**Chapter 1—The Scope of Corporate Finance**

**MULTIPLE CHOICE**

1. \_\_\_\_\_\_\_\_\_\_ activities allow corporations to raise capital by selling stock to investors.

|  |  |
| --- | --- |
| a. | NYSE |
| b. | Secondary market |
| c. | Primary market |
| d. | Money market |
| e. | Centralized Nasdaq |

ANS: C PTS: 1 REF: 1.1 OBJ: TYPE: fact retention

2. Jane purchased Ford shares for $30. Later, she sold them in the secondary market for $40. Who received the profits from this sale?

|  |  |
| --- | --- |
| a. | Jane |
| b. | the exchange on which Ford shares are traded |
| c. | the investor who purchased the shares at $40 |
| d. | no new cash flow was generated, so there was no profit |
| e. | Ford |

ANS: A PTS: 1 REF: 1.1 OBJ: TYPE: fact retention

3. Which of the following would *not* interest a firm seeking longer-term financing?

|  |  |
| --- | --- |
| a. | issuing corporate bonds |
| b. | borrowing from a commercial bank |
| c. | issuing notes |
| d. | issuing commercial paper |
| e. | none of the above |

ANS: D PTS: 1 REF: 1.1 OBJ: TYPE: fact retention

4. Which of the following would be considered an advantage of the sole proprietorship form of business organization?

|  |  |
| --- | --- |
| a. | unlimited life |
| b. | pooled expertise |
| c. | wide access to capital |
| d. | unlimited personal liability |
| e. | income taxed at only one level |

ANS: E PTS: 1 REF: 1.2 OBJ: TYPE: fact retention

5. Double taxation:

|  |  |
| --- | --- |
| a. | occurs when governments tax profits at the corporate level and dividends at the personal level. |
| b. | is the single greatest advantage of the corporate form of business. |
| c. | can mean savings in taxes if a given business activity is conducted through a corporation rather than through a partnership. |
| d. | only occurs in corporations that have preferred stock outstanding. |
| e. | none of the above |

ANS: A PTS: 1 REF: 1.2 OBJ: TYPE: fact retention

6. Which of the following statements is false?

|  |  |
| --- | --- |
| a. | The objective of profit maximization typically translates into maximizing earnings per share. |
| b. | Profit maximization adequately deals with timing and risk. |
| c. | Profit maximization is not the proper objective for managers. |
| d. | Financial managers should not necessarily select projects with the highest expected monetary return. |
| e. | none of the above |

ANS: B PTS: 1 REF: 1.3 OBJ: TYPE: fact retention

7. The primary goal of a publicly-owned corporation should be to:

|  |  |
| --- | --- |
| a. | maximize total corporate revenue |
| b. | maximize the price per share |
| c. | minimize the chance of losses |
| d. | maximize earnings per share |
| e. | none of the above |

ANS: B PTS: 1 REF: 1.3 OBJ: TYPE: fact retention

NOT: Answer B is consistent with text. However, instructor may wish to change the answer to "maximize shareholder wealth," as share price can be increased through value-irrelevant reverse stock splits.

8. Which of these groups would not be considered "stakeholders" of the firm?

|  |  |
| --- | --- |
| a. | suppliers |
| b. | customers |
| c. | shareholders |
| d. | employees |
| e. | all of the above are considered “stakeholders” |

ANS: E PTS: 1 REF: 1.3 OBJ: TYPE: fact retention

9. Shareholders can attempt to overcome managerial agency problems by:

|  |  |
| --- | --- |
| a. | incurring monitoring expenditures |
| b. | relying on market discipline such as hostile takeovers |
| c. | using specialized compensation contracts |
| d. | incurring bonding costs |
| e. | all of the above |

ANS: E PTS: 1 REF: 1.3 OBJ: TYPE: fact retention

10. Being legally organized as a \_\_\_\_\_\_\_\_\_\_ offers clear competitive advantages over other organizational forms.

|  |  |
| --- | --- |
| a. | partnership |
| b. | private company |
| c. | public corporation |
| d. | multinational consortium |
| e. | sole proprietor |

ANS: C PTS: 1 REF: 1.2 OBJ: TYPE: fact retention

11. Which of the following is a basic function of corporate finance?

|  |  |
| --- | --- |
| a. | risk management |
| b. | corporate governance |
| c. | capital budgeting |
| d. | financial management |
| e. | all of the above |

ANS: E PTS: 1 REF: 1.1 OBJ: TYPE: fact retention

12. The \_\_\_\_\_\_\_\_\_\_ function focuses on raising capital to support a company's operations and investment programs.

|  |  |
| --- | --- |
| a. | financing |
| b. | capital budget |
| c. | financial management |
| d. | corporate governance |
| e. | risk-management |

ANS: A PTS: 1 REF: 1.1 OBJ: TYPE: fact retention

13. U.S. and non-U.S. companies raise the bulk of the funding they require each year through \_\_\_\_\_\_\_\_\_\_.

|  |  |
| --- | --- |
| a. | selling equity |
| b. | selling debt |
| c. | internal funding |
| d. | external funding |
| e. | venture capitalists |

ANS: C PTS: 1 REF: 1.1 OBJ: TYPE: fact retention

14. The \_\_\_\_\_\_\_\_\_\_ function is arguably the single most important activity of the firm's financial manager.

|  |  |
| --- | --- |
| a. | financing |
| b. | capital budgeting |
| c. | financial management |
| d. | corporate governance |
| e. | risk-management |

ANS: B PTS: 1 REF: 1.1 OBJ: TYPE: fact retention

15. Which of the following statements regarding financial markets and securities is the most accurate?

|  |  |
| --- | --- |
| a. | Debt represents an ownership interest in the firm. |
| b. | Trades of securities in the secondary market raise additional funds for corporations. |
| c. | Trades in the primary market are between issuing corporations and investors. |
| d. | More stock than bond transactions occur in the primary market. |
| e. | U.S. security issuers account for only a small portion of worldwide issues. |

ANS: C PTS: 1 REF: 1.1 OBJ: TYPE: fact retention

16. The market for debt instruments maturing in one year or less is the:

|  |  |
| --- | --- |
| a. | short-term debt market |
| b. | money market |
| c. | capital market |
| d. | primary market |
| e. | interest market |

ANS: B PTS: 1 REF: 1.1 OBJ: TYPE: fact retention

17. With which form of business organization do all owners enjoy limited liability?

|  |  |
| --- | --- |
| a. | Sole Proprietorship |
| b. | Partnership |
| c. | Corporation |
| d. | Limited Partnership |
| e. | Venture Capitalist |

ANS: C PTS: 1 REF: 1.2 OBJ: TYPE: fact retention

18. Incentive compensation plans are designed to:

|  |  |
| --- | --- |
| a. | motivate managers to do what is in the best interest of shareholders. |
| b. | overcome agency costs. |
| c. | tie management compensation to the stock price. |
| d. | typically give managers the right to purchase stock at a fixed price, usually the current market price at the time the right is granted. |
| e. | all of the above. |

ANS: E PTS: 1 REF: 1.3 OBJ: TYPE: fact retention

19. A risk averse manager would

|  |  |
| --- | --- |
| a. | Take on projects that maximize shareholder wealth |
| b. | Consistently accept projects that are above the firm’s level of risk |
| c. | Consistently accept projects that are well below the firm’s desired risk |
| d. | Only take risky projects |

ANS: C

Risk averse managers will shy away from risky projects

PTS: 1 REF: 1.3 OBJ: TYPE: application of concepts

20. Which of the following activities would be considered the risk management?

|  |  |
| --- | --- |
| a. | Purchasing derivative instruments such as forwards, futures, options, and swaps |
| b. | Matching the maturities of assets and liabilities |
| c. | Locating production plants in the same country as the firm’s customers |
| d. | All of the above could be risk management |

ANS: D PTS: 1 REF: 1.1 OBJ: TYPE: fact retention

21. Which of the following would may a firm ineligible for S Corporation status?

|  |  |
| --- | --- |
| a. | The firm has 55 shareholders |
| b. | All the shareholders are people (as opposed to other corporations) |
| c. | The firm is a French corporation |
| d. | The firm plans to eventually go public |

ANS: C

S corporations are US corporations meeting IRS S corporation requirements

PTS: 1 REF: 1.2 OBJ: TYPE: fact retention

22. Large publicly-traded corporations are exposed to agency costs because

|  |  |
| --- | --- |
| a. | The separation of ownership and control of the corporation |
| b. | The board of directors has outside members |
| c. | The high compensation of CEOs |
| d. | None of the above |

ANS: A PTS: 1 REF: 1.2 OBJ: TYPE: fact retention

23. The double taxation problem refers to:

|  |  |
| --- | --- |
| a. | The problem of different tax rates on capital gains and ordinary income. |
| b. | The problem of higher tax rates for shareholders relative to partners. |
| c. | The problem of income from foreign customers taxed both in the foreign market and then again as income in the US market. |
| d. | The problem of state and federal income taxes for corporations. |

ANS: B PTS: 1 REF: 1.2 OBJ: TYPE: fact retention

24. Professional-service firms (such as doctors or dentists) are likely set up as:

|  |  |
| --- | --- |
| a. | Corporations, to gain limited liability |
| b. | Partnerships, to gain tax advantages |
| c. | S corporations, to gain easy valuation |
| d. | Limited liability companies, to gain tax and liability benefits |

ANS: D PTS: 1 REF: 1.2 OBJ: TYPE: fact retention

**MATCHING**

*Match each corporate finance function with its related activities:*

|  |  |
| --- | --- |
| a. | corporate governance |
| b. | risk management |
| c. | capital budgeting |
| d. | financing |
| e. | financial management |

1. Selecting projects based on perceived risk and expected return.

2. Raising capital.

3. Developing internal structures to maintain value-maximizing activity.

4. Managing internal cash flows and the mix of debt and equity financing.

5. Recognizing and managing exposures to insurable and uninsurable risk.

1. ANS: C PTS: 1 REF: 1.1 OBJ: TYPE: fact retention

2. ANS: D PTS: 1 REF: 1.1 OBJ: TYPE: fact retention

3. ANS: A PTS: 1 REF: 1.1 OBJ: TYPE: fact retention

4. ANS: E PTS: 1 REF: 1.1 OBJ: TYPE: fact retention

5. ANS: B PTS: 1 REF: 1.1 OBJ: TYPE: fact retention

*Match the following advantages and disadvantages with the proper business organization form:*

|  |  |
| --- | --- |
| a. | corporation |
| b. | partnership |
| c. | sole proprietorship |

6. limited life

7. unlimited life

8. limited access to capital

9. unlimited access to capital

10. unlimited personal liability

11. limited liability

12. separate contracting

13. double taxation

14. ease of operation

6. ANS: B PTS: 1 REF: 1.2

OBJ: TYPE: application of concepts NOT: c is also correct

7. ANS: A PTS: 1 REF: 1.2

OBJ: TYPE: application of concepts

8. ANS: B PTS: 1 REF: 1.2

OBJ: TYPE: application of concepts NOT: c is also correct

9. ANS: A PTS: 1 REF: 1.2

OBJ: TYPE: application of concepts

10. ANS: B PTS: 1 REF: 1.2

OBJ: TYPE: application of concepts NOT: c is also correct

11. ANS: A PTS: 1 REF: 1.2

OBJ: TYPE: application of concepts

12. ANS: A PTS: 1 REF: 1.2

OBJ: TYPE: application of concepts

13. ANS: A PTS: 1 REF: 1.2

OBJ: TYPE: application of concepts

14. ANS: C PTS: 1 REF: 1.2

OBJ: TYPE: application of concepts

*Match the following descriptions to the proper terms:*

|  |  |
| --- | --- |
| a. | ignores the time value of money |
| b. | proper goal of the firm in modern finance |
| c. | considered part of the firm's social responsibility |
| d. | manager's concern with job security |
| e. | tie management's compensation to performance |

15. maximize shareholders' wealth

16. focus on stakeholders

17. maximize profit

18. control agency costs

19. agency costs

15. ANS: B PTS: 1 REF: 1.3 OBJ: TYPE: critical thinking

16. ANS: C PTS: 1 REF: 1.3 OBJ: TYPE: critical thinking

17. ANS: A PTS: 1 REF: 1.3 OBJ: TYPE: critical thinking

18. ANS: E PTS: 1 REF: 1.3 OBJ: TYPE: critical thinking

19. ANS: D PTS: 1 REF: 1.3 OBJ: TYPE: critical thinking

**SHORT ANSWER**

1. Boots-R-Us Inc. is a large manufacturer located in a small town in Texas. Given the large differential in labor costs between Texas and Mexico, this firm is considering closing all manufacturing operations in Texas and relocating in Mexico. Suppose this relocation will unambiguously increase shareholder wealth. Provide one reason related to corporate stakeholders suggesting why Boots-R-Us may decide not to relocate to Mexico.

ANS:

Boots-R-Us may decide that its employees are important stakeholders of the firm, and their job security overrides the shareholder wealth maximization model. There may be issues related to other stakeholders as well; however, employees appear likely to be the biggest potential losers if the proposed relocation occurs.

PTS: 1 REF: 1.3 OBJ: TYPE: application of concepts

2. Why is capital budgeting considered the single most important activity of the firm's financial manager?

ANS:

|  |  |
| --- | --- |
| 1. | The large scale of investment that management evaluate in the process. |
| 2. | For the firm to prosper, management must seek out the most promising capital investments. |
| 3. | The consequences of a flawed capital budgeting process are serious. |

PTS: 1 REF: 1.1 OBJ: TYPE: critical thinking

3. Identify the three basic steps of the capital budgeting process.

ANS:

|  |  |
| --- | --- |
| 1. | Identifying potential investments, |
| 2. | Analyzing the set of investment opportunities, identifying those that will create shareholder value, and perhaps prioritizing them, and |
| 3. | Implementing and monitoring the investments selected in step 2. |

PTS: 1 REF: 1.1 OBJ: TYPE: fact retention

4. Why must countries develop an effective system of corporate governance?

ANS:

|  |  |
| --- | --- |
| 1. | Encourage the development of competitive business and efficient financial markets; |
| 2. | Permit efficiency-enhancing mergers and acquisitions but block business combinations that significantly restrict competition; and |
| 3. | Provide protection for creditors and minority shareholders that limits the opportunities for managers or majority shareholders to expropriate wealth. |

PTS: 1 REF: 1.1 OBJ: TYPE: application of concepts

5. What is the focus of modern risk-management?

ANS:

It encompasses the identification, measurement, and management of all types of risk exposures. The focus is on the market-driven risks relating to adverse interest rate movements, changes in commodity prices, and fluctuations in currency values. It uses derivative instruments such as forwards, futures, options, and swaps to hedge (i.e. offset) many of the more threatening market risks.

PTS: 1 REF: 1.1 OBJ: TYPE: application of concepts

6. Explain why maximizing profits falls short of maximizing shareholders' wealth.

ANS:

|  |  |
| --- | --- |
| • | profits reflect the past instead of the future |
| • | profits ignore the time value of money |
| • | profits rely on accounting principles and do not measure the cash flows with which a company pays its bills |
| • | profits do not consider the risk of the investment |

PTS: 1 REF: 1.3 OBJ: TYPE: application of concepts

**Tax Liability**

Calculate the tax liability of a corporation and a partnership earning operating income of $5000000, if the corporate tax rate is 35 % and the owners’ personal tax rate is 30 %. Assume that all earnings are distributed to owners.

7. Refer to Tax Liability. Is there a tax advantage?

ANS:

|  |  |  |
| --- | --- | --- |
|  | Corporation | Partnership |
| Operating income | $5000000 | $5000000 |
| Less: Corporate tax (35%) | $1750000 | $      0 |
| Net income | $3250000 | $5000000 |
| Dividends or cash distributed | $3250000 | $5000000 |
| Less: Personal tax (30%) | $ 975000 | $1500000 |
| After-tax income | $2275000 | $3500000 |

There is a $1225000 advantage to using the partnership form of organization.

PTS: 1 REF: 1.2

OBJ: TYPE: application of concepts | TYPE: critical thinking

8. Refer to Tax Liability. If the partnership were changed to an S corporation, is there a tax advantage?

ANS:

|  |  |  |
| --- | --- | --- |
|  | Corporation | Partnership |
| Operating income | $5000000 | $5000000 |
| Less: Corporate tax (40%) | $1750000 | $      0 |
| Net income | $3250000 | $5000000 |
| Dividends or cash distributed | $3250000 | $5000000 |
| Less: Personal tax (35%) | $ 975000 | $1500000 |
| After-tax income | $2275000 | $3500000 |

The numbers and advantage would be the same, since S corporations are treated the same as partnerships when it comes to taxes.

PTS: 1 REF: 1.2

OBJ: TYPE: application of concepts | TYPE: critical thinking

9. Refer to Tax Liability. If the corporation elected to be an S corporation, is there a tax advantage?

ANS:

The S corporation tax and after tax income would be the same ($1500000 and $3500000) as the partnership.

PTS: 1 REF: 1.2

OBJ: TYPE: application of concepts | TYPE: critical thinking

10. What role does a financial intermediary provide in financial markets and how is their existence economically viable?

ANS:

Intermediaries serve the role of servicing savers and borrowers to achieve their desired pattern of intertemporal consumption. Instead of savers and borrowers having to deal with each other on an individual basis, they deal with the intermediary. The intermediary realizes a profit by lending at a higher rate than it pays savers (the spread)

PTS: 1 REF: 1.1 OBJ: TYPE: fact retention

11. What is an initial public offering (IPO)?

ANS:

When a firm issues equity shares of the firm to the public at large for the first time. This sale of securities is called a primary market transaction where the money flows from the investors to the firm.

PTS: 1 REF: 1.1 OBJ: TYPE: fact retention

12. What is a venture capitalist?

ANS:

Professional investors who invest in privately held firms. These individuals specialize in high risk/high return investments typically involving high growth firms.

PTS: 1 REF: 1.1 OBJ: TYPE: fact retention

13. What are the main advantages of the corporate form compared to other forms of business organization?

ANS:

Unlimited life

Limited liability

Separable contracting

Ready access to capital via capital markets

Ease of transferability

PTS: 1 REF: 1.2 OBJ: TYPE: fact retention

14. Describe important features of limited partnerships.

ANS:

Combines the best features of the general partner and the corporate form.

Limited liability

Profits are taxed as partnership income

Must be passive investors

PTS: 1 REF: 1.2 OBJ: TYPE: fact retention

15. How is status as a limited partnership likely to be desirable from a tax perspective in the early years of a firm’s existence?

ANS:

If a firm is generating large non-cash operating losses (as many young business do) it may be beneficial for an investor to take a limited partner role. This is due to the fact that the losses will flow directly through the partners and in certain cases the tax loss can be used to offset taxable income from other sources.

PTS: 1 REF: 1.2 OBJ: TYPE: application of concepts

16. How would a firm operate if it were run in the best interests of its bondholders?

ANS:

Bondholders receive a fixed return. This would lead management to make risk averse decisions that only compensate bondholders their fixed return and would thus not be value increasing decisions.

PTS: 1 REF: 1.3 OBJ: TYPE: critical thinking

17. What is a bonding expenditure?

ANS:

An agreement entered in by one party to reassure another party of their benevolent intentions. An example is a deferred compensation package entered into by a manager that based on performance.

PTS: 1 REF: 1.3 OBJ: TYPE: fact retention

**ESSAY**

1. Discuss three problems with profit maximization as a goal of the firm.

ANS:

Profit does not incorporate the time value of money. It fails to consider the timing of the benefits resulting from a given action or operation.

Profit is not a measure of cash flow. It may be influenced by choices related to depreciation and inventory.

Profit is not influenced by risk. For example, if two firms have the same expected cash flows, but one firm's cash flows are perceived as less risky, we prefer the less risky alternative.

PTS: 1 REF: 1.3 OBJ: TYPE: application of concepts

2. Consider a firm that employs profit maximization as a goal. Discuss one example of how an unscrupulous manager might behave such that her actions are to the detriment of stakeholders.

ANS:

There are, of course, many potential examples that might be appropriate in this instance. Managers may 'manage earnings' by changing accounting conventions strategically for personal gain. They may undertake risk-enhancing (reducing) investment decisions that are wealth reducing for bondholders (stockholders).

If compensation is tied to profits, decisions may be made in order to create large profits in the short term, while harming long term profitability. For instance, a manager might decide to stop all funding of research and development projects. This reduction in spending may bolster profits in the short run and allow a manager to benefit from extreme executive compensation payouts. However, in the long run, the firm may not be competitive in the industry because it has not kept pace with advances in technology or production techniques.

PTS: 1 REF: 1.3

OBJ: TYPE: application of concepts | TYPE: advanced critical thinking

3. In the typical corporate form of organization shareholders elect the Board of Directors, which subsequently "hires" managers. In a brief essay, discuss the importance of choosing an external Board of Directors to oversee a firm's management when separating ownership (shareholders) and control (managers). Discuss the concerns of many shareholders with respect to 'chummy' Boards of Directors.

(Your discussion should recognize that management often has a strong say in the slate of board candidates put forward for shareholder election.)

ANS:

A good essay should recognize that it is very difficult for managers to assist in choosing a Board that is both knowledgeable and willing to reprimand poor performance. The incentive to choose a friendly Board is difficult to surmount. Of course, management also needs to be able to work with the Board in a professional and effective manner on a number of important issues such as executive compensation (i.e., how senior management is paid).

PTS: 1 REF: 1.2 | 1.3 OBJ: TYPE: advanced critical thinking

4. The accepted North American goal of the firm is often considered to be shareholder wealth maximization (SWM). In Europe and other parts of the world, this goal is often relaxed to include the well-being of many stakeholders including shareholders, bondholders, employees, suppliers, and other related parties. This model is sometimes called the corporate wealth maximization (CWM) model. (Related examples include Keiritsu in Japan, and Chaebol in Korea.)

Do you believe that the SWM or the CWM best describes actual business practices in your region? Which model of behavior do you believe is inherently better?

ANS:

A good essay will recognize that the impact of different stakeholders on corporate goals may vary across regions. For instance, a large business enterprise in a small town may be more likely to donate locally. This activity may be viewed as consistent with SWM (through the creation of customer goodwill), or it may be viewed as consistent with CWM (primarily as a benefit to employees in the town, who are important stakeholders of the firm), or a combination of both of these impacts. Clearly, all stakeholders influence corporate goals to some extent. Which goal is *best*, is a difficult but important question.

PTS: 1 REF: 1.3 OBJ: TYPE: advanced critical thinking

5. The textbook states that ethical behavior is a necessary condition for shareholder wealth maximization. Do *you* believe the goal of the firm is always consistent with ethical considerations? What would you do if you could implement an unethical (*and undetectable*) action that would increase firm value?

ANS:

Although unethical behavior often results in market penalties that may lead to shareholder wealth reductions, there may be instances in which the firm goal and ethical considerations do not agree. To the extent this happens, we stress that there is only one measure of ethical behavior (and not a different measure at home and the workplace). To the extent that our legal, accounting, and press systems are diligent, we would expect ethical considerations and shareholder wealth maximization decisions to agree. Clearly an undetectable unethical act is still unethical, and therefore should not be undertaken.

PTS: 1 REF: 1.3 OBJ: TYPE: advanced critical thinking

6. What is the importance of ethics in corporate finance?

ANS:

By establishing ethics policies and guidelines and requiring employee compliance with them, companies can prevent major ethical violations, the major negative media attention that accompanies them, and most important the subsequent damage to the business and its shareholders. Ethical corporate behavior is necessary for achievement of the owner wealth maximization goal.

PTS: 1 REF: 1.3 OBJ: TYPE: critical thinking

7. What is the job of the board of directors?

ANS:

The board of directors governs the corporation on behalf of the shareholders. It is responsible for hiring and firing managers and setting the overall corporate policies that guide management in carrying out the day-to-day operations aimed at achieving the corporation's strategic goals.

PTS: 1 REF: 1.2 OBJ: TYPE: critical thinking

8. Why would a corporation elect to be treated as a Subchapter S corporation?

ANS:

The Subchapter S corporation gives a certain amount of flexibility to the organization not present in regular corporations. The S corporation is allowed to escape separate taxation at the corporate level. Each shareholder claims a proportionate share of profits as personal income and pay taxes at their marginal tax rate, escaping double taxation. The S corporation status yields the limited liability benefit of the corporate form along with the favorable tax treatment of the partnership form. If growth favors going public, the S corporation can easily switch back to being a regular C corporation.

PTS: 1 REF: 1.2 OBJ: TYPE: critical thinking

9. How do market forces constrain the opportunistic behavior of a firm's manager?

ANS:

Large investors have become more active in management putting pressure on under-performing management. The threat of a hostile takeover should motivate the firm to replace under-performing incumbent management and to act in the best interests of the firm's owners.

PTS: 1 REF: 1.3 OBJ: TYPE: critical thinking

10. What is the motivation to privatize state-owned enterprises?

ANS:

Privatization increases industrial competition leading to improved levels of service while initially increasing government revenues. Governments around the world have raised over 1.2 trillion dollars through privatization and those programs are expected to continue for the foreseeable future.

PTS: 1 REF: 1.2 OBJ: TYPE: critical thinking

11. Describe how a corporation finances its operations.

ANS:

Firms finance their operations with both internal and external funds. Businesses prefer to use and typically do use internal funds obtained from retention of earnings. If firms require external financing, financial managers can issue equity or debt to finance a firm's operations. Equity represents ownership interests and can be either common or preferred stock. Debt is borrowed money from creditors.

PTS: 1 REF: 1.1 OBJ: TYPE: fact retention

12. Why should the financial manager maximize shareholder wealth rather than profit?

ANS:

Profit maximization reflects what has happened in the past not what the future expectations are. Profit maximization does not take into account the timing of the profits. Profit maximization does not account for the cash flows available to the firm. Lastly, profit maximization ignores the risk in the earnings. Shareholder wealth maximization, on the other hand, considers the timing, size, and risk of cash flows. Stock prices take all of these factors into account. Therefore, the financial manager should attempt to maximize shareholder wealth rather than profits.

PTS: 1 REF: 1.3 OBJ: TYPE: fact retention | TYPE: critical thinking

13. Discuss the issue of double taxation using an example assuming earnings before taxes of $250000, corporate tax rate of 30% and personal tax rate of 35%. Contrast the tax issue of the corporation versus a partnership.

ANS:

Double taxation occurs when a corporation has earnings on which it is taxed and then distributes some portion of them as dividends to its owners. The dollars distributed as dividends are then taxed as income to the owners, thereby resulting in double taxation. If a corporation had earnings before tax of $250000, it would pay $75000 [0.30  $250000] in taxes. If the firm distributed its after tax net income of $175000 [$250000 – 75000 = $175000] to owners, the owners would then pay $61250 [$175000  0.35] in taxes. The result would be $136250 [$75000 + 61250] paid in total taxes under the corporate form of organization. If the firm were operated as a partnership, the total taxes paid on the $250000 in earnings would be treated as personal income taxes of $87500 [$250000  0.35].

PTS: 1 REF: 1.2 OBJ: TYPE: application of concepts

14. Discuss the agency problem and potential solutions for the problem.

ANS:

The agency problem exists because managers act as agents for shareholders of a corporation. In this capacity, the manager makes daily decisions for the operation of the business. These decisions should be made with the best interests of the shareholders in mind. The managers may not always act in the best interests of the shareholders, and shareholders are typically unable to monitor all actions of the managers. The resulting conflict between the goals of the firm's owners and its managers is the agency problem. The agency problem can be reduced by (1) relying on market forces to exert managerial discipline, (2) incurring monitoring and bonding costs necessary to supervise managers, and (3) structuring executive compensation packages that align the interests of managers and stockholders.

PTS: 1 REF: 1.3 OBJ: TYPE: fact retention