Chapter 1
An Overview of Financial Management

ANSWERS TO SELECTED END-OF-CHAPTER QUESTIONS

1-1  a. A proprietorship, or sole proprietorship, is a business owned by one individual. A partnership exists when two or more persons associate to conduct a business. In contrast, a corporation is a legal entity created by a state. The corporation is separate and distinct from its owners and managers.

b. In a limited partnership, limited partners’ liabilities, investment returns and control are limited, while general partners have unlimited liability and control. A limited liability partnership (LLP), sometimes called a limited liability company (LLC), combines the limited liability advantage of a corporation with the tax advantages of a partnership. A professional corporation (PC), known in some states as a professional association (PA), has most of the benefits of incorporation but the participants are not relieved of professional (malpractice) liability.

c. Stockholder wealth maximization is the appropriate goal for management decisions. The risk and timing associated with expected earnings per share and cash flows are considered in order to maximize the price of the firm’s common stock.

d. Social responsibility is the concept that businesses should be partly responsible for, and thus bear the costs of, the welfare of society at large. Business ethics can be thought of as a company’s attitude and conduct toward its employees, customers, community, and stockholders. A firm’s commitment to business ethics can be measured by the tendency of the firm and its employees to adhere to laws and regulations relating to such factors as product safety and quality, fair employment practices, and the like.

e. Normal profits are those profits close to the average for all firms within an industry. Similarly, a normal rate of return is a return on investment that is close to the return earned by an average firm in the industry. Firms with normal profits cannot easily increase their social responsibility costs unless the entire industry does so.

f. An agency problem arises whenever a manager of a firm owns less than 100 percent of the firm’s common stock, creating a potential conflict of interest called an agency conflict. The fact that the manager will neither gain all the benefits of the wealth created by his or her
efforts nor bear all of the costs of perquisite consumption will increase the incentive to take actions that are not in the best interests of the nonmanager shareholders.

g. Economic Value Added (EVA) is a method used to measure a firm’s true profitability. EVA is found by taking the firm’s after-tax operating profit and subtracting the annual cost of all the capital a firm uses. If the firm generates a positive EVA, its management has created value for its shareholders. If the EVA is negative, management has destroyed shareholder value.

h. Performance shares are shares of the firm’s stock given to executives on the basis of performance as measured by earnings per share, return on assets, return on equity, and so on. Executive stock options are performance-based incentive plans popular in the 1950s and 1960s which allowed managers to purchase stock at some time in the future at a given price. This type of plan lost favor in the 1970s; they generally did not pay in the 1970s because the stock market declined.

i. A hostile takeover, when management does not want the firm to be taken over, is most likely to occur when a firm’s stock is undervalued relative to its potential because of poor management. The managers of the acquired firm are generally fired, or lose the autonomy they had prior to the acquisition.

j. Profit maximization is merely maximizing the net income (earnings) of the firm. Because of factors such as risk, timing of earnings, number of shares outstanding, and so on, profit maximization does not necessarily lead to stockholder wealth maximization.

k. Earnings per share (EPS) is the net income of the firm divided by the number of shares of common stock outstanding (generally the average number of shares outstanding over some period, say a quarter or year).

l. Dividend policy is, basically, the decision regarding how much of current earnings should be paid to stockholders as dividends rather than retained and reinvested in the firm.

1-2 Sole 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 a sole proprietorship are (1) difficulty in obtaining large sums of capital; (2) unlimited personal liability for business debts; and (3) limited life. The disadvantages of a partnership are (1) unlimited liability, (2) limited life, (3) difficulty of transferring ownership, and (4) difficulty of raising large amounts of capital. The disadvantages of a corporation are (1) double taxation of earnings and (2) requirements to file state and federal reports for registration, which are expensive, complex and time-consuming.
No. The normal rate of return on investment would vary among industries, principally due to varying risk. The normal rate of return would be expected to change over time due to (1) underlying changes in the industry and (2) business cycles.

Stockholder wealth maximization is a long-run goal. Companies, and consequently the stockholders, prosper by management making decisions which 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 is the U.S. auto industry in the 1970s and 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.

Even though firms follow generally accepted accounting principles, there is still sufficient margin for firms to use different procedures. Leasing and inventory (LIFO versus FIFO) accounting are two of the many areas where procedural differences could complicate relative performance measures.

The management of an oligopolistic firm would be more likely to engage voluntarily in "socially conscious" practices, since they usually generate above-normal profits. Competitive firms would be less able to engage in such practices unless they were cost-justified. Investors would be more likely to invest in firms not contributing large sums of money to charity; thus, the socially-oriented firm is put at a disadvantage in the capital markets. For this reason, even highly profitable, publicly-owned firms are generally constrained against taking unilateral cost-increasing social actions.

Profit maximization does not reflect (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.

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.

Corporate philanthropy is always a sticky issue, but it can be justified in terms of helping to create a more attractive community which will make it easier to hire a productive work force. This corporate philanthropy could be received by stockholders negatively, especially those stockholders not living in its headquarters city. Stockholders are interested in actions that maximize share price, and if competing firms are not making similar contributions, the "cost" of
this philanthropy has to be borne by someone--the stockholders. Thus, stock price could decrease.

b. Companies must make investments in the current period in order to generate future cash flows. Stockholders should be aware of this, and assuming a correct analysis had been done, they should react positively to the decision. The foreign plant is in this category. This is covered in depth in Part IV of the text. Assuming that the correct capital budgeting analysis had been made, the stock price would increase in the future.

c. 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 Chapters 15 and 16.

d. Today (2001), nuclear generation of electricity is regarded as being quite risky. Therefore, if the company has a heavy investment in nuclear generators, its risk will be high, and its stock price will be adversely affected. However, this negative impact could be offset by higher profits if the nuclear generators provided significantly lower costs.

e. The company will be retaining more earnings, so its growth rate should go up, which should increase its stock price. The decline in dividends, however, will pull the stock price down. It is unclear whether the net effect on its stock will be an increase or a decrease in its price, but the change will depend on whether stockholders prefer dividends or increased growth.

1-11 The executive wants to demonstrate strong performance in a short period of time. Strong performance can be demonstrated either through improved earnings and/or a higher stock price. The current board of directors is well served if the manager works to increase the stock price; however, the board is not well served if the manager takes short-run actions which bump up short-run earnings, at the expense of long-run profitability and the company’s stock price. Consequently, the board may want to rely more on stock options and less on performance shares which are tied to accounting performance.

1-12 As the stock market becomes more volatile, the link between the stock price and the ability of senior management is weakened. Therefore, in this environment, companies may choose to de-emphasize the awarding of stock and stock options, and rely more on bonuses and performance shares which are tied to other performance measures besides the company’s stock price. Moreover, in this environment, it may be harder to attract or retain top talent if the compensation were tied too much to the company’s
stock price.

1-13 a. No, the TIAA-CREF is not an ordinary shareholder. Because it is the largest institutional shareholder in the United States and it controls $125 billion in pension funds, its voice carries a lot of weight. This "shareholder" in effect consists of many individual shareholders whose pensions are invested with this group.

b. The owners of TIAA-CREF are the individual teachers whose pensions are invested with this group.

C. For the TIAA-CREF to be effective in yielding its weight, it must act as a coordinated unit. In order to do this, the fund’s managers should solicit from the individual shareholders their "votes" on the fund’s practices, and from those "votes" act on the majority’s wishes. In so doing, the individual teachers whose pensions are invested in the fund have in effect determined the fund’s voting practices.