■ Ch. 1 Answers to Review Questions

1-1. The goal of a firm, and therefore of all financial managers, is maximizing shareholder wealth. The proper metric for this goal is the price of the firm's stock. Other things equal, an increasing price per share of common stock relative to the stock market as a whole indicates achievement of this goal.

1-2 Actions that maximize the firm's current profit may not produce the highest stock price because (1) some firm activities that result in slightly lower profit today generate much larger profits in the future periods (i.e., focusing on current profit overlooks the time value of money); (2) activities that generate higher accounting profits today may not result in higher cash flows to stockholders; and (3) activities that lead to high profits today may involve higher risk, which could result in significant future losses.

1-3 Risk is the chance actual outcomes may differ from expected outcomes. Financial managers must consider risk and return because the two factors tend to have an opposite effect on share price. That is, other things equal, an increase in the risk of cash flows to shareholders will depress firm stock price while higher average cash flows to shareholders will increase stock price.

1-4 Maximizing shareholder wealth does not mean overlooking or minimizing the welfare of other firm stakeholders. Firms with satisfied employees, customers, and suppliers tend to produce higher (or less risky) cash flows for their shareholders compared with companies that neglect non-owner stakeholders. That said, customers prefer lower prices for firm output, firm employees prefer higher wages, and firm suppliers prefer higher prices for the input goods and services they provide. So actions that produce the highest price of the firm's stock cannot simultaneously maximize customer, employee, and supplier satisfaction.

1-5 Broadly speaking, the decisions made by financial managers fall under three headings: (i) investment, (ii) capital budgeting, and (iii) working capital. Investment decisions involve the firm's long-term projects while financing decisions concern the funding of those projects. Working-capital decisions, in contrast are related to the firm's management of short-term financial resources.

1-6 Financial managers must recognize the tradeoff between risk and return because shareholders prefer higher cash flows but dislike large swings in cash flows. And, as a general rule, actions that boost the firm's average cash flows also result in greater cash-flow greater volatility. Viewed another way, firm actions to reduce the chance cash flows will be low or negative also tend to reduce average cash flows over time. Understanding this tradeoff is important because shareholders are risk averse. That is, they will only accept larger swings in a firm's cash flows only if compensated over time with higher average cash flows.

1-7 Finance is often considered applied economics. One reason is firms operate within the larger economy. More importantly, the bedrock concept in economics—marginal benefit-marginal cost analysis—is also central to managerial finance. Marginal benefit-marginal cost analysis is the notion a firm (or any other economic actor) should take only those actions for which the extra benefits exceed the extra costs. Nearly, all financial decisions ultimately turn on an assessment of their marginal benefits and marginal costs.

1-8 Accountants and financial managers perform separate but equally important functions for the firm. Accountants primarily collect and present financial data according to generally accepted financial principles while financial managers make investment, capital-budgeting, and working-capital decisions with financial data. In part because of their different functions, accountants and financial managers log firm revenues and expenses using different conventions. Accountants operate on an accrual basis, recognizing revenues as firm output is sold (whether or not payment is actually received) and firm expenses as incurred. Financial managers, in contrast, focus on actual inflows and outflows of cash, recognizing revenues when physically received and expenses when actually paid.

1-9 Like any economic actor, managers respond to incentives. Managers have a fiduciary duty to maximize shareholder wealth, but as humans, they also have personal goals—such as maximizing their own income, wealth, reputation, and quality of life. If the personal benefits of delivering for shareholders (or the costs of slighting them) are small, a financial manager might opt to further his own interest at the expense of shareholders. For example, CEOs of large firms—those with more sales, assets, employees, etc.—tend to receive more compensation than CEOs of smaller firms. If a CEO has to choose between two operating strategies—one that produces modest growth for his firm but a large jump in current stock price and another that generates rapid growth but a more modest rise in share price—and the firm's board is not closely monitoring the CEO, she might pursue the high-growth strategy to boost her future compensation. A partial solution to such a problem is a compensation closely linking CEO compensation to firm stock price.

1-10 Sole proprietorships are the most common form of business organization, while corporations tend to be the largest. Large firms tend to organize as corporations to insulate owners from losses (limit liability) and facilitate acquisition of financial capital to fund growth.

1-11 Stockholders are the owners of a corporation. Their ownership (equity) takes the form of common stock or, less frequently, preferred stock. Stockholders elect the board of directors, which has ultimate responsibility for guiding corporate affairs and setting general policy. The board usually comprises key corporate personnel and outside directors. The corporation's president or chief executive officer (CEO) reports to the board. He or she oversees day-to-day operations subject to the general policies established by the board. The corporation's owners (shareholders) do not have a direct relationship with management; they provide input by electing board members and voting on major charter issues. Shareholders receive compensation in two forms: (i) dividends paid on their stock (from corporate earnings) and (ii) capital gains from increases in the price of their shares (which reflect market expectations about future dividends).

1-12 Generally speaking, income from sole proprietorships and partnerships is taxed only once at the individual level; the owner or owners pay personal income tax on their share of firm's profits. In contrast, corporate income is taxed first at the firm level (via the corporate income tax paid on firm profits) and then again at the personal level (via personal income tax paid on dividends or capital gains enjoyed by shareholders).

1-13 Agency problems arise when managers place personal goals ahead of their duty to shareholders to maximize stock price. The attendant costs are called agency costs. Agency costs can be implicit or explicit; either way they reduce shareholder wealth. An example of an "implicit" agency cost is the dividends or capital gains shareholders miss out on because the firm's management team pursued a personal interest (like maximizing sales to boost future compensation) rather than maximizing shareholder wealth. Of course, if shareholders sense stock price is not what it should be, they will start monitoring management more closely (as in the chapter opener with Brookdale Senior Living). The expenses associated with greater monitoring are an example of an "explicit" agency cost. Agency problems in a firm can be reduced with a properly constructed and followed corporate-governance structure. Such a structure will feature checks and balances that reduce management's interest in and ability to deviate from shareholder-wealth maximization. Like all corporate decisions, reducing agency costs is subject to marginal benefit–marginal cost analysis. In other words, the firm should invest in policies to align the incentives of management and shareholders as long as the marginal benefits exceed the marginal costs.

1-14 Firms most commonly try to mitigate agency problems by linking pay to metrics connected with shareholder wealth. Incentive plans tie compensation to share price. For example, the CEO might receive options offering the right to purchase stock at a set price (say current price) any time in the next few years. If the CEO takes actions that subsequently boost share price, she can profit personally by exercising the option—purchasing stock at the set price—and reselling at the higher market price. The higher the firm's stock price, the more money the CEO can make, so options create a powerful incentive to focus laser-like on shareholder wealth. There is a downside, however. Sometimes general market trends swamp all the good done by management, so even though the CEO obsessed over shareholder wealth, her options proved worthless because a bear market hammered the firm's stock price. This problem has made performance plans more popular. These plans link compensation with performance measures related to stock price that management can more closely control—such as earnings per share (EPS) and EPS growth. When targets for the performance metrics are attained, managers receive rewards like performance shares and/or cash bonuses.

1-15 If the board of directors fails to keep management focused on shareholder wealth, market forces can apply the necessary pressure. Two such forces are activism by institutional investors (such as Land and Buildings in the chapter opener) and the threat of hostile takeovers. Institutions typically hold large quantities of shares in many corporations. Because of their large stakes, these investors actively monitor management and vote their shares for the benefit of all shareholders. Large institutional investors reduce agency problems by using their voting clout to elect new directors that will make the changes in policies and personnel necessary to get underperforming stock to its highest possible price. The threat of hostile takeover can also keep management focused on shareholders. Say a firm has a stock price of $15, but that price could be $20 with bold action management is reluctant to take. The lure of a $5 capital gain per share could tempt an outside individual, group of investors or firm not supported by existing management to purchase controlling interest and force the necessary changes. Incumbent management knows "necessary changes" means unemployment, so the threat of takeover could be enough to align their interests with those of the owners.