Fundamentals Of Corporate Finance (Canadian) 10th edition Ross Solutions Manual

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CHAPTER 1
INTRODUCTION TO CORPORATE FINANCE

Learning Objectives

LO1 The basic types of financial management decisions and the role of the financial manager.
LO2 The financial implications of the different forms of business organization.
LO3 The goal of financial management.
LO4 The conflicts of interests that can arise between managers and owners.
LO5 The roles of financial institutions and markets.
LO6 Types of financial institutions.
LO7 Trends in financial markets.

Answers to Concepts Review and Critical Thinking Questions

1. **(LO1)** Capital budgeting (deciding on whether to expand a manufacturing plant), capital structure (deciding whether to issue new equity and use the proceeds to retire outstanding debt), and working capital management (modifying the firm's credit collection policy with its customers). (LO1)

2. **(LO2)** Disadvantages: unlimited liability, limited life, difficulty in transferring ownership, hard to raise capital funds. Some advantages: simpler, less regulation, the owners are also the managers.

3. **(LO2)** The primary disadvantage of the corporate form is the double taxation to shareholders of distributed earnings and dividends. Some advantages include: limited liability, ease of transferability, ability to raise capital, unlimited life, and so forth.

4. **(LO4)** The treasurer's office and the controller's office are the two primary organizational groups that report directly to the chief financial officer. The controller's office handles cost and financial accounting, tax management, and management information systems, while the treasurer's office is responsible for cash and credit management, capital budgeting, and financial planning. Therefore, the study of corporate finance is concentrated within the treasury group's functions.

5. **(LO3)** To maximize the current market value (share price) of the equity of the firm (whether it's publicly-traded or not).

6. **(LO4)** In the corporate form of ownership, the shareholders are the owners of the firm. The shareholders elect the directors of the corporation, who in turn appoint the firm's management. This separation of ownership from control in the corporate form of organization is what causes agency problems to exist. Management may act in its own or someone else's best interests, rather than those of the shareholders. If such events occur, they may contradict the goal of maximizing the share price of the equity of the firm.

7. **(LO5)** A primary market transaction. A secondary market transaction would entail the sale between two 3rd parties (i.e. not the corporation).

8. **(LO5)** In auction markets like the Toronto Stock Exchange (TSX), brokers and agents meet at a central location (the exchange) to match buyers and sellers of assets. Physical locations for stock markets are disappearing as trading becomes more electronic. Dealer markets like Nasdaq consist of dealers operating at dispersed locales who buy and sell assets themselves, communicating with other dealers either electronically or literally over-the-counter. Dealer markets are less transparent than auction markets where trades are reported publicly almost immediately. The auction market run by the TSX is where the stocks of larger Canadian companies are traded; the TSX also operates a dealer market called the Venture Exchange for companies too small to qualify for the TSX auction exchange.

9. **(LO3)** Such organizations frequently pursue social or political missions, so many different goals are conceivable. One goal that is often cited is revenue minimization; i.e., provide whatever goods and services are offered at the lowest possible cost to society. Another would be to best serve the maximum possible number of stakeholders at the lowest cost. A better approach might be to observe that even a not-for-profit business has equity. Thus, one answer is that the appropriate goal is to maximize the value of the equity.

10. **(LO3)** Presumably, the current stock value reflects the risk, timing, and magnitude of all future cash flows, both short-term *and* long-term. If this is correct, then the statement is false.

11. **(LO3)** An argument can be made either way. At the one extreme, we could argue that in a market economy, all of these things are priced. There is thus an optimal level of, for example, ethical and/or illegal behavior, and the framework of stock valuation explicitly includes these. At the other extreme, we could argue that these are non-economic phenomena and are best handled through the political process. A classic (and highly relevant) thought question that illustrates this debate goes something like this: "A firm has estimated that the cost of improving the safety of one of its products is $30 million. However, the firm believes that improving the safety of the product will only save $20 million in product liability claims and lost customer goodwill. What should the firm do?"

12. **(LO3)** The goal will be the same, but the best course of action toward that goal may be different because of differing social, political, and economic institutions.

13. **(LO4)** The goal of management should be to maximize the share price for the current shareholders. If management believes that it can improve the profitability of the firm so that the share price will exceed $35, then they should fight the offer from the outside company. If management believes that this bidder or other unidentified bidders will actually pay more than $35 per share to acquire the company, then they should still fight the offer. However, if the current management cannot increase the value of the firm beyond the bid price, and no other higher bids come in, then management is not acting in the interests of the shareholders by fighting the offer. Since current managers often lose their jobs when the corporation is acquired, poorly monitored managers have an incentive to fight corporate takeovers in situations such as this.

14. **(LO4)** We would expect agency problems to be less severe in other countries, primarily due to the relatively small percentage of individual ownership. Fewer individual owners means that each individual owner has a greater incentive to monitor and control the firm—i.e. there is less free-riding. The high percentage of institutional ownership might lead to a higher degree of agreement between owners and managers on decisions concerning risky projects. In addition, institutions may be better able to implement effective monitoring mechanisms on managers than can individual owners, based on the institutions' deeper resources and experiences with their own management. The increase in institutional ownership of stock in Canada and in the United States and the growing activism of these large shareholder groups may lead to a reduction in agency problems for Canadian and U.S. corporations and a more efficient market for corporate control.

15. **(LO5) Major institutions:**
Chartered banks -accept deposits and issue commercial loans, corporate loans, personal loans and mortgages.
Trust companies-accept deposits and make loans, but also engage in fiduciary activities such as managing assets for estates, registered retirement savings plans, etc.
Investment dealers -non-depository institutions that assist firms in issuing new securities.

Insurance companies -engage in indirect financing by accepting funds in a form similar to a deposit and making loans.
Pension funds -invest contributions from employers and employees in securities offered by financial markets.
Mutual funds -pool individual investments to purchase a diversified portfolio.
Hedge funds -cater to sophisticated investors and seek high returns by using aggressive financial strategies prohibited by mutual funds.
Note that larger financial institutions may embody many of these different institution. For example, CIBC is a chartered bank that owns an investment dealer and mutual funds. Furthermore, it has an insurance arm "CIBC Insurance"

Major markets:
Money market -financial markets where short-term debt instruments are bought and sold.
Capital markets -financial markets where long-term debt and equity securities are bought and sold.
Derivatives markets – where options and futures are traded on financial instruments and commodities
Primary markets are where securities are sold for the first time; secondary markets are where outstanding securities trade.

16. **(LO5)** Indirect finance-funds are transferred from suppliers of capital to demanders of capital through a financial intermediary. Life insurance companies engage in indirect finance by accepting funds in a form similar to deposits and making loans.
Direct finance-funds are transferred from suppliers of capital to demanders of capital but financial intermediaries are bypassed. Bankers' acceptances are an example of direct finance.

17. **(LO5) Trends:**
Financial engineering -the creation of new securities or financial processes. This engineering could be used to package and sell risky assets to investors; for example, banks can package and sell mortgages into mortgage backed securities and sell these on to other investors.

Derivative securities -options, futures, forwards, and other securities whose value is derived from the price of another, underlying asset. For example, a futures contract to purchase oil sets a fixed purchase/selling price for a future date, but its value depends on the price of oil. These derivatives can help businesses divest risks that are not core to their business, such as foreign exchange and input price (like oil) risk.

Regulatory dialectic -the pressures that financial institutions and regulatory bodies exert on each other. For example, when restrictions are removed, growth opportunities may increase. However, the absence of regulatory restrictions may also lead to problems such as the global financial crisis starting in 2007 caused by excessive financial leverage, so it is important that there be an appropriate level of regulatory oversight.

These trends have made financial management a much more complex and technical activity.

INTRODUCTION:
COURSE MATERIALS AND LECTURE NOTES

The Tenth Canadian Edition of ***Fundamentals of Corporate Finance*** can be readily adapted to meet the individual preferences of course instructors and the differing backgrounds and needs of introductory finance students. One of many possible sequences is listed below.

Course Outline

Chapter	**Topic**
Chapter 1	Introduction to Corporate Finance
Chapter 2	Financial Statements, Cash Flow, and Taxes
Chapter 3	Working with Financial Statements
Chapter 4**	Long-Term Financial Planning and Corporate Growth
Chapter 5	Introduction to Valuation: The Time Value of Money
Chapter 6	Discounted Cash Flow Valuation
Chapter 7	Interest Rates and Bond Valuation
Chapter 8	Stock Valuation
Chapter 9	Net Present Value and Other Investment Criteria
Chapter 10	Making Capital Investment Decisions
Chapter 11*	Project Analysis and Evaluation
Chapter 12	Lessons from Capital Market History
Chapter 13	Return, Risk, and the Security Market Line
Chapter 14	Cost of Capital
Chapter 15*	Raising Capital
Chapter 16	Financial Leverage and Capital Structure Policy
Chapter 17	Dividends and Dividend Policy
Chapter 18	Short-Term Finance and Planning
Chapter 19	Cash and Liquidity Management
Chapter 20	Credit and Inventory Management
Chapter 21**	International Corporate Finance
Chapter 22	Leasing
Chapter 23	Mergers and Acquisitions
Chapter 24**	Enterprise Risk Management
Chapter 25	Options and Corporate Securities
Chapter 26**	Behavioural Finance: Implications for Financial Management

* May be assigned as outside reading if time is short.
** May be covered in part or omitted without loss of continuity if time is short.

PowerPoint Note 1: If there is a slide that you do not wish to include in your presentation, choose to hide the slide under the "Slide Show" menu, instead of deleting it. If you decide that you would like to use that slide at a later date, you can just unhide it.

PowerPoint Note 2: Be sure to check out the notes that accompany the slides on the "Notes Pages" within PowerPoint.

CHAPTER 1
INTRODUCTION TO CORPORATE FINANCE

LEARNING OBJECTIVES
After studying this chapter, students should understand:
LO1 The basic types of financial management decisions and the role of the financial manager.
LO2 The financial implications of the different forms of business organization.
LO3 The goal of financial management.
LO4 The conflicts of interests that can arise between managers and owners.
LO5 The roles of financial institutions and markets.
L06 Types of Financial Institutions
L07 Trends in Financial Markets

SLIDES

S1.1 : Key Concepts and Skills
S1.2: Chapter Outline
S1.3: Corporate Finance
S1.4: Financial Manager
S1.5: Financial Management Decisions
S1.6: Forms of Business Organization
S1.7: Sole Proprietorship
S1.8: Partnership
S1.9: Corporation
S1.10: Income Trust
S1.11 Co-operative
S113: Goal of Financial Management
S1.13: Primary Goal of Financial Management
S1.13: The Agency Problem
S1.14: Managing Managers
S1.15: Social Responsibility and Ethical Investing
S1.16: Work the Web Example (2 pages)
S1.18: What is the Role of Financial Markets in Corporate Finance?
S1.19: Cash Flows to and from the Firm
S1.20: Financial Institutions
S1.21: Trends in Financial Markets and Management
S1.22: Outline of Text
S1.23: Quick Quiz
S1.24: Summary

CHAPTER WEB SITES

Section	*Web Address*
1.1	www.cfo.com
1.2	www.canadianlawsite.ca
	www.canadabusiness.ca
	www.coop.gc.ca/
1.3	www.ethicscentre.ca
1.4	www.aircanada.ca
	www.jantziresearch.com
	www.international.gc.ca/international/
	www.unepfi.org/fineadmin/documents/freshfields_legal_resp_20051123.pdf
1.5	www.rbcem.com
	www.osc.gov.on.ca
	www.tmx.com
	www.nyse.com
	www.microsoft.com
	www.intel.com
	www.world-exchanges.org
1.6	www.globeinvestor.com
	www.ific.ca
	www.terrapinn.com/2008/hfwcanada/
	www.hedgefund.net
1.7	www.royalbank.ca
Internet Application	www.tmx.com
	www.cmhc.ca
	www.sb.gov.bc.ca/bizstart-prop.php
	www.goldmansachs.com
	www.nyse.com
	www.socialinvestment.ca
	www.janitziresarch.com

CHAPTER ORGANIZATION

ANNOTATED CHAPTER OUTLINE

S1.1: Key Concepts and Skills

- Know the basic types of financial management decisions and the role of the financial manager
- Know the financial implications of the different forms of business organization
- Know the goal of financial management
- Understand the conflicts of interest that can arise between owners and managers
- Understand the various types of financial markets and financial institutions
- Know the types of financial institutions
- Understand and know the trends in the financial markets

S1.2: Chapter Outline

- Corporate Finance and the Financial Manager
- Forms of Business Organization
- The Goal of Financial Management
- The Agency Problem and Control of the Corporation
- Financial Markets and the Corporation
- Financial Institutions
- Trends in Financial Markets and Financial Management
- Outline of the Text

1.1 CORPORATE FINANCE AND THE FINANCIAL MANAGER

S1.3: Corporate Finance

A. What Is Corporate Finance?

Corporate finance is the study of the answers to the following questions:

1. What long-term investments should we make? That is, what lines of business will you be in and what sorts of buildings, machinery, equipment, and research and development facilities will you need?

2. Where will we get the funds to pay for our investment? Will you bring in other owners or will you borrow the money?

3. How will you manage your everyday financial activities, such as collecting from customers and paying suppliers?

In other words, the capital budgeting question, the capital structure question, and the net working capital question.

S1.4: Financial Manager

B. The Financial Manager

The *Chief Financial Officer, CFO*.

Treasurer - oversees cash management, financial planning, and capital expenditures.

Controller – oversees taxes, cost accounting, financial accounting, and data processing.

Financial managers try to answer some or all of these questions.

S1.5: Financial Management Decisions

C. Financial Management Decisions

Capital budgeting - The process of planning and managing a firm's investments in fixed assets. It is concerned with the *size*, *timing*, and *riskiness* of cash flows.

Capital structure - The mix of debt and equity used by a firm. What are the least expensive sources of funds? Is there a best mix? When and where to raise funds?

Working capital management - Managing short-term assets and liabilities. How much cash and inventory to keep around? What is our credit policy? Where will we obtain short-term loans?

1.2 FORMS OF BUSINESS ORGANIZATION

S1.6: Forms of business organization

Three major forms: Sole Proprietorship
Partnership
Corporation
Income Trust
Co-operative (Co-op)

S1.7: Sole Proprietorship

A. Sole Proprietorship

Sole Proprietorship - A business owned by one person. Easy to start up, with low regulation, and profits are taxed as personal income. But involves *unlimited liability*, its life is limited to the owner's, and the equity that can be raised is limited to the proprietor's wealth.

S1.8: Partnership

B. Partnership

In a partnership there are multiple owners.

General partnership - All partners share in gains or losses, all have unlimited liability for all partnership debts.

Limited partnership - One or more *general partners* will run the business and have unlimited liability. The *limited partner's* liability is limited to their contribution to the partnership.

Partnerships allow more equity capital than is available to a sole proprietorship, are relatively easy to start up, and are taxed at the personal rate. But there is *unlimited liability*, and the partnership dissolves upon death or sale. Furthermore, it is difficult to sell and there can be disputes between partners.

S1.9: Corporation

C. Corporation

A corporation is a business created as a distinct legal entity composed of one or more individuals or entities.

Corporations are the most important form of business organization in Canada. There are several advantages to the corporate form:

1. Limited liability for stockholders.
2. Unlimited life for the business.
3. Ownership can be easily transferred.
4. Professional management (separation of ownership and management)

These characteristics make it easier for corporations to raise capital.

The disadvantage to corporations is *double taxation* and *management is different from* *ownership (principal-agent problem)*

S1.10: Income Trust

D. Income Trust

Business income trusts (also called income funds) hold the debt and equity of an underlying business and distribute the income generated to unit holders.

Because income trusts are not corporations, they are not subject to corporate income tax and their income is typically taxed only in the hands of unit holders. As a result, some investors viewed trusts as tax efficient and were generally willing to pay more for a company after it converted from a corporation to a trust.

S1.11: Co-operative (Co-op)

A co-operative is an enterprise that is equally owned by its members, who share the benefits of co-operation based on how much they use the co-operative's services.

The co-ops are generally classified into four types:

1. Consumer Co-op
2. Producer Co-op
3. Worker Co-op
4. Multi-Stakeholder Co-op

S1.12: Work the Web Example

<u>The Internet can help people to get information about how to start a new business. One excellent site is www.canadabusiness.ca</u>

1.3 THE GOAL OF FINANCIAL MANAGEMENT

S1.13: Goal of Financial Management

A. Possible Goals

There are many possible goals - some involve profit, some not.

B. The Goal of Financial Management

Maximize the current value per share of existing stock.

C. More General Goals

To increase the market value of equity, even for private firms.
The goal does not imply illegal or unethical practices.

S1.14: Primary Goal of Financial Management

Three equivalent goals of financial management:
- Maximize shareholder wealth
- Maximize share price
- Maximize firm value

1.4 THE AGENCY PROBLEM AND CONTROL OF THE CORPORATION

S1.15: The Agency Problem

A. Agency Relationships

The relationship between stockholders and management is called an *agency relationship*. This occurs when one party (*principal*) pays another (*agent*) to represent them. The possibility of conflict of interest between the parties is termed the *agency problem*.

B. Management Goals

The goals of management may conflict with those of shareholders.

Agency costs - Two types: *direct* and *indirect*. Direct costs come about in compensation and perquisites for management. Indirect costs are the result of monitoring managers.

C. Do Managers Act in Shareholders' Interest

Whether managers do, in fact, act in the best interest of shareholders depends on two factors. First, how closely are management goals aligned with shareholder goals? Second, can managers be replaced if they do not pursue shareholder goals?

S1.16: Managing Managers

C. Do Managers Act in the Stockholders' Interests?

The alignment between management and shareholders is influenced by compensation, possible change of control, and stakeholder claims.

Managerial compensation - Firm performance and management compensation and prospects are linked.

Control of the Firm - Management can be replaced by several methods which involve stockholders, such as proxy fights or takeovers.

Stakeholders - Anyone who potentially has a claim on a firm, including creditors and employees.

S1.17: Social Responsibility and Ethical Investing (2 pages)

D. Corporate Social Responsibility and Ethical Investing

Many large corporations maintain specific policies on important social issues and there is a growing trend among many investors to make an effort to invest in socially responsible firms while at the same time deemphasizing businesses engaged in various controversial business activities.

Issues include treatment of the community, customers, the environment, and human rights

- Work the web example:
  - The Internet provides a wealth of information about individual companies
  - One excellent site is ca.finance.yahoo.com
  - Click on the web surfer to go to the site, choose a company and see what information you can find!

1.5 FINANCIAL MARKETS AND THE CORPORATION

S1.18: Financial Markets and the Corporation?

A. Cash Flows to and from the Firm

Financial markets: As is typical of other markets, financial markets are a mechanism that brings buyers and sellers together. Here debt and equity securities are bought and sold.

B. Money versus Capital Markets

Money market - The market in which short-term (1 year or less) securities are bought and sold. It is a *dealer market*, i.e., dealers buy and sell from their inventories.

Capital market - The market for long-term debt and equity shares. It is primarily a *brokered market*, i.e., brokers match up buyers and sellers.

C. Primary versus Secondary Markets

Primary market - Refers to the original sale of securities. *Public offer*, *SEC registration*, *underwriters* are part of this market.
Secondary market - Refers to the resale of securities. *Stock exchanges (TSE)* and the *over-the-counter*, *OTC*, are parts of this market.

Listing - Stocks that trade on an exchange are said to be *listed*.

S1.19: Cash flows to and from the Firm

a. The firm issues securities to raise cash
b. Firm invests in assets
c. Firm's operations generate cash
d. Cash is paid to government as taxes, and to other stakeholders
e. Reinvested cash flows are plowed back into the firm
f. Cash is paid to investors in the form of dividends and interest

1.6 FINANCIAL INSTITUTIONS

S1.20: Financial institutions

A. Financial Institutions

Intermediaries - Financial institutions make funds available to firms from the funds placed in their trust by investors. Examples of financial institutions or intermediaries include: *chartered banks*, *trust companies*, *investment dealers*, *insurance companies* and *mutual funds*.

Indirect finance - funds are supplied to demanders through a financial intermediary. One example is a bank loan.

Direct finance - funds are supplied to demanders directly from suppliers - with no financial intermediary. One example is a bond issue directly to the end bondholder.

1.7 TRENDS IN FINANCIAL MARKETS AND FINANCIAL MANAGEMENT

S1.21: Trends in Financial Markets and Management

- *Financial engineering* - the creation of new securities or financial processes which help to reduce risk, lower financing costs and/or minimize taxes. A controversial example of this is the *credit default swap* in the United States.
- *Derivatives* – financial assets that depend on the value of other assets
- *Technology* such as E-business
- *Corporate Governance* reform
- *Excessive leverage – the lead up to the financial crisis was the result of high amounts of leverage*

1.8 OUTLINE OF THE TEXT

S1.22: Outline of the Text

Part One:	Overview of Corporate Finance
Part Two:	Financial Statements and Long-Term Financial Planning
Part Three:	Valuation of Future Cash Flows
Part Four:	Capital Budgeting
Part Five:	Risk and Return
Part Six:	Cost of Capital and Long-Term Financial Policy
Part Seven:	Short-Term Financial Planning and Management
Part Eight:	Topics in Corporate Finance
Part Nine:	Derivative Securities and Corporate Finance

S1.23: Quick quiz

- What are the three types of financial management decisions and what questions are they designed to answer?
- What are the three major forms of business organization?
- What is the goal of financial management?
- What are agency problems and why do they exist within a corporation?
- What is the difference between a primary market and a secondary market?

1.9 SUMMARY AND CONCLUSIONS

S1.24: Summary

- You should know:
    - The advantages and disadvantages between a sole proprietorship, partnership and corporation
    - The primary goal of the firm

- What an agency relationship and agency cost are
- What ethical investing is
- The role of financial markets
- The role of financial institutions