Answers to Review Questions

1. **Finance** is the art and science of managing money. Finance affects all individuals, businesses, and governments in the process of the transfer of money through institutions, markets, and instruments.

2. **Financial services** is the area of finance concerned with the design and delivery of advice and financial products to individuals, businesses, and government.

   *Managerial finance* encompasses the functions of budgeting, financial forecasting, credit administration, investment analysis, and funds procurement for the firm. Managerial finance is the management of the firm’s funds within the firm. This field offers many career opportunities, including financial analyst, capital budgeting analyst, and cash manager (Note: Other answers possible).

3. Sole proprietorships are the most common form of business organization, while corporations are responsible for the majority of business receipts and profits. Corporations account for the majority of business receipts and profits because they receive certain tax advantages and can expand more easily due to access to capital markets.

4. Stockholders are the true owners, through equity in common and preferred stock, of a corporation. They elect the board of directors, which has the ultimate authority to guide corporate affairs and set general policy. The board is usually composed of key corporate personnel and outside directors. The president (CEO) reports to the board. He or she is responsible for day-to-day operations and carrying out policies established by the board. The owners of the corporation do not have a direct relationship with management but give their input through the election of board members and voting on major charter issues. The owners of the firm are compensated through the receipt of cash dividends paid by the firm or by realizing capital gains through increases in the price of their common stock shares.

5. The most popular form of limited liability organizations other than corporations are:
   - Limited partnerships—a partnership with at least one general partner with unlimited liability and one or more limited partners that have limited liability. In return for the limited liability, the limited partners are prohibited from active management of the partnership.
   - S corporation—if certain requirements are met, the S corporation can be taxed as a partnership but receive most of the benefits of the corporate form of organization.
   - Limited liability corporation (LLC)—This form of organization is like an S corporation in that it is taxed as a partnership but primarily functions like a corporation. The LLC differs from the S corporation in that it is allowed to own other corporations and be owned by other corporations, partnerships, and non-U.S. residents.
   - Limited liability partnership (LLP)—A partnership form authorized by many states that gives the partners limited liability from the acts of other partners, but not from personal individual acts of malpractice. The LLP is taxed as a partnership. This form is most frequently used by legal and accounting professionals.

These firms generally do not have large numbers of owners. Most typically have fewer than 100 owners.
6. Virtually every function within a firm is in some way connected with the receipt or disbursement of cash. The cash relationship may be associated with the generation of sales through the marketing department, the incurring of raw material costs through purchasing, or the earnings of production workers. Since finance deals primarily with management of cash for operation of the firm every person within the firm needs to be knowledgeable of finance to effectively work with employees of the financial departments.

7. The treasurer or financial manager within the mature firm must make decisions with respect to handling financial planning, acquisition of fixed assets, obtaining funds to finance fixed assets, managing working capital needs, managing the pension fund, managing foreign exchange, and distribution of corporate earnings to owners.

8. Finance is often considered a form of applied economics. Firms operate within the economy and must be aware of economic principles, changes in economic activity, and economic policy. Principles developed in economic theory are applied to specific areas in finance. From macroeconomics comes the institutional structure in which money and credit flows take place. From microeconomics, finance draws the primary principle used in financial management, marginal analysis. Since this analysis of marginal benefits and costs is a critical component of most financial decisions, the financial manager needs basic economic knowledge.

9. Accountants operate on an accrual basis, recognizing revenues at the point of sale and expenses when incurred. The financial manager focuses on the actual inflows and outflows of cash, recognizing revenues when actually received and expenses when actually paid. The accountant primarily gathers and presents financial data; the financial manager devotes attention primarily to decision making through analysis of financial data.

10. The two key activities of the financial manager as related to the firm’s balance sheet are:
(a) Making investment decisions: Determining both the most efficient level and the best mix of assets; and
(b) Making financing decisions: Establishing and maintaining the proper mix of short- and long-term financing and raising needed financing in the most economical fashion.

11. Profit maximization is not consistent with wealth maximization due to: (1) the timing of earnings per share, (2) earnings which do not represent cash flows available to stockholders, and (3) a failure to consider risk.

12. **Risk** is the chance that actual outcomes may differ from expected outcomes. Financial managers must consider both risk and return because of their inverse effect on the share price of the firm. Increased risk may decrease the share price, while increased return may increase the share price.

13. The goal of the firm, and therefore all managers, is to maximize shareholder wealth. This goal is measured by share price; an increasing price per share of common stock relative to the stock market as a whole indicates achievement of this goal.
14. Corporate governance refers to a system of organizational control that is used to define and establish lines of responsibility and accountability among major participants in the corporation. These participants include the shareholders, board of directors, officers and managers of the corporations and other stakeholders. A company’s organizational chart is an example of a broad arrangement of corporate governance. More detailed responsibilities would be established within each branch of the organizational chart.

The Sarbanes-Oxley Act of 2002 is directed toward reducing the apparent conflicts of interest that exist in many corporate structures. The Act has many provisions, but the major thrust of the act is to reduce the number of situations in which a conflict of interest can arise and to hold management more accountable for the financial and operating information they communicated to the public.

15. In recent years the magnitude and severity of “white collar crime” has increased dramatically, with a corresponding emphasis on prosecution by government authorities. As a result, the actions of all corporations and their executives have been subjected to closer scrutiny. This increased scrutiny of this type of crime has resulted in many firms establishing corporate ethics guidelines and policies to cover employee actions in dealing with all corporate constituents. The adoption of high ethical standards by a corporation strengthens its competitive position by reducing the potential for litigation, maintaining a positive image, and building shareholder confidence. The result is enhancement of long-term value and a positive effect on share price.

16. Market forces—for example, shareholder activism from large institutional investors—can reduce or avoid the agency problem because these groups can use their voting power to elect new directors who support their objectives and will act to replace poorly performing managers. In this way, these groups place pressure on management to take actions that maximize shareholder wealth.

The threat of hostile takeovers also acts as a deterrent to the agency problem. Hostile takeovers occur when a company or group not supported by existing management attempts to acquire the firm. Because the acquirer looks for companies that are poorly managed and undervalued, this threat motivates managers to act in the best interests of the firm’s owners.

Institutional investors are a powerful source of shareholder involvement in the monitoring of managers to reduce the agency problem. Institutions hold large quantities of shares in many of the corporations in their portfolio. Managers of these institutions should be active in the monitoring of management and vote their shares for the benefit of the shareholders. The power of institutional investors far exceeds the voting power of individual investors.

17. Firms incur agency costs to prevent or minimize agency problems. It is unclear whether they are effective in practice. The four categories of agency cost are monitoring expenditures incurred by the owners for audit and control procedures, bonding expenditures to protect against the potential consequences of dishonest acts by managers, structuring expenditures that use managerial compensation plans to provide financial incentives for managerial actions consistent with share price maximization, and opportunity costs resulting from the difficulties typically encountered by large organizations in responding to new opportunities.

The agency problem and the associated agency costs can be reduced by a properly constructed and followed corporate governance structure. The structure of the governance system should be designed to institute a system of checks and balances to reduce the ability and incentives of management to deviate from the goal of shareholder wealth maximization.
Structuring expenditures are currently the most popular way to deal with the agency problem—and also the most powerful and expensive. Compensation plans can be either incentive or performance plans. Incentive plans tie management performance to share price. Managers may receive stock options giving them the right to purchase stock at a set price. This provides the incentive to take actions that maximize stock price so that the price will rise above the option’s price level. This form of compensation plan has fallen from favor recently because market behavior, which has a significant effect on share price, is not under management’s control. As a result, performance plans are more popular today. With these, compensation is based on performance measures, such as earnings per share (EPS), EPS growth, or other return ratios. Managers may receive performance shares and/or cash bonuses when stated performance goals are reached.

In practice, recent studies have been unable to document any significant correlation between CEO compensation and share price.

18. The key participants in financial transactions are individuals, businesses, and governments. These parties participate both as suppliers and demanders of funds. Individuals are net suppliers, which means that they save more dollars than they borrow, while both businesses and governments are net demanders since they borrow more than they save. One could say that individuals provide the excess funds required by businesses and governments.

19. Financial markets provide a forum in which suppliers of funds and demanders of loans and investments can transact business directly.

Primary market is the name used to denote the fact that a security is being issued by the demander of funds to the supplier of funds. An example would be Microsoft Corporation selling new shares of common stock to the public.

Secondary market refers to the trading of securities among investors subsequent to the primary market issuance. In secondary market trading, no new funds are being raised by the demander of funds. The security is trading ownership among investors. An example would be individual “A” buying common stock of Microsoft through a broker.

Financial institutions and financial markets are not independent of each other. It is quite common to find financial institutions actively participating in both the money market and the capital market as both suppliers and demanders of funds. Financial institutions often channel their investments and obtain needed financing through the financial markets. This relationship exists since these institutions must use the structure of the financial marketplace to find a supplier of funds.

20. The money market is a financial relationship between the suppliers and demanders of short-term debt securities maturing in one year or less, such as U.S. Treasury bills, commercial paper, and negotiable certificates of deposit. The money market has no one specific physical location. Typically the suppliers and demanders are matched through the facilities of large banks in New York City and through government securities dealers.

21. The Eurocurrency market is the international equivalent of the U.S. money market and is used for short-term bank time deposits denominated in dollars or other major currencies. These deposits can be lent by the banks to creditworthy corporations, governments, or other banks at the London Interbank Offered Rate (LIBOR)—the base rate used for all Eurocurrency loans.
22. The *capital market* is a financial relationship created by a number of institutions and arrangements that allows the suppliers and demanders of long-term funds (with maturities greater than one year) to make transactions. The key securities traded in the capital markets are bonds plus common and preferred stock.

23. Securities exchanges provide a forum for debt and equity transactions. They bring together demanders and suppliers of funds, create a continuous market for securities, allocate scarce capital, determine and publicize security prices, and aid in new financing.

The *over-the-counter market* is not a specific institution, but rather an intangible market for the buyers and sellers of securities not listed on the major exchanges. The dealers are linked with purchasers and sellers through the National Association of Securities Dealers Automated Quotation System (NASDAQ), a complex telecommunications network. Prices of traded securities are determined by both competitive bids and negotiation. The over-the-counter market differs from organized security exchanges in its lack of a physical trading location and the absence of listing and membership requirements.

24. In addition to the U.S. capital markets, corporations can raise debt and equity funds in capital markets located in other countries. The *Eurobond market* is the oldest and largest international debt market. Corporate and government bonds issued in this market are denominated in dollars or other major currencies and sold to investors outside the country in whose currency the bonds are denominated. Foreign bond markets also provide corporations with the opportunity to tap other capital sources. Corporations or governments issue bonds denominated in the local currency and sold only in that home market. The *international equity market* allows corporations to sell blocks of stock to investors in several countries, providing a diversified investor base and additional opportunities to raise larger amounts of capital.

25. An *efficient market* will allocate funds to their most productive uses due to competition among wealth-maximizing investors. Investors determine the price of assets through their participation in the financial markets and publicize those prices that are believed to be close to their true value.

26. The *ordinary income* of a corporation is income earned through the sale of a firm’s goods or services. Taxes on corporate ordinary income have two components: a fixed amount on the base figure for its income bracket level, plus a progressive percentage, ranging from 15% to 39%, applied to the excess over the base bracket figure. A *capital gain* occurs when a capital asset is sold for more than its initial purchase price. Capital gains are added to ordinary income and taxed at the regular corporate rates. The *average tax rate* is calculated by dividing taxes paid by taxable income. For firms with taxable income of $10 million or less, it ranges from 15 to 34 percent. For firms with taxable income in excess of $10 million, it ranges between 34 and 35 percent. The *marginal tax rate* is the rate at which additional income is taxed.

27. *Intercorporate dividends* are those received by a corporation for stock held in other corporations. To avoid triple taxation, if ownership is less than 20%, these dividends are subject to a 70% exclusion for tax purposes. (The exclusion percentage is higher if ownership exceeds 20%.) Since interest income from intercorporate bond investments is taxed in full, this tax exclusion increases the attractiveness of stock investments over bond investments made by one corporation in another.

28. The tax deductibility of corporate expenses reduces their actual after-tax cost. Corporate interest is a tax-deductible expense, while dividends are not.