CHAPTER 1
INTRODUCTION TO CORPORATE FINANCE

Answers to critical thinking and concepts review questions

1. Capital budgeting (deciding on whether to expand a manufacturing plant), capital structure (deciding whether to issue new equity and use the proceeds to retire outstanding debt), and working capital management (modifying the firm's credit collection policy with its customers).

2. Disadvantages include unlimited liability, limited life, difficulty in transferring ownership and hard to raise capital funds. Some advantages include simpler structure, less regulation, the owners are also the managers, and sometimes personal tax rates are better than corporate tax rates.

3. The primary disadvantage of the corporate form is the double taxation to shareholders of distributed earnings and dividends for some shareholders. Some advantages include: limited liability, ease of transferability, ability to raise capital, and unlimited life.

4. The treasurer's office and the chief accountant's office are the two primary organisational groups that report directly to the chief financial officer. The chief accountant's office handles cost and financial accounting, tax management, and management information systems. The treasurer's office is responsible for cash and credit management, capital budgeting, and financial planning. Therefore, the study of corporate finance is concentrated within the functions of the treasurer's office.

5. To maximise the current market value (share price) of the equity of the firm (whether it's publicly traded or not).

6. In the corporate form of ownership, the shareholders are the owners of the firm. The shareholders elect the directors of the corporation, who in turn appoint the firm's management. This separation of ownership from control in the corporate form of organisation is what causes agency problems to exist. Management may act in its own or someone else's best interests, rather than those of the shareholders. If such events occur, they may contradict the goal of maximising the share price of the equity of the firm.

7. A primary market transaction.

8. In auction markets like the ASX, brokers buy and sell shares on the instructions of their clients, placing orders on the ASX's automated trading system. Dealer markets such as NASDAQ in the US represent dealers operating in dispersed locales who buy and sell assets themselves. They usually communicate with other dealers electronically or literally over the counter.

9. Since such organisations frequently pursue social or political missions, many different goals are conceivable. One goal that is often cited is revenue minimisation; i.e., providing their goods and services to society at the lowest possible cost. Another approach might be to observe that even a not-for-profit business has equity. Thus, an appropriate goal would be to maximise the value of the equity.

10. An argument can be made either way. At one extreme, we could argue that in a market economy, all of these things are priced. This implies an optimal level of ethical and/or illegal behaviour and the framework of share valuation explicitly includes these. At the other extreme, we could argue that these are non-economic phenomena and are best handled through the political process. The following is a classic (and highly relevant) thought question that illustrates this debate: 'A firm has estimated that the cost of improving the safety of one of its products is $30 million. However, the firm believes that improving the safety of the product will only save $20 million in product liability claims. What should the firm do?'

11. The goal will be the same, but the best course of action towards that goal may require adjustments due to different social, political, and economic climates.

12. The goal of management should be to maximise the share price for the current shareholders. If management believes that it can improve the profitability of the firm so that the share price will exceed $35, then they should fight the offer from the outside company. If management believes that this bidder or other unidentified bidders will actually pay more than $35 per share to acquire the company, then they should still fight the offer. However, if the current management cannot increase the value of the firm beyond the bid price, and no other higher bids come in, then management is not acting in the interests of the shareholders by fighting the offer. Since current managers often lose their jobs when the corporation is acquired, poorly monitored managers have an incentive to fight corporate takeovers in situations such as this one.

13. We would expect agency problems to be less severe in some other countries, primarily due to the relatively small percentage of individual ownership. Fewer individual owners should reduce the number of diverse opinions concerning corporate goals. The high percentage of institutional ownership might lead to a higher degree of agreement between owners and managers on decisions concerning risky projects. In addition, institutions may be able to implement more effective monitoring mechanisms than can individual owners, given an institutions' deeper resources and experiences with their own management. The increase in institutional ownership of shares in Australia and the growing activism of these large shareholder groups may lead to a reduction in agency problems for Australian firms as well as a more efficient market for corporate control.

14. How much is too much? Who is worth more, Ralph Norris or Nicole Kidman? The simplest answer is that there is a market for executives just as there is for all types of labour. Executive compensation is the price that clears the market. The same is true for athletes and performers. Having said that, one aspect of executive compensation deserves comment. A primary reason that executive compensation has grown so dramatically is because companies have increasingly moved to share-based compensation. Such movement is obviously consistent with the attempt to better align shareholder and management interests. In recent years, share prices have soared, so management has cleaned up. It is sometimes argued that much of this reward is simply due to rising share prices in general, not managerial performance. Perhaps in the future, executive compensation will be designed to reward only differential performance, i.e., share price increases in excess of general market increases.