

Chapter 1

Discussion Questions

- 1-1. Regulation was greatly increased with the Dodd – Frank Act and other measures.
- 1-2. The student should be prepared to pay a higher price for the promised \$2 from the Royal Bank. The risk is lower.
- 1-3. The goal of shareholder wealth maximization implies that the firm will attempt to achieve the highest possible valuation in the marketplace. It is the one overriding objective of the firm and should influence every decision. The problem with a profit maximization goal is that it fails to take account of risk, the timing of the benefits is not considered, and profit measurement is a very inexact process.
- 1-4. Agency theory examines the relationship between the owners of the firm and the managers of the firm. In privately owned firms, management and the owners are usually the same people. Management operates the firm to satisfy its own goals, needs, financial requirements and the like. As a company moves from private to public ownership, management now represents all owners. This places management in the agency position of making decisions in the best interest of all shareholders.
- 1-5. Because institutional investors such as pension funds (Ontario Teachers', CPP) and mutual funds own a large percentage of major companies, they are having more to say about the way publicly owned companies are managed. As a group, they have the ability to vote large blocks of shares for the election of a board of directors, which is supposed to run the company in an efficient, competitive manner. The threat of being able to replace poor performing boards of directors makes institutional investors quite influential. Since these institutions, like pension funds and mutual funds, represent individual workers and investors, they have a responsibility to see that the firm is managed in an efficient and ethical way.
- 1-6. Insider trading occurs when someone has information that is not available to the public and then uses the information to profit from trading in a company's common stock. The provincial securities commissions are responsible for protecting against insider trading.
- 1-7. Regulations set the "rules of the game" in which the firm operates. Shareholder wealth maximization can and should still be sought within the rules, for economic efficiency to be achieved. Society judge's deregulation benefits against the costs of regulation.
- 1-8. Management operates within a competitive market and they should be paid their opportunity cost. If managers do not act to maximize shareholder wealth, share prices will become depressed. To the extent manager's compensation is tied to share price performance, shareholders can fire managers, and there exists a market for corporate control, management will be compensated based on their economic contribution.

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- 1-9. Daily functions- cash management, inventory control, receipt and disbursement of funds. Occasional- share issue, bond issue, capital budgeting and dividend decisions.
- 1-10. There is unlimited liability for the sole proprietorship and partnership forms of ownership. Under the limited partnership, only the general partner(s) has unlimited liability, with limited partners obligated only to the extent of their initial contribution. Finally, all shareholders in a corporation have limited liability, although owner/shareholders of small businesses often have to give banks their personal guarantees.
- 1-11. The corporate form is best suited to large organizations because of the easy divisibility of ownership through issuance of shares. Also, the corporation has continued existence independent of any shareholder.
- 1-12. Money markets refer to those markets dealing with short-term securities that have a life of one year or less. Capital markets refer to securities with a life of more than one year.
- 1-13. A primary market refers to the use of the financial markets to raise new funds. After the securities are sold to the public (institutions and individuals), they trade in the secondary market between investors. It is in the secondary market that prices are continually changing as investors buy and sell securities based on the expectations of corporate prospects. A liquid secondary market promotes a successful primary market.
- 1-14. Government debt loads require financing. This puts large demands (\$1 trillion in accumulated federal and provincial debt in 2017) on the capital markets, putting upward pressure on interest rates and a corporation's ability to invest in capital projects. When governments finance their deficits abroad they place Canada's economic levers outside of our control and debt servicing payments can impact the foreign exchange markets. As the government debt load relative to GDP been reduced in recent years there has been less pressure on interest rates, corporations have borrowed more, but there have been less 'risk free' government securities available (causing liquidity problems particularly in the money markets).
- 1-15. Stakeholders include: shareholders, creditors, employees, unions, environmentalists, consumer groups, Canada Revenue Agency, government regulatory bodies, customers, managers and others.

Internet Resources and Questions

1. www.nobelprize.org
2. www.fin.gc.ca
3. www.bankofcanada.ca
4. <http://www.onex.com/Our-Goals/Index?Key'GenPage=1073751432>
<http://www.rbc.com/aboutus/visionandvalues.html>
5. <http://www.bce.ca/responsibility/corporateresponsibility>

Problems

1-1. Incubus Corporation

a.	Common stock (contributed capital)	\$40,000
	Retained earnings (deficit)	<u>(7,000)</u>
		\$33,000
b.	Common stock	\$40,000
	Retained earnings	<u>2,000</u>
		\$42,000
c.	Common stock	\$60,000
	Retained earnings	<u>8,000</u>
		\$68,000

1-2. Puppet Corporation

a.	Common stock	\$20,000
	Retained earnings	<u>2,000</u>
		\$22,000
b.	Common stock	\$20,000
	Retained earnings	<u>8,000</u>
		\$28,000
c.	Common stock	\$30,000
	Retained earnings	<u>10,500</u>
		\$40,500

- 1-3.** Two to Ten Dollar Corporation would be expected to have the higher valuation because the \$10 per share dividend (although achieved later) is expected to be sustained for a much longer period of time. Building earnings for longer term sustainability is more valuable than quick returns that peter out.

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- 1-4.** Share value is a combination of expected earnings (or cash flow) and the risk inherent in those cash flows. Although the financial institution reports lower earnings it is because of restructuring charges that lower reported earnings. Cash flows are not likely to be effected. Future earnings should be more reliable and therefore less risky than those of the new health services company. Therefore the market is likely to suggest a higher value for the financial institution.

1-5. Board of Directors Decision

- a.* A combination of high profit margins and strong consumer acceptance should be positive for share value. However a new product introduces a high degree of risk that will mitigate higher share values.
- b.* More detailed financial information for investors should increase their confidence in the activities of the firm and lower the risk of their investment. This will be offset by the likely increase costs of providing this information. In an environment of questionable ethics by management this should be slightly positive to share value.
- c.* Pollution control devices will increase firm costs. The local residents will view the firm more positively which should have some positive cash flow effects as they may be more willing to purchase the firm's products and will decrease possible litigations or harassment. Overall it is likely to be a neutral or slightly negative effect on share value.
- d.* Aligning management compensation motivators with shareholder goals should be positive for share values with implemented. The effect however may be small.

There is no correct answer. It depends on the tradeoff between risk, returns and costs.