Solutions Manual for Finance-Applications and Theory 2025 Release 1st Edition by Cornett, Adair, Nofsinger

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CHAPTER 1 − INTRODUCTION TO FINANCIAL MANAGEMENT

Questions

LG1

1. Describe the type of people who use the financial markets.

   The financial markets are used by people who have extra money now and want it to grow for their future. They offer this capital through the financial markets to others who have good ideas and opportunities but need the capital to implement them. These types of people are denoted as Type 2 and 3 people in Figure 1.1.

LG1

2. What is the purpose of financial management? Describe the kinds of activities that financial management involves.

   Financial management is the process of making decisions for the acquisition, use, and repayment of capital. Decisions for the acquisition of capital can include how the business is organized, what type of capital should be obtained, and how much capital should be obtained. Decisions for the uses of capital include what new business projects to invest in, what capital to retain to fund ongoing projects, and to reduce taxation. Decisions for the repayment of capital involve paying capital back to its providers.

LG2

3. What is the difference in perspective between finance and accounting?

   Accounting focuses on recording and presenting the past business activities. This information is good for evaluating past performance. The finance function uses this past data along with current information to make decisions on what business activities to do now and in the future. Decisions about the future involve much uncertainty, so risk evaluation is part of the finance job.

LG3

4. What personal decisions can you think of that will benefit from learning finance?

   Learning finance will help the student build wealth and reduce costs in their personal life. After taking this class, the student should be able to make good decisions about funding their future retirement and investment allocations. People with finance knowledge can also reduce costs by making good decisions in borrowing while buying cars, homes, and using credit cards.

LG4

5. What are the three basic forms of business ownership? What are the advantages and disadvantages to each?

   The three basic business forms are the sole proprietorship (SP), the partnership (Part), and the corporation (Corp). Advantages and disadvantages can be determined along several dimensions: control, risks, access to capital, and taxation. The SP owner has total control of business decisions. Control decreases for owners of Part and then Corp. The owner has a high risk to their personal wealth in a SP and Part, but low risk in a Corp. Access to capital is addressed in question 6. Lastly, SP and Part owners are taxed as if the business was personal income. The Corp owner is taxed twice, once at the corporation level and then again at the personal level.

LG4

6. Among the three basic forms of business ownership, describe the ability of each form to access capital.

   The corporation has the highest access to capital. It can acquire new equity capital from the public market. Also, banks are more willing to lend to corporations. Debt investors are also more likely to buy the bonds of a corporation. Partnerships have the next best access to capital. With larger numbers of partners involved with the business, the more likely banks will lend and debt investors will buy its bonds. Partnerships do not have access to the public equity market. Lastly, sole proprietorships have poor access to capital. Generally speaking, the sole proprietor cannot borrow as much money from banks or debt investors.

LG4

7. Explain how the founder of a business can eventually lose control of the firm. How can the founder ensure this will not happen?

   When the founder wants the business to grow quickly, more capital is required. In the early stages of a small fast-growing company, it is equity capital that is available. In other words, the founder must give up a portion of his or her ownership to other investors. As this process continues over time, the founder may find that he or she no longer owns a majority of the firm. There may come a time when enough of these other owners that own a combined 50+ percent of the firm come together and change the leadership of the firm.

LG5

8. Explain the shareholder wealth maximization goal of the firm and how it can be measured. Make an argument for why it is a better goal than maximizing profit.

   The shareholder wealth maximization goal of the firm states that managers should run the company in such a way that maximizes the wealth of the stockholders. Progress for this goal can be measured using the stock price. The stock price contains what investors know about the current profitability of the firm and expectations about future profits and opportunities. Maximizing profit is a similar goal, but not quite as good. A manager could maximize this year's profit at the detriment of future profits. This would not be good for long-term investors.

LG5

9. Name and describe as many corporate stakeholders as you can.

   Stockholders, managers, and employees are all stakeholders with a very close relationship to the firm. Customers, suppliers, banks, and bondholders have a close relationship to the firm. Local government, local community people, and people who enjoy the environment are also stakeholders.

LG6

10. What conflicts of interest can arise between managers and stockholders?

    Stockholders own the firm and hire managers to run the firm. Managers, therefore, control the day-to-day operations of the firm. Since the stockholders can't see these decisions, it is possible that the managers will manage the firm in such a way that it benefits themselves more than the shareholders. This conflict of interest can manifest as higher costs to the firm for things that benefit the managers. It can also show up in decisions to make poor acquisitions of other firms in order to make the company bigger and then argue for higher managerial pay.

LG6

11. Figure 1.9 shows firm monitors. In your opinion, which group is in the best position to monitor the firm? Explain. Which group has the potential to be the weakest monitor? Explain.

    Auditors are in a great position to monitor the company. They are specifically tasked with identifying and reporting the activities of the company. The members of the Board of Directors are also in a good position to monitor the firm because they are at a high position and are charged with hiring, firing, and monitoring management. These two groups do well when they are independent of management. Financial analysts are not in a good position to monitor management because they have no special ability to acquire private information about management's activities. In addition, they sometimes experience conflicts of interest in their rating of firms.

LG6

12. In recent years, governments all over the world have passed laws that increased the penalties for executives' crimes. Do you think this will deter unethical corporate managers? Explain.

    Better monitoring and increased punishment should reduce unethical behavior from corporate managers for a while. Executives are smart enough to not push any gray areas or commit fraud during this time with heightened awareness of executive crime. However, this focus will wane many years from now. Although these new laws will still apply, unethical managers may once again behavior badly.

LG6

13. Every year, the media reports on the vast amounts of money (sometimes hundreds of millions of dollars) that some CEOs earn from the companies they manage. Are these CEOs worth it? Give examples.

    When a CEO earns hundreds of millions of dollars, it is usually because they have had an incentive compensation plan pay off big. These incentive plans have been given many years before. If the firm's stock price increases enough over the years, then the CEO's stock options become very valuable. If the CEO's leadership over the years is responsible for the increase in stock price, then it is likely worth it. Of course, if the stock price declines later, then it would not be worth it. In December 2024, a Delaware judge rejected Elon Musk's $101.4 billion pay package as Tesla CEO. This was the second time the judge struck down the package, which was originally valued at $56 billion. The package was made up of 303 million Tesla stock options and had been approved by a majority of Tesla shareholders in June 2024. However, the judge ruled against Musk, siding with the main shareholder who challenged the package, saying that Musk and Tesla's board failed to prove that the compensation plan was fair.

LG7

14. Why is ethical behavior so important in the field of finance?

    Ethical behavior is so important because finance involves the management of other people's capital. People must be willing to invest their capital with others if the economy is to thrive. But nobody wants to offer their capital if they believe they will be taken advantage of. Thus, it is very important to the economy to have confidence in ethical behavior.

LG7

15. Does the goal of shareholder wealth maximization conflict with behaving ethically? Explain.

No. The goal of shareholder wealth maximization is to maximize the stock price over the long term. Unethical behavior may temporarily increase the stock price, but it will eventually be found out. When that happens, the company is punished by a falling stock price.

LG8

16. Describe how financial institutions and markets facilitate the expansion of a company's business?

    Companies need additional capital to fund large business expansion opportunities. Financial institutions and markets provide that capital. A firm's opportunities may offer higher profits to the firm than the costs paid for the capital. So facilitating the firm's expansion also leads to increased value of the firm.

Integrated Mini-case: Corporate Citizenship

What is a company's responsibility to society? Proponents of the modern view of stakeholder theory argue that companies have a social obligation to operate in ethically, socially, and environmentally responsible ways. This active approach is referred to as *corporate social responsibility (CSR) or corporate citizenship*. The idea of corporate citizenship is that a firm should conduct its business in a manner that meets its economic, legal, ethical, and philanthropic expectations in a sustainable manner. The recent buzz words in this globally popular arena are *environment, society, and governance (ESG)*.

The economic responsibilities have the highest priority. A firm must be efficient and survive over the long term in order to be useful to society. It must also execute its business activities in a legal and ethical way. These responsibilities are those over and above the ones codified in laws and are in line with societal norms and customs. They are expected by society even though they may be ill-defined. This could include things such as environmental ethics. Philanthropy is the least important priority. The corporate citizenship concept focuses more on engagement with stakeholders to achieve mutual goals.

Some corporations have responded to this trend by including CSR-oriented statements in their corporate goals. These statements recognize that CSR has value in a code of conduct or ethics, a commitment to local communities, an interest in employee health and education, an environmental consciousness, and recognition of social issues (diversity, social fairness, etc.). In October 2006, The Conference Board surveyed large U.S. firms on corporate citizenship issues, and 198 firms responded.[1] When asked about the top three CSR topics receiving attention at the company, community/stakeholder involvement ranked first, corporate giving second, and environmental sustainability a very close third. Corporate

[1] United Nations, 2015, "Principles for Responsible Investment," **www.unpri.org**, and David Vidal, "Reward Trumps Risk: How Business Perspectives on Corporate Citizenship and Sustainability Are Changing," *Executive Action Series*, The Conference Board, No. 216, November 2006.

governance, management of CSR activities, health and safety, investor relations, labor, and human rights were also mentioned.

What is the motivation for these companies to fund CSR programs? When asked, 92 percent stated that enhancing corporate reputation was very important. Other popular responses were for recruiting and retention (78 percent), reducing risk (65 percent).

a. In the summer of 2015, Volkswagen was touting on its corporate website that it was one of only two automakers to be listed in both the Dow Jones Sustainability Index (DJSI) World and DJSI Europe. It was considered a "best in ESG class" firm. Unfortunately, in September of that year, the news broke that Volkswagen had programmed some of its cars to cheat on the diesel emissions tests. This event has had significant ramifications for Volkswagen's relationships with its customers, investors, and regulatory agencies around the world. Investigate this story and describe what has happened to Volkswagen since this scandal broke.

b. What activities might companies engage in to satisfy the four components of corporate citizenship: economic, legal, ethical, and philanthropic?

c. By embracing citizenship goals, assess whether corporations can insulate themselves from many activist actions, thereby avoiding negative media events.

SOLUTION:

a. Since the diesel emissions scandal erupted in September 2015, Volkswagen has encountered significant legal, financial, and reputational challenges. The company confessed to installing software in diesel vehicles to manipulate emissions tests, impacting around 11 million cars globally.
In addition, Volkswagen's stock value dropped sharply, losing about 30% within a year. The company set aside billions to cover fines, settlements, and vehicle buybacks, with the total costs estimated at \$33.3 billion by June 2020. In April 2017, a U.S. federal judge ordered Volkswagen to pay a \$2.8 billion criminal fine. Additionally, in January 2017, Volkswagen agreed to plead guilty to criminal charges and pay \$4.3 billion in penalties.
The scandal also led to significant leadership changes. CEO Martin Winterkorn resigned in September 2015 and was charged with fraud and conspiracy in the United States. His trial began in Germany in September 2024, facing charges of fraud, market manipulation, and false testimony.
Volkswagen's global reputation also suffered, reflected in its removal from the Dow Jones Sustainability Indexes in October 2015 and a 24.7% decline in U.S. sales in November 2015. The scandal triggered broader industry-wide investigations, with the UK government examining 47 car models from 20 brands for pollution limit violations in late 2024. In summary, the emissions scandal resulted in substantial financial penalties, legal actions against executives, and lasting reputational damage for Volkswagen, alongside increased scrutiny across the automotive industry.

b. The best economic component is to strive for shareholder wealth maximization. This will help the firm survive for the long-term to benefit its employees and the communities it operates in. Firms should always behave in a lawful manner. U.S. firms should obey U.S. laws even when operating in countries where a behavior may be legal there, but illegal in the United States. The firm can behave in an ethical manner. Among other things, this means producing products that that are not harmful. This is important for the long-term success of the firm. Lastly, the company can give to charity at both the local, community level and to large, national organizations.
c. Companies can insulate themselves to some degree by being aggressive in promoting its citizenship activities. That is, firms can build up some goodwill with its good deeds. However, there are many activists with many topics. It is difficult to be known for good citizenship activities in all things. This takes manager's time and effort and company money that might be better served focusing on the business of the firm. So, a firm that has a good reputation for treating its people well might still be criticized by environmental activists. Firms that are known for contributing to local communities might be criticized on its activities in foreign countries.

Integrated Mini-Case
Corporate Citizenship

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