Solution Manual for Finance Applications and Theory 3rd Edition by Cornett Adair Nofsinger

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Questions

LG1 1. Describe the type of people who use the financial markets.

The financial markets are used by people who have extra money now and want it to grow for their future. They offer this capital through the financial markets to others who have good ideas and opportunities, but need the capital to implement them. These types of people are denoted as Type 2 and 3 people in Figure 1.1.

LG1 2. What is the purpose of financial management? Describe the kinds of activities that financial management involves.

Financial management is the process of making decisions for the acquisition, use, and repayment of capital. Decisions for the acquisition of capital can include how the business is organized, what type of capital should be obtained, and how much capital should be obtained. Decisions for the uses of capital include what new business projects to invest in, what capital to retain to fund ongoing projects, and to reduce taxation. Decisions for the repayment of capital involve paying capital back to its providers.

LG2 3. What is the difference in perspective between finance and accounting?

Accounting focuses on recording and presenting the past business activities. This information is good for evaluating past performance. The finance function uses this past data along with current information to make decisions on what business activities to do now and in the future. Decisions about the future involve much uncertainty, so risk evaluation is part of the finance job.

LG3 4. What personal decisions can you think of that will benefit from learning finance?

Learning finance will help the student build wealth and reduce costs in their personal life. After taking this class, the student should be able to make good decisions about funding their future retirement and investment allocations. People with finance knowledge can also reduce costs by making good decisions in borrowing while buying cars, homes, and using credit cards.

LG4 5. What are the three basic forms of business ownership? What are the advantages and disadvantages to each?

The three basic business forms are the sole proprietorship (SP), the partnership (Part), and the corporation (Corp). Advantages and disadvantages can be determined along several dimensions: control, risks, access to capital, and taxation. The SP owner has total control of business decisions. Control decreases for owners of Part and then Corp. The owner has high risk to their personal wealth in a SP and Part, but low risk in a Corp. Access to capital is addressed in question 6. Lastly, SP and Part owners are taxed as if the business was personal income. The Corp owner is taxed twice, once at the corporation level and then again at the personal level.

LG4 6. Between the three basic forms of business ownership, describe the ability of each form to access capital.

The corporation has the highest access to capital. It can acquire new equity capital from the public market. Also, banks are more willing to lend to corporations. Debt investors are also more likely to buy the bonds of a corporation. Partnerships have the next best access to capital. With larger numbers of partners involved with the business, the more likely banks will lend and debt investors will buy its bonds. Partnerships do not have access to the public equity market. Lastly, sole proprietorships have poor access to capital. Generally speaking, the sole proprietor cannot borrow as much money from banks or debt investors.

LG4 7. Explain how the founder of a business can eventually lose control of the firm. How can the founder ensure this will not happen?

When the founder wants the business to grow quickly, more capital is required. In the early stages of a small fast growing company, it is equity capital that is available. In other words, the founder must give up a portion of his or her ownership to other investors. As this process continues over time, the founder may find that he or she no longer owns a majority of the firm. There may come a time when enough of these other owners that own a combined 50+ percent of the firm come together and change the leadership of the firm.

LG5 8. Explain the shareholder wealth maximization goal of the firm and how it can be measured. Make an argument for why it is a better goal than maximizing profit.

The shareholder wealth maximization goal of the firm states that managers should run the company in such a way that maximizes the wealth of the stockholders. Progress for this goal can be measured using the stock price. The stock price contains what investors know about the current profitability of the firm and expectations about future profits and opportunities. Maximizing profit is a similar goal, but not quite as good. A manager could maximize this year’s profit at the detriment of future profits. This would not be good for long-term investors.

LG5 9. Name and describe as many corporate stakeholders as you can.

Stockholders, managers, and employees are all stakeholders with a very close relationship to the firm. Customers, suppliers, banks, and bondholders have a close relationship to the firm. Local government, local community people, and people who enjoy the environment are also stakeholders.

LG6 10. What conflicts of interest can arise between managers and stockholders?

Stockholders own the firm and hire managers to run the firm. Managers, therefore, control the day to day operations of the firm. Since the stockholders can't see these decisions, it is possible that the managers will manage the firm in such a way that it benefits themselves more than the shareholders. This conflict of interest can manifest as higher costs to the firm for things that benefit the managers. It can also show up in decisions to make poor acquisitions of other firms in order to make the company bigger and then argue for higher managerial pay.

LG6 11. Figure 1-9 shows firm monitors. In your opinion, which group is in the best position to monitor the firm? Explain. Which group has the potential to be the weakest monitor? Explain.

Auditors are in a great position to monitor the company. They are specifically tasked with identifying and reporting the activities of the company. The members of the Board of Directors are also in a good position to monitor the firm because they are at a high position and are charged with hiring, firing, and monitoring management. These two groups do well when they are independent of management. Financial analysts are not in a good position to monitor management because they have no special ability to acquire private information about management's activities. In addition, they sometimes experience conflicts of interest in their rating of firms.

LG6 12. In recent years, governments all over the world have passed laws that increased the penalties for executives' crimes. Do you think this will deter unethical corporate managers? Explain.

Better monitoring and increased punishment should reduce unethical behavior from corporate managers for awhile. Executives are smart enough to not push any gray areas or commit fraud during this time with heightened awareness of executive crime. However, this focus will wane many years from now. Although these new laws will still apply, unethical managers may once again behavior badly.

LG6 13. Every year, the media reports on the vast amounts of money (sometimes hundreds of millions of dollars) that some CEOs earn from the companies they manage. Are these CEOs worth it? Give examples.

When a CEO earns hundreds of millions of dollars, it is usually because they have had an incentive compensation plan pay off big. These incentive plans have been given many years before. If the firm's stock price increases enough over the years, then the CEO's stock options become very valuable. If the CEO's leadership over the years is responsible for the increase in stock price, then it is likely worth it. Of course, if the stock price later declines, then it would not be worth it. The late Steve Jobs of Apple Computer earned $646 million in 2006. While this is an obscene amount of money, Jobs' return to Apple heralded the iPod, iTunes, iPhone, iPad, and better computers. In his most recent turn at Apple, the stock went from an equivalent of $5 per share to $80 per share in 2006 and to $175 in 2007. This pay is all incentive pay as he earned a salary of $1 during this time.

LG7 14. Why is ethical behavior so important in the field of finance?

Ethical behavior is so important because finance involves the management of other people's capital. People must be willing to invest their capital with others if the economy is to thrive. But nobody wants to offer their capital if they believe they will be taken advantage of. Thus, it is very important to the economy to have confidence in ethical behavior.

LG7 15. Does the goal of shareholder wealth maximization conflict with behaving ethically? Explain.

No. The goal of shareholder wealth maximization is to maximize the stock price over the long term. Unethical behavior may temporarily increase the stock price, but it will eventually be found out. When that happens, the company is punished by a falling stock price.

LG8 16. Describe how financial institutions and markets facilitate the expansion of a company's business?

Companies need additional capital to fund large business expansion opportunities. Financial institutions and markets provide that capital. A firm's opportunities may offer higher profits to the firm than the costs paid for the capital. So facilitate the firm's expansion also leads to increased value of the firm.

Research It!
Corporate Governance

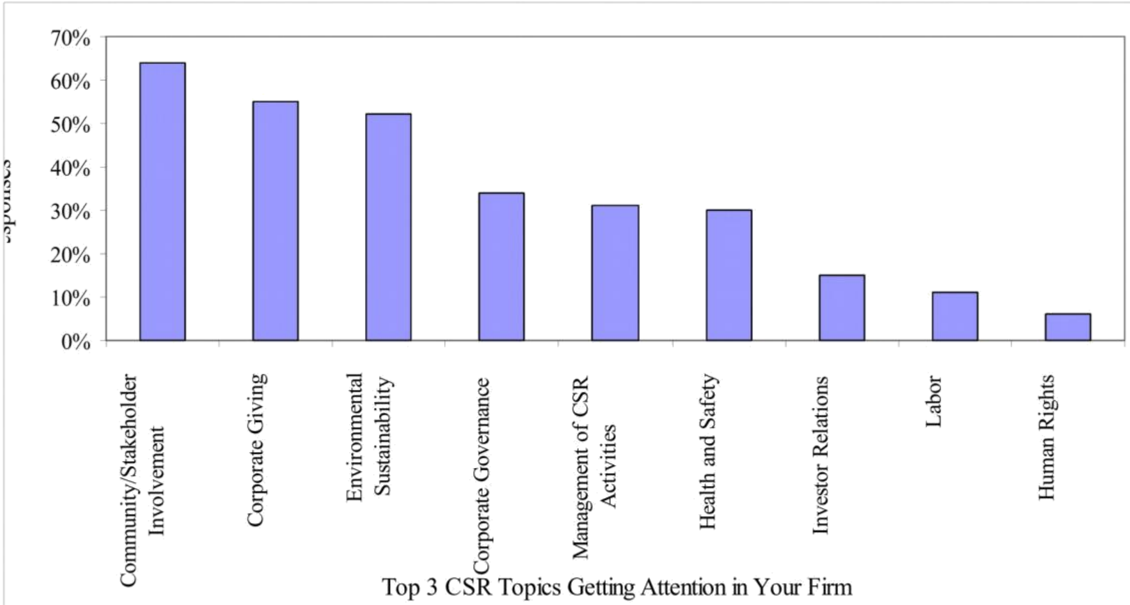
The corporate governance system continues to evolve. After the very visible governance failures in the early 2000s, the national focus was placed on this issue. The U.S. government passed new laws regarding auditing, board of directors' composition, and executive behavior. Directors also began to change the form of executive incentive compensation. Some believe the changes went too far and have placed a costly burden on public corporations. Others believe that some new laws did not go far enough to reign in the extreme levels of executive compensation. For information on this ongoing debate, visit the leading independent source for U.S. corporate governance and executive compensation, SOLUTION: The Corporate Library offers many data and information services on corporate governance. In addition, they provide a commentary on various decisions made by company executives and provide advice on proposed new laws and regulation.

Integrated Mini-case: Corporate Citizenship

What is a company's responsibility to society? Proponents of the modern view of stakeholder theory argue that companies have a social obligation to operate in ethically, socially, and environmentally responsible ways. This active approach is referred to as corporate social responsibility (CSR) or corporate citizenship. The idea of corporate citizenship is that a firm should conduct its business in a manner that meets its economic, legal, ethical, and philanthropy expectations.

The economic responsibilities have the highest priority. A firm must be efficient and survive over the long term in order to be useful to society. It must also execute its business activities in a legal and ethical way. These responsibilities are those over and above the ones codified in laws and are in line with societal norms and customs. They are expected, by society even though they may be ill-defined. This could include things such as environmental ethics. Philanthropy is the least important priority. The corporate citizenship concept focuses more on engagement with stakeholders to achieve mutual goals.

Some corporations have responded to this trend by including CSR-oriented statements in their corporate goals. These statements recognize that CSR has value in a code of conduct or ethics, a commitment to local communities, an interest in employee health and education, an environmental consciousness, and recognition of social issues (e.g. diversity, social fairness, etc.). In October of 2006, The Conference Board surveyed large U.S. firms on corporate citizenship issues, 198 firms responded. When asked about the top 3 CSR topics receiving attention at the company, the results were:



What is the motivation for these companies to fund CSR programs? When asked, 92 percent stated that enhancing corporate reputation was very important. Other popular responses were for recruiting and retention (78 percent), reducing risk (65 percent).

a. Wal-Mart generates over $11 billion in profits per year and is the largest corporate employer in the U.S., with 1.4 million employees. But Wal-Mart also seems to be coming under increasing pressure from different social groups for its business practices. Community groups have worked to keep Wal- Mart from coming to their towns. Wal-Mart claims that its low prices help everyone in the community. Also by giving over $270 million to charity last year, it is the largest corporate cash contributor in the United States.
b. What activities might companies engage in to satisfy the four components of corporate citizenship: economic, legal, ethical, and philanthropy?
c. By embracing citizenship goals, assess whether corporations can insulate themselves from many activist actions, thereby avoiding negative media events.

SOLUTION:

"The truth is that Wal-Mart has let America down by lowering wages, forcing good paying American jobs overseas, and cutting costs with total disregard for the values that have made this nation great. Wal-Mart has needlessly exploited illegal immigrants, faces

> the largest gender discrimination lawsuit in history, forced workers to work in an unsafe environment, and—**incredibly**—broken child labor laws."

Wal- Mart aggressively publicizes its charitable contributions. At the time of this writing, their website was promoting the following gifts: scholarships for thousands of students, 3 million meals (about $1 million) to America's Second Harvest, $200,000 to Salvation Army, $1.2 million to schools, and many more. In addition, Wal-Mart promotes its sustainability efforts. Its website reports:

> "At Wal-Mart, we know that being an efficient and profitable business and being a good steward of the environment are goals that can work together. Our environmental goals at Wal-Mart are simple and straightforward: To be supplied 100 percent by renewable energy; to create zero waste; and to sell products that sustain our resources and the environment."

b. The best economic component is to strive for shareholder wealth maximization. This will help the firm survive for the long-term to benefit its employees and the communities it operates in. Firms should always behave in a lawful manner. U.S. firms should obey U.S. laws even when operating in countries where a behavior may be legal there, but illegal in the United States. The firm can behave in an ethical manner. Among other things, this means producing products that that are not harmful. This is important for the long-term success of the firm. Lastly, the company can give to charity at both the local, community level and to large, national organizations.

c. Companies can insulate themselves to some degree by being aggressive in promoting its citizenship activities. That is, firms can build up some goodwill with its good deeds. However, there are many activists with many topics. It is difficult to be known for good citizenship activities in all things. This takes manager's time and effort and company money that might be better served focusing on the business of the firm. So, a firm that has a good reputation for treating its people well might still be criticized by environmental activists. Firms that are known for contributing to local communities might be criticized on its activities in foreign countries.