

Understanding Financial Management: A Practical Guide

Guideline Answers to the Concept Check Questions

Chapter 1

Introduction to Financial Management

Concept Check 1.1

1. **What is financial management?**

Financial management is an integrated decision-making process concerned with acquiring, financing, and managing assets to accomplish some overall goal within a business entity. Finance is one of the key functions within any organization.

2. **How do the roles of the firm's treasurer and controller differ?**

The treasurer is responsible for handling external financial matters, such as managing cash and credit, capital budgeting, raising funds, and financial analysis and planning. The controller's responsibilities mainly deal with internal matters, which are accounting in nature. These activities involve cost accounting, taxes, payroll, and management information systems as well as preparing financial statements, budgets, and forecasts.

3. **What are three broad classifications of decisions within financial management? How are they related?**

Financial management involves three major types of decisions: (1) long-term investment decisions, (2) long-term financing decisions, and (3) working capital management decisions, which are short-term in nature. These decisions concern the acquisition and allocation of resources among the various activities of a firm. Investment decisions typically affect financing decisions and vice versa. Although all these decisions are important, investment decisions are typically the most important because they affect a firm's growth and profitability.

4. **How does the notion of a risk-return tradeoff affect the behavior of financial managers?**

When making financial decisions, managers should assess the potential risk and rewards associated with their decisions. The assumption is that most managers are risk-averse. Such managers should only be willing to accept higher levels of risk if they expect to receive higher amounts of return.

Concept Check 1.2

1. **What are the major advantages and disadvantages of corporations?**

The major advantages of corporations are unlimited life, limited liability, ease of ownership transfer, ability to raise funds, and proportional distribution of income. The major disadvantages of corporations are cost and complexity to start, double taxation, and separation of ownership and management.

2. **Why can the separation of ownership and management potentially lead to conflicts?**

In theory, managers should operate in the best interests of the owners, who are the stockholders within corporations. In practice, the interests of managers and owners may differ. This can create a principal-agent problem involving conflicts of interests.

Concept Check 1.3

1. **How does value (wealth) maximization differ from stakeholder theory as a corporate goal?**

Stakeholder theory asserts that managers should make decisions that take into account the interests of all stakeholders of the firm. Such stakeholders include not only financial claimholders but also employees, managers, customers, suppliers, local communities, government, and others. Thus, stakeholder theory involves trying to maximize multiple objectives. Maximization of shareholder wealth focuses on owners and is a single-valued objective. This does not mean that corporate managers should disregard stakeholders other than owners. On the contrary, they need to be aware of the needs, wants, and interests of these other constituencies, but the owners come first.

2. **What is the practical difficulty of using shareholder theory as the corporate goal?**

Various stakeholders may have different or conflicting objectives. Maximizing multiple objectives is difficult, if not impossible, to achieve in practice, especially when conflicts exist among them.

3. **What should be the financial goal of the firm? Why?**

The financial goal of the firm is to maximize shareholder wealth as reflected in the market price of the stock. Investors generally prefer more wealth to less wealth. Shareholder wealth maximization is consistent with the long-run interests of stakeholders and society.

4. **What are several assumptions underlying shareholder wealth maximization?**

The corporate objective function of maximizing shareholder wealth assumes that managers operate in the best interests of stockholders, not themselves, and do not attempt to expropriate wealth from lenders to benefit stockholders. Stockholder wealth maximization also assumes that managers do not take actions to deceive financial markets in order to boost the price of the firm's stock. Another assumption is that managers act in a socially responsible manner and do not create unreasonable costs to society in pursuit of stockholder wealth maximization.

Concept Check 1.4

1. **How do explicit costs differ from implicit costs? Give several examples of each.**

Explicit costs are measurable costs of doing business. Typical explicit costs include operating expenses such as cost of good sold and taxes. *Implicit costs* are the returns the employed resource would have earned in its next best use. Implicit costs include opportunity costs associated with a firm's equity, costs of assets used in production, and owner-provided services. Total costs are the sum of both the explicit and implicit costs for all the resources used by the firm.

2. **What is the difference between accounting profit and economic profit?**

Accounting profit is the difference between revenues and usually only explicit costs, recorded according to accounting principles. *Economic profit* is the difference between revenues and total costs (explicit and implicit costs, including the normal rate of return on capital). Thus, an economic profit results when sales revenue exceeds the cost of production, including opportunity costs. When a firm's revenues are just equal to its total costs, economic profit is zero.

3. **Is accounting profit or economic profit more relevant to achieving the financial goal of maximizing shareholder wealth? Why?**

From the perspective of maximizing shareholder wealth, economic profit is more relevant than accounting profit. Because accounting profit ignores implicit costs, it is generally higher than economic profit. By maximizing economic profit, the financial manager can maximize shareholder wealth.

Concept Check 1.5

1. **What is an agency relationship?**

An *agency relationship* involves two parties – one a principal and the other an agent. An *agent* is a person authorized by another person or group, called a *principal*, to act on the behalf of the principal in transactions with a third party. An agent is subject to the control of the principal, does not have title to the principal's property, and owes the duty of obedience to the principal's orders. In financial management, the major agency

relationships are between stockholders and managers and between stockholders and creditors (debtholders).

2. **Why do agency problems exist in large corporations?**

Agency problems exist in large corporations because conflicts of interest sometimes arise between stockholders and managers. In most large corporations, managers only own a small percentage of the stock. They may take actions to place their interests above those of the stockholders. For example, managers may increase their personal wealth by raising their salaries, bonuses, or option grants as high as possible and by increasing their perquisites including luxurious offices, corporate jets, generous retirement plans, and the like at the expense of outside stockholders. Agency problems can also exist between stockholders and creditors. Stockholders may take actions through their firm's managers that affect the riskiness of the firm such as investing in more risky assets. Increasing a firm's riskiness can negatively affect the safety of its debt.

3. **What is the difference between direct and indirect agency costs? Give an example of each.**

Stockholders incur agency costs to reduce agency conflicts by instituting incentives, constraints, and punishments. Direct agency costs often result from corporate expenditures that benefit management but involve a cost to the stockholders. Incentives such as bonuses, stock options, and perquisites (fringe benefits) are examples of such costs. Monitoring costs, which are costs borne by stockholders to monitor or limit the actions of the managers, are another type of direct agency cost. One example is paying outside auditors to determine the accuracy of accounting information. Another example is the cost of having a board of directors whose job is to make sure that decisions are in the best interests of shareholders. An indirect agency cost could result from management's failure to make a profitable investment because of its aversion to risk.

4. **Describe four mechanisms available for aligning the interests of managers and stockholders.**

The following are four mechanisms for aligning the interests of managers and stockholders.

- *Managerial compensation.* Incentive compensation systems serve as one means of aligning the interests of shareholders and managers. These systems can take many forms and include providing salaries, bonuses, performance shares, and stock options to reward superior performance and to penalize poor performance. Turning managers into substantial owners is likely to reduce the incidence of agency conflicts.
- *Direct shareholder intervention.* Outside investors, especially those holding a large proportion of the firm's shares, can use their voting power to influence the company's actions and the composition of its board of directors.
- *Threat of dismissal.* Top managers are subject to achieving certain performance standards. If they are unable to reach these standards, the board of directors or other executives can dismiss these managers. Their replacements may be more effective in acting in the best interests of the stockholders than are the existing managers.

- *Threat of acquisition.* Underperforming firms may become takeover targets. Managers of such firms may not be providing sufficient value to their stockholders. The acquisition of a target, especially in a hostile takeover, often results in subsequently firing managers of the acquired firm. Thus, the threat of acquisition can be an incentive for managers to make decisions that are in the best interests of their stockholders.