

CHAPTER 1

CONCEPT REVIEW QUESTIONS

1. What is the “marginal benefits greater than or equal to marginal costs” decision rule, and why should financial managers constantly seek to apply it to business decisions?

When making investment and financial decisions, managers should always apply a decision rule asking whether the marginal benefits of this decision outweigh the marginal costs. Managers should only take actions and accept projects where the marginal benefits are greater than or equal to marginal costs. Following this rule ensures that the wealth of the firm’s shareholders will be maximized

2. Think of another company or product besides Apple’s iPod and note the connections between other functional areas and finance.

Many companies have connections between other functional areas and finance. For example, any company with international dealings must look at the impact of foreign exchange on its business. Does the firm generate revenues overseas? Does it have foreign suppliers? What impact do currency changes have on operations? If the dollar weakens, then imports become more expensive for U.S. citizens and domestic production companies may benefit. On the other hand, if the firm sells its product abroad, a weaker dollar may increase foreign sales. The finance function may hedge some of the impact of currency fluctuations on the firm’s financial statements.

3. List and briefly describe five main career paths open to finance graduates.

The five most important career paths for finance professionals are in corporate finance, commercial banking, invest banking, money management and consulting. Corporate finance is concerned with the duties of the financial manager in a business

firm, while commercial banking involves providing loans and other financial services to a bank's customers. Investment banking involves three main types of activities: (1) helping corporate customers obtain funding via security market issues or complex structured financings, (2) providing advice to corporate clients on a variety of financial issues and transactions, including mergers and acquisitions and derivative products, and (3) trading debt and equity securities for customers or for the firm's own account. Money management involves acting as a fiduciary, investing and managing money on someone else's behalf, while consultants are hired by companies to analyze their business processes and strategies and then to recommend how these should be changed to make the firm more competitive.

4. Based on your own personal attributes and desires, which of paths would you prefer?

Finance career opportunities have multiple aspects and it might be advisable to seek a path that corresponds to your personal aspirations.

5. What is a *financial intermediary*? Why do you think these institutions have steadily been losing "market share" to capital markets as the principal source of external financing for corporations?

A financial intermediary is an institution that raises capital by issuing liabilities against itself, and then uses the funds so raised to make loans to corporations and individuals. Borrowers, in turn, repay the intermediary, meaning that they have no direct contact with the savers who actually funded the loans. Capital markets have grown steadily in importance, principally because the rapidly declining cost of information processing has made it much easier for large numbers of investors to obtain and evaluate financial data for thousands of potential corporate borrowers and issuers of common and preferred stock equity.

6. List the five basic corporate finance functions. What is the general relationship among them?

The five basic corporate functions are financing (or capital raising), capital budgeting, financial management, corporate governance, and risk management. These functions are all related, for example, a company needs financing to fund its capital budgeting choices. The financial management decision concerns management of its internal cash flows and its mix of external debt and equity. Its financing needs are related to how much internal capital the firm can generate and its choice of debt or equity financing. A Board of Directors, which generally makes major financing and investment decisions governs companies, and all of the decisions will depend on the risk involved. With all of the functions, it is important to understand how value is created.

7. Which of the five basic corporate finance functions might be considered “nontraditional”? Why do you think these functions have become so important in recent years?

Issues in corporate finance and risk management have become more prominent in recent years. For example, executive stock options have been touted as a way to align the interests of managers with shareholders. Now, there is a growing controversy about executive stock options, for example, that these encouraged some executives to take measures, some fraudulent, that pushed up stock prices in the short run, making their options more valuable. With the development of a vast array of derivative securities, risk management has become more complicated.

8. Do you consider that good corporate governance is something that can be legislated for, or is it something that is emergent?

Both. Corporate governance is determined by the legal system (cf. the SO Act of 2002). It may also be viewed as part of a company’s strategy as it affects its reputation and returns.

9. What are the advantages and disadvantages of the main types of organizational forms.

Advantages of Proprietorships and
Partnerships

1. Easy to form
2. Few regulations
3. No corporate income taxes
4. Being one's own boss

Disadvantages

1. Limited life
2. Unlimited liability
3. Hard to raise capital

Advantages of Corporations

1. Unlimited life
2. Easy to transfer ownership
3. Limited liability
4. Easier to raise capital

Disadvantages

1. Double taxation
2. Costly set up
3. Costly period reports required

Hybrid forms are successful because they can combine the advantages of several forms of organization. For example, the limited liability partnership has the advantages of a partnership, without the disadvantage of unlimited liability.

10. Comment on the following statement: "Sooner or later, all successful private companies that are organized as proprietorships or partnerships must become corporations."

The answer to this is largely opinion. There are many proprietorships and partnerships that remain so throughout their life. However, if a business is to grow, it probably will thrive as a corporation, with better access to capital, less risk of losing everything (limited liability), easy transferability and unlimited life.

11. What are the relative advantages and disadvantages of using sophisticated management compensation packages to align the interests of managers and shareholders?

Advantages of sophisticated compensation packages

- Allow better alignment among shareholder and management interests
- When a large part of a manager's wealth is invested in company stock, he/she will work harder to maximize stock price so his/her personal wealth is also maximized.

Disadvantages

- Stock price could increase because the overall stock market is rising, not because the manager has done a good job.
- Compensation packages have raised U.S. executive pay well above that of non-management employees and above that of their counterparts in other countries.
- Some managers receive high compensation even when the company is performing poorly.

12. Why are *ethics* important in corporate finance? What is the likely consequence of unethical behavior by a corporation and its managers?

Unethical behavior can have severe financial consequences for a company, for example, Arthur Andersen went bankrupt because of the fallout from Enron's collapse. For many businesses, reputation is critical to conducting business. A firm with a reputation for shady dealing will lose value relative to its ethical competitors.

13. Why did the United States government pass the *Sarbanes-Oxley Act of 2002*, and what are its key provisions?

The U.S Congress passed the *Sarbanes-Oxley Act of 2002* in response to the accounting scandals surrounding Enron, WorldCom and other companies that went bankrupt in 2001, and due to concerns about auditors' conflicts of interest. The law was passed in an effort to improve corporate governance practices in U.S. public companies. The act established a new *Public Company Accounting Oversight Board*, with the power to license auditing firms and regulate accounting and auditing standards. This act also gave the U.S. *Securities and Exchange Commission (SEC)* greater powers to supervise corporate governance practices in public companies. The act requires both the Chief Executive Officer (CEO) and the Chief Financial Officer (CFO) of all large companies to *personally* certify their firms' financial statements, meaning that the CEOs and CFOs can be held personally liable for any questionable or misleading numbers reported to public investors. This Act also prevents auditing firms from providing other services – such as consulting, valuation, and tax advisory work – to the companies they are auditing, and mandates the lead auditing partner must rotate off the audit every five years. Perhaps the most crucial internal change the Act mandates is to give the firm's Audit Committee much greater power, responsibility and independence. The Act requires that each member of the audit committee must also be a member of the board of directors – but otherwise be independent (not an officer or employee) – and mandates that at least one of the committee members must be a “financial expert.”