



# Chapter 1

## Corporate Finance and the Financial Manager

### *Answers to Concept Check questions*

1. A corporation is a legal entity separate from its owners. The liability of the owners for the debts of the corporation is limited to their investment. In this respect they are similar to the limited partners of a limited partnership. However, the general partners of a limited partnership have the same rights and privileges as partners in any general partnership; in particular, they are personally liable for the debts of the firm.
2. Advantages: Limited liability, liquidity, infinite life, unlimited number of owners.  
  
Disadvantages: Separation of ownership and control, more complicated and expensive to set up.
3. The financial manager has three main tasks:
  - Make investment decisions
  - Make financing decisions
  - Manage cash flow from operating activities.
4. The goal of the financial manager is to maximise the wealth of the owners of the firm.
5. Shareholders control a firm by electing the Board of Directors, who have the ultimate decision-making authority in the corporation.
6. A financial manager could hold the position of Chief Financial Officer, Financial Controller or Treasurer, and could also be responsible for capital budgeting, risk management or credit management.
7. One ethical issue confronting the financial manager is the agency problem, which arises when managers put their own self-interest ahead of the interests of shareholders. Other conflicts of interests could arise if managers make decisions that benefit other stakeholders at the expense of shareholders.
8. The stock market provides liquidity to corporate investors, enables them to quickly and easily sell their shares, and also determines the market price for shares.
9. The stock market enables the financial manager to determine the market price for shares and hence the value of the company in the eyes of shareholders.

This is an important barometer for the performance of the firm and its managers.

10. In the financial cycle, (1) people invest and save their money; (2) that money, through loans and shares, flows to companies who use it to fund growth through new products, generating profits and wages; and (3) the money then flows back to the savers and investors.
11. The main roles of financial institutions are to: (1) move funds from those who have extra funds (savers) to those who need funds (borrowers and firms); (2) move funds through time (e.g. you can transfer your future salary into funds today by taking out a loan); and (3) help spread out risk-bearing.

## **Answers to Problems**

*Note:* All problems in this chapter are available in MyFinanceLab. An asterisk (\*) indicates problems with a higher level of difficulty.

1. A corporation is a legal entity separate from its owners. This means ownership shares in the corporation can be freely traded. None of the other organisational forms share this characteristic. In addition, investors in a corporation can remain anonymous, and there is no limit on the number of owners a corporation can have.
2. Owners' liability is limited to the amount they invested in the firm. Shareholders are not responsible for any encumbrances of the firm; in particular, they cannot be required to pay back any debts incurred by the firm.
3. Corporations and limited liability companies. Limited partnerships provide limited liability for the limited partners, but not for the general partners.
4. Advantages:        Limited liability, liquidity, infinite life, unlimited number of owners.  
  
Disadvantages:    Separation of ownership and control, more complicated and expensive to set up.
5. Under the 'classical' tax system, company profits are taxed at the company tax rate, and then dividends paid to shareholders from the company's after-tax profit are taxed at the shareholder's marginal tax rate. Company profits are therefore taxed twice.

Under the 'imputation' tax system, dividends paid to shareholders from a company's after-tax profit carry 'imputation credits' which effectively give the shareholder credit for the tax paid by the company. The shareholder only needs to pay additional tax if his or her marginal tax rate exceeds the corporate tax rate. The result is that company profits, in the hands of shareholders, are only taxed at the shareholder's marginal tax rate.

6. First, the corporation pays the taxes. After taxes,  $\$2 \times (1 - 0.3) = \$1.40$  is left to pay dividends. Each share receives \$1.40 in dividends and \$0.60 in imputation credits, representing the tax paid by the corporation. Tax is payable on the grossed-up dividend, which is equal to the cash dividend plus the imputation credits. Your assessable income is therefore \$2.00 and the tax payable is  $\$2 \times 0.19 = \$0.38$ . You then deduct the imputation credits to determine the net amount of tax to be paid, which is equal to  $\$0.38 - \$0.60 = -\$0.22$ . Because the company tax rate is greater than your personal tax rate,

you are entitled to a tax credit of \$0.22 which can be refunded or offset against other tax payable. You are left with  $\$1.40 + \$0.22 = \$1.62$ , and hence the effective tax rate that you have paid on the \$2.00 in company profit is  $\$0.38/\$2.00 = 19\%$ .

7. The cash dividend is \$1.40 and your assessable income remains \$2.00. The tax payable is  $\$2 \times 0.45 = \$0.90$ . You then deduct the imputation credits to determine the net amount of tax to be paid, which is equal to  $\$0.90 - \$0.60 = \$0.30$ . You are left with  $\$1.40 - \$0.30 = \$1.10$ , and hence the effective tax rate that you have paid on the \$2.00 in company profit is  $\$0.90/\$2.00 = 45\%$ .
8. The investment decision is the most important decision that a financial manager makes, as the manager must decide how to put the owners' money to its best use.
9. The goal of maximising shareholder wealth is agreed upon by all shareholders because all shareholders are better off when this goal is achieved.
10. Shareholders can:
  - a. Ensure that employees are paid with company shares and/or share options.
  - b. Ensure that underperforming managers are fired.
  - c. Write contracts that ensure that the interests of the managers and shareholders are closely aligned.
  - d. Mount hostile takeovers.
11. When your parents pay for the meal, you benefit from the food but do not take on the cost of the food. This is similar to the agency problem in corporations, when managers can benefit from taking actions in their own personal interests using money that belongs to shareholders.
12. The agent (renter) will not take the same care of the apartment as the principal (owner), because the renter does not share in the costs of fixing damage to the apartment. To mitigate this problem, having the renter pay a deposit would motivate the renter to keep damages to a minimum. The deposit forces the renter to share in the costs of fixing any problems that are caused by the renter.
13. There is an ethical dilemma when the CEO of a firm has opposite incentives to those of the shareholders. In this case, you (as the CEO) have an incentive to potentially overpay for another company (which would be damaging to your shareholders) because your pay and prestige will improve.
14. The shares of a public corporation are traded on an exchange (or 'over the counter' in an electronic trading system) while the shares of a private corporation are not traded on a public exchange.
15. A primary market is where the company sells shares of itself to investors. The secondary market is where investors can buy and/or sell the company's shares with other investors (but not the company itself).
16. Investors always buy at the ask price and sell at the bid price. Since ask prices always exceed bid prices, investors 'lose' this difference. It is one of the costs of transacting. Since the market makers take the other side of the trade, they make up this difference.

- 17.** Stock market indices are designed to represent the overall change in share prices within a particular stock market over a particular period. A stock market index is a single number calculated from the prices of shares included in the index. They are set a particular base value at a particular point in time; for example, the Australian All Ordinaries Index was set at 500 in January 1980. The change in the number from period to period represents the average change in the price of the shares within the index. For example, if the Australian All Ords hits 5000 points, the shares within the index have risen tenfold, on average, since January 1980. Most stock market indices include a large number of shares which cover the overwhelmingly majority of the market by market capitalisation (the Australian All Ords covers 95% of the shares within the ASX by market capitalisation).

Some of the major stock market indices around the world are:

All Ordinaries Index	Australia
S&P/ASX 200	Australia
Dow Jones Industrial Average	United States
S&P 500	United States
Nasdaq Composite	United States
CAC 40	France
DAX	Germany
Hang Seng	Hong Kong
Nikkei 225	Japan
Straits Times Index	Singapore
FTSE 100	United Kingdom

- 18.** You would buy at \$5.30 and sell for \$5.29.
- 19.** The financial cycle describes how money flows from savers to companies and back. In the financial cycle, (1) people invest and save their money; (2) that money, through loans and stock, flows to companies who use it to fund growth through new products, generating profits and wages; and (3) the money then flows back to the savers and investors.
- 20.** Insurance companies essentially pool premiums together from policyholders and pay the claims of those who have an accident, fire, medical need, or die. This process spreads the financial risk of these events out across a large pool of policyholders and the investors in the insurance company. Similarly, mutual funds and pension funds take your savings and spread them out among the stocks and bonds of many different companies, limiting your risk exposure to any one company.
- 21.** 'Investment banking' refers to the business of advising companies in major financial transactions. Examples include buying and selling companies or divisions, and raising new capital by issuing shares or bonds.
- 22.** Mutual funds, superannuation funds and hedge funds all pool together money and invest it on behalf of the investors in the fund. They differ in terms of who the investors in the fund are and what the primary objective is. Mutual and superannuation funds are most similar except that superannuation funds are investing retirement savings invested through the workplace with the objective of providing retirement income for those employees. Hedge funds are only open to investments by wealthy individuals and endowments. They invest across all asset categories, usually seeking low-risk investment strategies that will generate high returns.