# Chapter 2
# Financial Management

## Synopsis

The purpose of this chapter is to introduce the reader to the forms of business, and the relation between the forms of business and the objectives of financial management. We focus on agency issues and the alignment of incentives with the objectives of shareholders and other stakeholders.

This is important groundwork to help students understanding the framework in which investment and financing decisions are made.

## Learning Outcomes

**LO 2.1** List the advantages and disadvantages of the primary forms of a business organization.

**LO 2.2** Describe the ultimate objective of a company and explain why this is a logical objective.

**LO 2.3** List and describe agency costs and how they may affect owners' wealth.

**LO 2.4** Discuss the primary types of decisions made by business entities regarding the financial management of assets, as well as the associated financing decisions.

## Chapter Outline

**2.1 Forms of business organizations**

A. Sole proprietorship
B. Partnerships
C. Corporations
D. Limited Liability companies
E. Subchapter S corporations
F. Prevalence

**2.2 The goals of the business enterprise**

A. Stakeholders
B. The goal of the business enterprise

**2.3 The role of management and agency issues**

A. The agency relationship and agency costs

B. Aligning managers' and owners' interests

**2.4 Financial management**

A. Investment decisions
B. Financing decisions

# Discussion Questions for Special Features

| Feature | Learning outcome | Discussion questions |
|---|---|---|
| *Opening vignette:* Social Responsibility | 2.2 | 1. Is Green Mountain's business ethics reflected in its market value? How would you know?<br>2. If the company were to buy products from environmentally sensitive areas, but doing so saves money, is this consistent with maximizing shareholder wealth? Explain.<br>3. Do Green Mountain's ethical principles put the company at a comparative disadvantage relative to its competitors?<br>Look up the stock: GMCR |
| *Global Perspectives*: Forms of Business | 2.1 | 1. Some familiar companies are actually headquartered in other countries. Which country is Bayer AG headquartered?<br>2. The limited liability company originated in Germany in 1892, and its use in the U.S. is relatively new (since the 1970s). Why would the limited liability company be a popular form both in the U.S. and elsewhere? |
| *Lessons to be learned:* Economic Value Added | 2.2 | 1. Why is focusing on earnings per share short-sighted?<br>2. If a company generates negative economic profit, what does this mean? |
| *Finance in the News:* General Electric Sheds Light on its Smooth Earnings | 2.3 | 1. Who may be harmed by the earnings smoothing?<br>2. What type of agency cost is involved in this case?<br>Check out the stock: GE |
| *Ethics:* The cost of fraud | 2.4 | 1. Who, if anyone, is harmed in the case of the manipulation of accounting information?<br>2. Which managers should be held accountable for accounting fraud?<br>3. Why is a clawback used in these cases?<br>Check out the stock: BZH |

# Concept Review Questions

## 2.1 Forms of business organizations

1. Sole proprietorships' advantages include control of the management of the enterprise, one layer of taxation. Sole proprietorships' disadvantages include lack of access to capital markets, limited external financing, and limited life of the enterprise, Partnerships have similar advantages and disadvantages as sole proprietorships, but also require a partnership agreement to determine the division of control and income.
2. The advantage of an LLC is that there is limited liability for its owners, whereas for partnerships there is unlimited liability for each partner.
3. The primary advantage of the corporate structure is that it has access to capital markets and can therefore issue debt or equity. Another advantage is that the enterprise has an unlimited life. One disadvantage of the corporate structure is that there are two (or more) layers of taxation. Another disadvantage is that for large corporations, there is a separation of management and owners.

## 2.2 The goals of the business enterprise

1. The primary goal of a corporation is to maximize shareholders' wealth.
2. The stakeholders of a company include the shareholders, the employees, and the community in which is does business.

## 2.3 The role of management and agency issues

1. In small businesses, especially in sole proprietorships and partnerships, the owners are typically the managers. For large enterprises, and especially corporations, there is a separation of owners and managers, raising the possibility of agency costs/
2. Agency costs are direct costs, such as the monitoring costs of producing annual reports, and indirect costs (e.g., managers making decisions that are self-serving) associated with addressing potential problems with the separation of management and ownership.
3. It has been believed that aligning management's interests with those of shareholders by increasing the focus on share price through stock options would reduce agency costs. However, these have not worked as well as expected because these options do not always result in stock ownership and a long-term perspective.

## 2.4 Financial management

1. The financial management of assets requires making decisions regarding long-term investments (capital budgeting) and short-term, operating assets.
2. Key financing decisions include managing short-term sources of financing to meet seasonal or cyclical needs, and the capital structure decision, which is deciding how much debt is appropriate, relative to equity.

# Answers to Multiple Choice Questions

1. A
2. C
3. A
4. A

 

5. B
6. C
7. B
8. C
9. B
10. B

# Solutions to Practice Questions and Problems

### 2.1 Forms of business enterprise

11.

| ***Form of business*** | ***Liability*** | ***Life*** | ***Taxation*** | ***Access to capital*** | ***Management and owners relationship*** |
|---|---|---|---|---|---|
| Sole proprietorship | Unlimited | Limited | Flow through | Limited | Manager and owner are the same |
| Partnership | Unlimited | Limited | Flow through | Limited | Manager and owner are often the same |
| Corporation | Limited | Unlimited | Double taxation | Can issue debt and equity | Separation of management and owners |
| Limited liability company | Limited | Unlimited | Flow through | Limited | Depends on the size of the company and structure |

12. Primary differences:
    1. Taxation (partnership income taxed once, corporate income taxed at the corporate level and at the owners' level when distributed).
    2. Liability (partners have unlimited liability; shareholders have limited liability).
    3. Life (partnership has a limited life; a corporation is perpetual).

13. Flow-through taxation is taxation on the income after it flows through the business to the owners.

14. Comparing the two strategies, the LLC is preferred to the Subchapter S except with respect to the life of the business entity. The Subchapter S has the advantage that it has a perpetual life.

| ***Characteristic*** | ***Sub S*** | ***LLC*** | ***Advantage to:*** |
|---|---|---|---|
| Taxation | Pass-through | Pass-through | LLC |
| Ownership | Maximum of 75 | No maximum | LLC |

 

| | | | |
|---|---|---|---|
| | shareholders | | |
| Liability | Limited liability | Limited liability | -- |
| Life | Perpetual | Limited | Sub S |

15.

| | ***Dividend Payout*** | ***Corporate Tax Rate*** | ***Shareholders' Tax on Dividend Income*** | ***Effective Tax on Corporate Income*** |
|---|---|---|---|---|
| A. | 40% | 45% | 15% | 0.483 or 48.3% |
| B. | 20% | 40% | 0% | 0.4 or 40% |
| C. | 25% | 35% | 15% | 0.374375 or 37.44% |
| D. | 25% | 40% | 15% | 0.4225 or 42.25% |

16. Corporate tax rate = 40%; individual tax rate = 32%

| | |
|---|---|
| Corporate taxable income | \$5,000,000 |
| Corporate tax | 2,000,000 |
| Corporate income after tax | \$3,000,000 |
| | |
| Distribution to shareholders | \$750,000 |
| Shareholders' tax | 240,000 |
| Income after tax | \$510,000 |

The effective tax rate is (\$240,000 + 2,000,000) ÷ \$5,000,000 = 44.8%

17.

**A. 36%**

B. effective rate = 0.36 + [(1-0.36) × 1 × 0.40] = 0.36 + 0.256 = **61.6%**

C. effective rate = 0.36 + [(1-0.36) × 1 × 0.20] = 0.36 + 0.128 = **48.8**%

## 2.2 The goals of the business enterprise

18. To maximize the value of the ownership interest.

19. A stakeholder is any party that is affected by the business entity, including shareholders and employees.

20. Earnings represent the results of the assets in place, as well as accounting principles selected to reflect past performance. The value of equity is forward-looking.

21. In a competitive market, if a company maximizes owners' wealth, this will result in an efficient allocation of resources because the company will want to make those decisions – that involve resources – that are the best uses of these resources.

## 2.3 The role of managers and agency issues

22. Agency costs are direct and indirect costs resulting from agents (the managers) acting in the best interests of the principals (shareholders). Examples: the cost of creating an annual report; the costs of arranging board of directors' meetings; managers consuming perquisites (e.g., country club membership paid by the company).

 

23. ***Example 1:*** If another company proposes an acquisition, managers that are self-serving may reject a bid that provides shareholders with a price above the current market value. ***Example 2:*** Managers may use company property, such as a corporate jet, for personal benefit.
24. Shareholders electing members of the board of directors who will be diligent in monitoring management; devise a compensation scheme that relates performance to pay (e.g., restricted stock grants); becoming a publicly-traded corporation, with monitoring by analysts and the disclosure requirements of the SEC.
25. Earnings can be manipulated or managed; the relation between earnings and value is not strong because earnings are historical (that is, based on past decisions) and value is forward-looking.
26. The reasoning is that if the executive has stock option, he/she will want to maximize the price of the company's stock.
27. Shareholders elect a board of directors, who monitor management.

## 2.4 Financial management

28. Capital structure is how a company finances its assets through debt and equity.
29. The focus in evaluating an investment project is the risk of the project and how the investment project will affect the company's futures cash flows.
30.

| ***Decision*** | ***Investment*** | ***Financing*** |
|---|---|---|
| Buying a new plant | ☑ | ☐ |
| Acquiring another company | ☑ | ☐ |
| Issuing a bond | ☐ | ☑ |
| A corporation buying back its own stock | ☐ | ☑ |
| Borrowing from a bank | ☐ | ☑ |

31.

| | ***Hewlett-Packard*** | ***Boeing*** | ***Verizon*** |
|---|---|---|---|
| Proportion of current assets | 43% | 59% | 10% |

Hewlett-Packard and Boeing are both manufacturers, so they need to maintain an inventory of raw materials sufficient to support the production process, as well as inventory in process and finished goods. Boeing manufactures aircraft, which are built to specifications and have a long production process; hence Boeing has a greater need for working capital.
Verizon is a telecommunications company, which is, in large part, a service company. The inventory and receivables for this company would be much smaller than that of the other two companies.

 

# Solutions to Cases

## Case 2.1 The Tex Tech Company

A. Dan should choose Project B, which would increase the value of the firm by more than Project A. If Dan is self-serving, he would be tempted to select project A, which provides a higher bonus for him.
B. The owner likely prefers Project B, the project that produces the greater value.
C. Altering the bonus scheme, such that the bonus is a function of the value of Tex Tech.

## Case 2.2 To Invest or not to Invest

A. Factors to consider:
    1. How many years will the new system benefit the company?
    2. What is the risk that the savings will be less than expected?
    3. What is the cost of capital for the company? Considerations: the cost of equity, the amount of debt and equity the company uses (i.e., its capital structure), and tax rate (because the $10,000 in interest is tax deductible).
B. The determination cannot be made on the basis of this information. If the company pays taxes, the cost of the debt will be less than $10,000 and there would be profit before considering the cost of equity for the company.