Solution Manual

to accompany

Fundamentals of Corporate Finance 2nd edition

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CHAPTER 1

The financial manager and the company

WILEY

Chapter 1

The Financial Manager and the Company

Learning Objectives

1. **Identify the key financial decisions facing the financial manager of any company.**
2. **Identify the basic forms of business organisation used in Australia, and review their respective strengths and weaknesses.**
3. **Describe the typical organisation of the financial function in a large company.**
4. **Explain why maximising the current value of the company's shares is the appropriate goal for management.**
5. **Discuss how agency conflicts affect the goal of maximising shareholder value.**
6. **Explain why ethics is an appropriate topic in the study of corporate finance.**

Suggested and Alternative Approaches to the Material

This chapter presents a general survey of interesting topics in corporate finance. It begins with a brief discussion of the role of the financial manager and is followed by an examination of the different legal forms of business. Although all of the most common organisational forms are discussed, the most common form for the purposes of the remainder of the text is the company form. The chapter then proceeds with the financial function of the manager and the goal of the company, which is to maximise shareholder wealth. It is this goal that requires that we recognise its conflicts such as agency and ethical problems.

This chapter is intended to help students begin to understand the long list of interesting problems that confront the financial manager and shareholders of the company. While omitting this chapter from a course syllabus will not necessarily diminish the direct understanding of the material, such an omission could give the impression that the remaining material in the course is mechanical in nature. Therefore, it is recommended that the instructor devote a lecture, or a portion of a lecture, on the chapter in order to establish a proper basis for future chapter-related discussions.

Summary of Learning Objectives

1. Identify the key financial decisions facing the financial manager of any company.

In running a business, the financial manager faces three basic decisions: (1) which productive assets should the company buy (capital budgeting), (2) how should the company finance the productive assets purchased (financing decision), and (3) how should the company manage its day-to-day financial activities (working capital decisions). The financial manager should make these decisions in a way that maximises the current value of the company share price.

2. Identify the basic forms of business organisations used in Australia, and review their respective strengths and weaknesses.

A business can organise itself in three basic ways: as a sole trader, a partnership, or a company (public or private). Most large companies elect to organise as public companies because of the ease this form offers in raising money and transferring ownership; the major disadvantages are extensive regulation by the Australian Securities and Investments Commission (ASIC). Some companies operate as private companies to escape much of the ASIC regulation but must give up access to the public capital markets. Smaller businesses tend to organise as sole traders or partnerships. The advantages of these forms of organisation include ease of formation and the fact that the income of sole traders and partnerships is taxed at the personal income tax rate. The major disadvantage is unlimited personal liability of the owners. The owners of a company select the form of organisation that they believe will best allow management to maximise the value of the company.

3. Describe the typical organisation of the financial function in a large company.

The board of directors is the most powerful governing body within the company. They are elected by the owners, and their major responsibility is to represent the best interests of the owners. To this end, the board is responsible for hiring the CEO and, if circumstances are warranted, to fire the CEO. The board also advises the CEO on a wide range of matters, monitors the company's performance, and ratifies key decisions made by management.

4. Explain why maximising the current value of the company's share price is the appropriate goal for management.

The goal of the financial manager is to maximise the current value of the company's share price. Maximising share price value is an appropriate goal because it forces management to focus on decisions that will generate the greatest amount of wealth for shareholders. Since the value of a share (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).

5. **Discuss how agency conflicts affect the goal of maximising shareholder value.**
In most large companies, there is a significant degree of separation between management and ownership. As a result, there is concern that shareholders have little control over corporate managers and that management may thus be tempted to pursue its own self-interest rather than maximising the wealth of the owners. The resulting problems are called agency costs. Owners try to reduce agency costs by developing compensation agreements that link employee compensation to the company's performance and by having independent boards of directors and external auditors monitor management.

6. **Explain why ethics is an appropriate topic for study in corporate finance.**
Ethical behaviour is important in business. If we lived in a world where there were no ethical norms, we would discover that it would be difficult to do business. As a practical matter, the law and market forces provide important incentives that foster ethical behaviour in the business community but are not enough to ensure ethical behaviour. An ethical culture means that people have a set of moral principles—a moral compass, so to speak—that helps them to identify ethical issues and then to make ethical judgments without being told what to do.

Summary of Key Equations

The chapter is primarily a qualitative chapter and does not have a relevant summary of key equations.

Before You Go On Questions and Answers

Section 1.1

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

   The three most basic financial 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. *Why are capital budgeting decisions among the most important decisions in the life of a company?*

   The capital budgeting decisions are considered the most important in the life of the company because these decisions determine which productive assets the company purchases and these assets generate most of the company's cash flows. Furthermore, capital 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.

3. *Explain why you would accept an investment project 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 company, making the owners wealthier. Most people start a business to increase their wealth.

Section 1.2

1. *Why are many businesses operated as sole traders?*

   Many businesses elect to operate as sole traders because of the small operating scale and capital base of their companies. This form of business organisation is fairly easy to start and impose few regulations on the owners.

2. *What are some advantages and disadvantages of operating as a partnership?*

   The key advantages are similar to those of sole traders. Besides, partnerships have access to more capital, and the pooling of knowledge, experience and skills. The key disadvantages are possible disputes among the partners over profit sharing, administration and business development and that each partner is personally responsible for business debts and liabilities incurred by the other partners.

3. *What are some advantages and disadvantages of operating as a company?*

   The main advantages of operating as a company 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. And because a company usually has a lot of shares outstanding, large blocks of securities can be bought or sold without an appreciable impact on the price of the share. The major disadvantages of companies are the cost to establish and register, and the higher compliance costs and stricter record-keeping requirements as compared to other forms of business structure.

Section 1.3

1. *What are the major responsibilities of the CFO?*

   The major responsibilities of a CFO are recommendation and financial analysis of financial decisions. Although all top managers in a company participate in these decisions, the final report and analysis is ultimately the responsibility of the CFO.

2. *Identify three 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, and the internal auditor. The controller is the company's chief accounting officer, and thus prepares the financial statements and taxes. This position also requires close cooperation with the external auditors. The treasurer's responsibility is the collection and disbursement of cash, investing excess cash, raising new capital, handling foreign exchange, and overseeing the company's pension fund management. He also assists the CFO in handling important share market relationships. Finally, the internal auditor is responsible for conducting risk assessment and for performing audits of high-risk areas.

3. *Why should the company's accounts be audited by an external auditor?*

   A company's accounts are audited by an external auditor for an independent opinion as to whether the company's financial statements present fairly, in all material respects, the financial position of the company and results of its activities.

Section 1.4

1. *Why is profit maximisation an unsatisfactory goal for managing a company?*

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

2. *Explain why maximising the current market price of a company's shares is an appropriate goal for the company's management.*

   Maximising the current market price of a company's shares is an appropriate goal for the company's management because it is an unambiguous objective and it is easy to measure. One can simply look at the value of the company's share on any given day to determine whether it went up or down.

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

   The fundamental determinant of an asset's value is the future cash flow the asset is expected to generate. 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 agency conflicts?*

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

2. *What are corporate raiders?*

   Corporate raiders can make the economy more efficient by keeping the top managers on their toes. Top managers know that if the company's performance declines and its share price 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 in the economy is twofold: first, the fear of takeovers pushes managers to do a better job, and second, if the managers are not performing up to expectations, the company can be rescued and restructured into a contributor again.

3. *What is the main objective of the corporate law reforms in the United States and in Australia?*

   The main goals of the corporate reforms in the United States and in Australia are to reduce agency costs in companies, to restore ethical conduct in the business sector, and to improve the integrity of accounting reporting systems within companies.

Section 1.6

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

   Conflict of interest in the business setting refers to a conflict between a person'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 moral values, that helps them to identify moral issues and then make ethical judgments without being told what to do.

Critical Thinking Questions

1.1 *Describe the cash flows between a company and its stakeholders.*

Cash flows are generated by a company'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 shareholders in the form of dividends.

1.2 *What are the three fundamental decisions the financial management team is concerned with, and how do they affect the company'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 company needs to buy productive assets. This is typically accomplished by selling long-term debt and equity. Finally, working capital decisions involve how companies manage their current assets and liabilities. The focus here is seeing that a company has enough money to pay its bills and that any spare money is invested to earn interest.

1.3 *What is the difference between shareholders and stakeholders?*

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

1.4 *Explain why profit maximisation is not the best goal for a company. What is an appropriate goal?*

Although profit maximisation 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 profit for similar companies can vary widely. Second, accounting profits do not exactly equal cash flows. Third, profit maximisation does not account for timing and ignores risk associated with cash flows. An appropriate goal for financial managers who do not have these objections is to maximise the value of the company's current share price. In order to achieve this goal, management must make financial decisions so that the total value of cash inflows exceeds the total value of cash outflows.

1.5 *In determining the price of a company's shares, what are some of the external and internal factors that affect price? What is the difference between these two types of variables?*

External factors that affect the company's share 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 or regulations. On one hand, external factors are variables over which the management has no control. On the other hand, internal factors that affect the share price can be controlled by management to some degree, because they are company specific, such as financial management decisions, product quality and cost, and the line of business management has selected to enter. Finally, perhaps the most important internal variable that determines the share price is the expected cash flow stream: its magnitude, timing, and riskiness.

1.6 *Identify the sources of agency costs. What are some ways a company can control these factors?*

Agency costs are the costs that result from a conflict of interest between the agent and the 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 by tying management compensation to company's performance or by establishing an independent board of directors. Outside factors that contribute to the minimization of agency costs are the threat of corporate raiders that can take over a company not performing up to expectations and the competitive nature of the managerial labour market.

1.7 *What is CLERP 9 and what are its main goals?*

CLERP 9 is the outcome of a review of corporate reporting and disclosure laws in Australia. The main goal of CLERP 9 is to strengthen the law in the areas of corporate governance, disclosure and regulation of audit and financial reporting. Among others, CELRP 9 will strengthen the standard for auditor independence, including requiring the rotation of auditors of listed companies after 5 years, strengthen the obligations of auditors to report breaches of the law to ASIC, and enhance disclosure and accountability to shareholders, including on executive and director remuneration.

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

For example, imagine a situation in which you are a financial officer at a growing software company and your company has decided to hire outside consultants to formulate a global expansion strategy. Coincidentally, your wife works for one of the major consulting companies 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 wife's company, because it will benefit your family's financial situation if she lands the contract, regardless of whether it makes the best sense for your company.

Questions and Problems

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

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

1.2 **Management role:** What is working capital management?

It is the management of current assets, such as inventory, and current liabilities, such as money owed to suppliers.

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

A profitable company is able to generate more than enough cash through its productive assets to cover its operating expenses, taxes, and payments to creditors. Unprofitable companies fail to do this, and therefore they may be forced to declare insolvency.

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

Financial managers are most concerned about the capital budgeting decision, the financing decision, and the working capital decision.

1.5 **Cash flows:** What is the general decision rule for a company considering undertaking a project? Give a real-life example.

A company should undertake a capital project only if the value of its future cash flows exceeds the cost of the project**.** For example: undertaking a capital project that requires a cash outlay of $10,000 when the present value of all future cash flows from the project is more than the initial outlay of $10,000.

1.6 **Management role:** What is capital structure, and why is it important to a company?

Capital structure shows how a company is financed; it is the mix of debt and equity on the liability side of the balance sheet. It is important as it affects the risk and the value of the company. In general, companies with higher debt-to-equity proportions are riskier because debt comes with legal obligations to pay periodic payments to creditors and to repay the principal at the end.

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

Working capital management is the day-to-day management of a company's current assets and liabilities to make sure that there is enough cash to cover operating expenses and there is spare cash to earn interest. The financial manager has to make decisions about the inventory levels or terms of collecting payments (receivables) from customers.

1.8 Organisational form: What are the three basic forms of business organisation discussed in this chapter?

The three basic forms of business organisation we discussed are sole trader, partnership, and company.

1.9 Organisational form: What are the advantages and disadvantages of becoming a sole trader?

Advantages:
- It is the easiest business type to start.
- It is the least regulated.
- Owners keep all the profits and do not have to share the decision-making authority with anyone.

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

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

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 organisation's debts and legal obligations no matter what stake they have in the business. One way to avoid this is to form a limited partnership in which only general partners have unlimited liability and limited partners are only responsible for business obligations up to the amount of capital they contributed to the partnership.

1.11 Organisational form: Who are the owners of a company, and how is their ownership represented?

The owners of a company are its shareholders, and the evidence of their ownership is represented by proportions of ordinary shares. Other types of ownership do exist and include preferred shares.

1.12 Organisational form: Explain what is meant by shareholders' limited liability.

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

1.13 Organisational form: What is the business organisation form preferred by companies that require a large capital base, and why?

A company can list on securities exchange, such as the Australian Securities Exchange (ASC) as a public company to gain access to the public markets.

1.14 Finance function: What is the most important governing body within a business organisation? What responsibilities does it have?

The most important governing body within an organisation is the board of directors. Its main role is to represent the shareholders. The board also hires (and occasionally fires) the CEO and advises him or her on major decisions.

1.15 Finance function: All public companies hire a public accounting firm to perform an independent audit of the financial statements. What exactly does an audit mean?

An independent public accounting firm that performs an audit of a company ensures that the financial numbers are reasonably accurate, that accounting principles have been adhered to year after year and not in a manner that distorts the company's performance.

1.16 Company's goal: What are some of the drawbacks to setting profit maximisation as the main goal of a company?

- It is difficult to determine what is meant by profits.
- 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 of risk of cash flows.

1.17 Company's goal: What is the appropriate goal of financial managers? Can managers' decisions affect this goal in any way? If so, how?

The appropriate goal of financial managers should be to maximise the current value of the company's share price. Managers' decisions affect the share price in many ways as the value of the share is determined by the future cash flows the company can generate. Managers can affect 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.

1.18 Company's goal: What are the major factors affecting share price?

The following factors affect the share price: the company, the economy, economic shocks, the business environment, expected cash flows, and current market conditions.

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

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

1.20 Company's goal: What can happen if a company is poorly managed and its share price falls substantially below its maximum?

If the share 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.

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

Some of the regulations include:

a. The majority of board members must be outsiders.
b. A separation of the CEO and chairman of the board positions is recommended.
c. The CEO and CFO must certify all financial statements.

1.22 Business ethics: How could business dishonesty and low integrity cause an economic downfall? Give an example.

Business dishonesty and lack of transparency lead to corruption, which in turn creates inefficiencies in an economy, inhibits the growth of capital markets, and slows the rate of economic growth. For example, until the mid-1990s the Russian market had a difficult time attracting investors as there was no reliable financial information on any of the companies. Only after the Russians made a conscious decision to make their records and motives transparent were they able to draw foreign investments.

1.23 Agency conflicts: What are some possible ways to resolve a conflict of interest?

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 lawsuit are represented by the same company, 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 companies not being allowed to serve as consultants to companies for which they perform audits.

1.24 Business ethics: What ethical conflict does insider trading present?

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 morally wrong and has also been made illegal.