**Chapter 1**

**The Financial Manager and the Firm**

**Before You Go On Questions and Answers**

**Section 1.1**

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

The three most 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.

1. **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 these assets generate most of the firm’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.

**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.

1. **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. And because 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.

1. **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 are recommendation and financial analysis of financial decisions. Although all top managers in a firm participate in these decisions, the final report and analysis is ultimately the responsibility of the CFO.

1. **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 firm’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 Wall Street relationships. Finally, the internal auditor is responsible for conducting risk assessment and for performing audits of high-risk areas.

1. **Why does the internal auditor report to both the CFO and 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.

1. **Explain why maximizing the current 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 it is easy to measure. One can simply look at the value of the company’s stock on any given day to determine whether it went up or down.

1. **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 maximization of shareholder value is pushed to the side.

1. **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 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 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.

1. **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 in the business sector, and to improve the integrity of accounting reporting systems within firms.

**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 identify moral issues and then make ethical judgments without being told what to do.

**Self-Study Problems and Solutions**

1. **Give an example of a capital budgeting decision and a financing decision.**

**Solution:** Capital budgeting involves deciding which productive assets the firm invests in, 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**

**Level: Basic**

1. **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**

**Level: Basic**

1. **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**

**Level: Basic**

1. **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: 2**

**Level: Basic**

1. **What are typically the main components of an 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: 5**

**Level: Basic**

**Discussion Questions and Answers**

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**

**Level: Basic**

Bloomcode: Comprehension

AACSB: Analytic

IMA: Corporate Finance

AICPA: Industry/Sector Perspective

1. *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. This is typically accomplished by selling long-term debt and equity. Finally, working capital decisions involve how firms manage their current assets and liabilities. The focus here is seeing that a firm has enough money to pay its bills and that any spare money is invested to earn a return.

**LO: 1**

**Level: Basic**

Bloomcode: Comprehension

AACSB: Analytic

IMA: Decision Analysis

AICPA: Decision Modeling

1. *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**

**Level: Basic**

Bloomcode: Analysis

AACSB: Analytic

IMA: Corporate Finance

AICPA: Industry/Sector Perspective

1. *Suppose that a group of 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: 2**

**Level: Basic**

Bloomcode: Application

AACSB: Analysis

IMA: Business Economics

AICPA: Industry/Sector Perspective

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

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

**LO: 2**

**Level: Basic**

Bloomcode: Comprehension

AACSB: Analytic

IMA: Business Economics

AICPA: Industry/Sector Perspective

1. *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 vary 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 who do not have these objections is to maximize the value of the firm’s current stock 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.

**LO: 4**

**Level: Intermediate**

Bloomcode: Comprehension

AACSB: Analytic

IMA: Performance Measurement

AICPA: Strategic/Critical Thinking

1. *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 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 stock price can be controlled by management to some degree, because they are firm specific, such as financial management decisions, product quality and cost, and the line of business, the management has selected to enter. Finally, perhaps the most important internal variable that determines the stock price is the expected cash flow stream: its magnitude, timing, and riskiness.

**LO: 4**

**Level: Basic**

Bloomcode: Comprehension

AACSB: Analytic

IMA: Strategic Marketing

AICPA: Measurement

1. *Identify the sources of agency costs. What are some ways these costs can be controlled in a company?*

Agency costs are the costs that result from conflicts 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 and 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 labor market.

**LO: 5**

**Level: Basic**

Bloomcode: Comprehension

AACSB: Analytic

IMA: Business Economics

AICPA: Industry/Sector Perspective

1. *What is the Sarbanes-Oxley Act, and what does it focus on? Why does it focus in 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 system within firms. Failures in these areas led to the corporate scandals that preceded passage of Sarbanes-Oxley.

**LO: 5**

**Level: Basic**

Bloomcode: Knowledge

AACSB: Analytic

IMA: FSA

AICPA: Legal/Regulatory Perspective

1. *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 wife 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 wife’s firm, because it will benefit your family’s financial situation if she lands the contract, regardless of whether or not it makes the best sense for your firm.

**LO: 6**

**Level: Intermediate**

Bloomcode: Application

AACSB: Analytic

IMA: Business Economics

AICPA: Industry/Sector Perspective

**Questions and Problems and their Solutions**

**BASIC**

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. **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. **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 they may be forced to declare bankruptcy.

**LO:** 1.1

Bloomcode: Analysis

AACSB: Analytic

IMA: Cost Management

AICPA: Measurement

1. **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. **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 future cash flows from that line are expected to produce only $9,000,000 in future cash flows. 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. **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 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.

**LO:** 1.1

Bloomcode: Comprehension

AACSB: Analytic

IMA: Corporate Finance

AICPA: Industry/Sector Perspective

1. **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 (account receivables), and the firm’s policy on paying accounts payable.

**LO:** 1.1

Bloomcode: Comprehension

AACSB: Analytic

IMA: Decision Analysis

AICPA: Strategic/Critical Thinking

1. **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, and limited liability company and partnerships.

**LO:** 1.2

Bloomcode: Knowledge

AACSB: Reflective Thinking

IMA: Business Economics

AICPA: Industry/Sector Perspective

1. **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 the 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. **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 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 have invested to the partnership.

**LO:** 1.2

Bloomcode: Comprehension

AACSB: Analytic

IMA: Business Economics

AICPA: Industry/Sector Perspective

1. **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. **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. **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 the dividends.

**LO:** 1.2

Bloomcode: Comprehension

AACSB: Analytic

IMA: Business Economics

AICPA: Industry/Sector Perspective

1. **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. **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. **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 numbers are reasonably accurate, that accounting principles have been adhered to year after year and not in a manner that distorts the firm’s performance, and that the accounting principles used are in accordance with generally accepted accounting principles (GAAP).

**LO:** 1.3

Bloomcode: Comprehension

AACSB: Analytic

IMA: FSA; Reporting

AICPA: Risk Analysis; Reporting

1. **Firm’s goal:** What are some of the drawbacks to setting profit maximization as the main goal of a company?

**Solution:**

* + 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 or risk of cash flows.

**LO:** 1.4

Bloomcode: Comprehension

AACSB: Analytic

AICPA: Strategic/Critical Thinking

IMA: Corporate Finance

1. **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 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.

**LO:** 1.4

Bloomcode: Comprehension

AACSB: Analytic

AICPA: Strategic/Critical Thinking

IMA: Decision Analysis

1. **Firm’s goal:** What are the major factors that affect a firm’s stock price?

**Solution:** The factors affecting the stock price include: the characteristics of the firm, the economy, economic shocks, the business environment, expected cash flows, and current market conditions.

**LO:** 1.4

Bloomcode: Comprehension

AACSB: Analytic

AICPA: Strategic/Critical Thinking

IMA: Corporate Finance

1. **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 represent the firm. An agency conflict arises when the agent’s interests and behaviors are at odds with 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:** 1.5

Bloomcode: Comprehension

AACSB: Analytic

IMA: Business Economics

AICPA: Industry/Sector Perspective

1. **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. **Agency conflicts:** What are some of the regulations that pertain to 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 chairman of the board positions is recommended.
  + Firm is required to have a code of ethics approved by the board.

**LO:** 1.5

Bloomcode: Comprehension

AACSB: Analytic

IMA: FSA

AICPA: Legal/Regulatory Perspective

1. **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, weak ethics in the business community 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:** 1.6

Bloomcode: Comprehension

AACSB: Analytic

IMA: Business Economics

AICPA: Industry/Global Perspective

1. **Agency conflicts:** 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 lawsuit 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:** 1.5

Bloomcode: Application

AACSB: Analytic

IMA: FSA

AICPA: Legal/Regulatory Perspective

**1.25** **Information asymmetry:** Describe what an information asymmetry is in a business transaction. Explain how the inequity associated with an 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:** 1.6

Bloomcode: Comprehension

AACSB: Analytic

IMA: Strategic Marketing

AICPA: Marketing/Client Focus

**1.26** **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 morally wrong and has also been made illegal.

**LO:** 1.6

Bloomcode: Comprehension

AACSB: Ethics

IMA: Business Applications

AICPA: Professional Demeanor

**Sample Test Problems**

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**

**Level: Intermediate**

Bloomcode: Comprehension

AACSB: Analytic

IMA: Decision Analysis

AICPA: Decision Modeling

1. Which of the following is/are advantages of the corporate form of organization?
   1. Reduced start-up costs
   2. Greater access to capital markets
   3. Unlimited liability
   4. 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: 2**

**Level: Intermediate**

Bloomcode: Comprehension

AACSB: Analytic

IMA: Business Economics

AICPA: Industry/Sector Perspective

1. 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: 4**

**Level: Intermediate**

Bloomcode: Comprehension

AACSB: Analytic

IMA: Strategic/Critical thinking

AICPA: Corporate Finance

1. 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 owners’ interests. The cost of mechanisms, such as audits, that help control agency conflicts are also agency costs.

**LO: 5**

**Level: Intermediate**

Bloomcode: Comprehension

AACSB: Analytic

AICPA: Industry/Sector Perpsective

IMA: Business Economics

1. 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 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: 5**

**Level: Intermediate**

Bloomcode: Comprehension

AACSB: Analytic

AICPA: Strategic/Critical Thinking

IMA: Performance Measurement