Fundamentals of Corporate Finance 6th edition Berk Solutions Manual

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Chapter 1
Corporate Finance and the Financial Manager

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Note: All problems in this chapter are available MyLab Finance

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 organizational forms share this characteristic.

2. Owners' liability is limited to the amount they invested in the firm. Stockholders 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 give their owners limited liability. Limited partnerships provide limited liability for the limited partners, but not for the general partners.

4. Advantages: Limited liability, liquidity, infinite life
Disadvantages: Double taxation, separation of ownership and control

5. C corporations must pay corporate income taxes; S corporations do not pay corporate taxes but must pass on the income to shareholders to whom it is taxable. S corporations are also limited to 75 shareholders and cannot have corporate or foreign stockholders.

6. First, the corporation pays the taxes. After taxes, $\$2 \times (1 - 0.25) = \$1.50$ is left to pay dividends. Once the dividend is paid, personal tax on this must be paid, leaving $\$1.50 \times (1 - 0.2) = \$1.20$. So after all the taxes are paid, you are left with $1.20.

7. An S corporation does not pay corporate income tax, so it distributes $2 to its stockholders. These stockholders must then pay personal income tax on the distribution. Thus, they are left with $\$2 \times (1 - 0.2) = \$1.60$.

8. The investment decision is the most important decision that a financial manager makes because the manager must decide how to put the owners' money to its best use.

9. The goal of maximizing 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 stock and/or stock options;
b. ensure that underperforming managers are fired;
c. write contracts that ensure that the interests of the managers and shareholders are closely aligned; and/or
d. mount hostile takeovers.

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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; 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) potentially have an incentive to overpay for another company (which would be damaging to your shareholders) because your pay and prestige will improve.

14. No—it will not necessarily make the shareholders better off. Even though you are reducing costs, which could increase cash flows in the short-term, you will deal with more costly warranty issues and with lost reputation with your customers, potentially leading them to buy from your competitors, which would reduce cash flows in the long-run. Making a less expensive, but lower quality product is NOT the same as maximizing the value of the shares (making your shareholders better off).

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16. 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.

17. 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).

18. A limit order specifies a price at which you are willing to buy or sell. It will be executed when there is demand or supply at that price. A market order is executed immediately at the best outstanding limit order. For example, a market buy order will be immediately executed against the best limit ask price.

19. Investors always buy at the ask and sell at the bid. Because ask prices always exceed bid prices, investors “lose” this difference. It is one of the costs of transacting. Because the market makers take the other side of the trade, they make up this difference.

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20. Using a dark pool allows traders not to reveal their intentions because limit order books are not visible. In addition, using a dark pool allows traders to potentially trade at a better price. However, dark pools sacrifice the guarantee of immediacy because an order may not be filled.

21. You would need to pay the ask price to buy Tesla. That price is $1,028.49 per share. If you sold, you would receive the bid price: $1,027.72 per share.

22. 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 that use it to fund growth through new products, generating profits and wages; and (3) the money then flows back to the savers and investors.

23. 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.

24. 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 stock or bonds.

25. Mutual, pension, and hedge funds all pool together money and invest it on behalf of the investors in the fund. They differ in terms of who invests in the fund and what the primary objective is. Mutual and pension funds are most similar except that pension 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.

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