consultants to companies for whom they perform audits.

LO: 1.6

Bloomcode: Application

AACSB: Analytic

IMA: FSA

AICPA: Legal/Regulatory Perspective

1.33 **Information asymmetry:** Describe what information asymmetry is in a business transaction. Explain how the inequity associated with information asymmetry might be, at least partially, solved through the market for goods or services.

Solution:

An information asymmetry exists when one party to a business transaction possesses information that is not available to the other parties in the transaction. If the parties with less information understand their relative disadvantage, they are likely to pay lower prices for the goods and services they purchase or charge higher prices for the goods and services they sell.

LO: 1.7

Bloomcode: Comprehension

AACSB: Analytic

IMA: Strategic Marketing

AICPA: Marketing/Client Focus

1.34 **Business ethics:** What ethical conflict does insider trading present?

Solution:

Insider trading is an example of information asymmetry. The main idea is that investment decisions should be made on an even playing field. Insider trading is illegal because it puts one party at a significant disadvantage in trading. If insider trading were allowed, capital transfers would be much more difficult.

LO: 1.7

Bloomcode: Comprehension

AACSB: Ethics

IMA: Business Applications

AICPA: Professional Demeanor

Sample Test Problems

1.1 Identify three fundamental types of decisions that financial managers make and identify which part of the balance sheet each of these decisions affects.

Solution:

1. *Capital Budgeting Decisions* – identifying the productive assets the firm should buy. These decisions affect long-term assets on the balance sheet.
2. *Financing Decisions* – determining how the firm should finance or pay for assets. These decisions affect long-term debt and stockholders' equity on the balance sheet.
3. *Working Capital Management Decisions* – determining how day-to-day financial matters should be managed. These decisions affect current assets and current liabilities on the balance sheet.

LO: 1.1

Level: Intermediate

Bloomcode: Comprehension

AACSB: Analytic

IMA: Decision Analysis

AICPA: Decision Modeling

1.2 Advantages of the corporate form of organization include which of the following?

a. Reduced start-up costs
b. Greater access to capital markets
c. Unlimited liability
d. Single taxation

Solution:

b. (Shares in a corporation can be sold to raise capital from investors who are not involved in the business. This greatly increases the amount of capital that can be raised to fund the business.)

LO: 1.2

Level: Intermediate

Bloomcode: Comprehension

AACSB: Analytic

IMA: Business Economics

AICPA: Industry/Sector Perspective

1.3 Why is stock value maximization superior to profit maximization as a goal for management?

Solution:

While profit maximization appears to be a logical goal at first glance, it has some serious drawbacks. First, since accounting profit is the difference between revenues and expenses, it can be distorted by accounting decisions. Second, accounting profits are quite different from cash flows. Since cash flows are the focus of investors, they should also be the focus of managers. Third, profit maximization does not account for when cash flows actually occur. Finally, profit maximization as a goal ignores the risk involved in generating the cash flows.

Stock value maximization is superior to profit maximization because it overcomes all of the listed shortcomings of profit maximization. This is because the value of a firm’s stock is determined by the cash flows that the firm is expected to produce. It accounts for (1) the size of the expected cash flows, (2) the timing of the expected cash flows, and (3) the riskiness of the expected cash flows.

LO: 1.4

Level: Intermediate

Bloomcode: Comprehension

AACSB: Analytic

IMA: Strategic/Critical thinking

AICPA: Corporate Finance

1.4 What are agency costs? Explain.

Solution:

Agency costs are costs that result from an agency relationship in which there is a conflict of interest between a principal and an agent. An agency relationship exists in a business when a firm’s managers (agents) are not also its owners (principals). Agency costs are incurred when managers act in ways that harm or contradict the owners’ interests. The cost of mechanisms, such as audits, which help control agency conflicts are also agency costs.

LO: 1.5

Level: Intermediate

Bloomcode: Comprehension

AACSB: Analytic

AICPA: Industry/Sector Perspective

IMA: Business Economics

1.5 Identify seven mechanisms that can help better align the goals of managers with those of stockholders.

Solution:

Mechanisms that can help align the goals of managers with those of stockholders are as follows: (1) the board of directors, (2) management compensation, (3) the managerial labor market, (4) competition among managers, (5) large stockholders, (6) the takeover market, and (7) the legal and regulatory environment.

Boards of directors that are independent from managers can help limit the extent to which managers are able to act solely in their own interest. Firms design compensation plans that are tied to firm performance in order to provide managers with incentives to make decisions consistent with the goal of stockholder value maximization. A third mechanism that helps align the goals of managers is the managerial labor market. It is difficult for poorly performing managers to find a good job elsewhere, and it is difficult for a poorly performing firm to hire good managers, which a firm's current managers typically want to do. Competition among managers within a firm is a fourth mechanism that helps align the goals of managers with those of stockholders. This is because managers who act in the interest of stockholders are more likely to advance within the firm. Because large stockholders have a lot to gain from aligning the goals of managers with their own, they are likely to expend resources to encourage managers to maximize stock value. Sixth, the threat of a takeover, which leads to the firing of poor managers, can provide current managers with incentives to perform well. Finally, laws and regulations limit the ability of managers to make decisions that harm stockholders.

LO: 1.5

Level: Intermediate

Bloomcode: Comprehension

AACSB: Analytic

AICPA: Strategic/Critical Thinking

IMA: Performance Measurement

Ethics Case

Discussion Questions

1. Should employee pay be linked to sales targets?

Students are likely to suggest, if the employee compensation plan been different, we may not have seen such behavior. In general, people do what they are paid for. So, having less of a focus on specific sales goals, or a lower amount of employee pay tied to the sales objectives might have decreased the chances that employees would have opened fraudulent accounts as they would not benefit financially from doing so.

2. Should the practice of cross-selling be eliminated?

Some students will suggest that the cross-selling strategy and sales goals are not inherently bad—they can be sound compensation and incentive strategies that encourage employees to work to grow the company and add value for shareholders. However, it would also seem important that the company have well-established procedures to verify that new accounts are legitimate and approved by customers. If employees know that their work will be checked, and that any fraudulent accounts will be discovered, then perhaps they would be less likely to make up accounts in the first place.

3. What other steps could Wells Fargo have taken ahead of time to avoid the problems that it faced?

A number of other suggestions are also likely to come up including employee ethics training, limiting managers' ability to pressure employees into aggressive selling, adopting a dismissal policy for unethical behavior, internal and external auditing of accounts, adopting claw back policies for more employees, and requiring independent monitoring of customer complaints.

4. Should senior executives Carrie Tolstedt and John Stumpf have been financially penalized by the company?

Many students will suggest that the senior manager of the Community Banking division and the firm's CEO bear responsibility for the actions of the employees who work for them. As a result, these managers should also be penalized. Moreover, although it took substantial external pressure before the board of directors decided to claw back compensation, going forward the financial penalties and the potential to be dismissed for such actions, sends a strong message to other employees at the firm that such unethical behavior will not be tolerated.

Other students might argue that the senior managers might not have been aware of the day-to-day actions of employees engaging in this behavior. Students might also argue that unless executives of a company breach their contract in a way that allows the firm to legally seek a claw back, perhaps there is not much that the company can do. In this case, however, it seems that Wells Fargo's claw back provision specifying reputational harm to the company provided a sufficient legal basis for the board to act.

5. How important is it to have regulators like the CPFB, SEC, OCC, or Congress involved in the oversight of situations such as that at Wells Fargo?

The discussion here might be very broad focusing on whether or not we should even have regulation, or very narrow with students suggesting that we definitely need regulation to protect customers, consumers, and employees who may not be in a position to protect themselves. Some students will also suggest that regulation is more reactive than proactive. That is, once corporate wrongdoing is discovered, politicians usually act to address the issues. Sometimes the focus is on the specific company involved, but other times it entails new laws and regulations that affect many companies (e.g., the Dodd-Frank Act). Moreover, regulatory agencies like the SEC have the authority and the responsibility to act to protect the interests of particular groups, and that can include imposing penalties on firms or executives and seeking compensation for the damaged parties.

