Finance Essentials 1st edition Kidwell Solutions Manual

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Solutions manual

to accompany

Finance essentials

1st edition

by

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Module 1: Finance in business

Self-study problems

1.1 Give an example of a financing decision and a capital budgeting decision.

Financing decisions determine how a company will raise capital. Examples of financing decisions would be securing a bank loan or the sale of debt in the public capital markets. Capital budgeting involves deciding which productive assets the company invests in, such as buying a new plant or investing in a renovation of an existing facility.

1.2 What is the decision criterion for financial managers when selecting a capital project?

Financial managers should only select a capital project if the value of the project's future cash flows exceeds the cost of the project. In other words, managers should only take on investments that will increase the company's value and thus increase the shareholders' wealth.

1.3 What are some ways to manage working capital?

Working capital is the day-to-day management of a company's short-term assets and liabilities. It can be managed through maintaining the optimal level of inventory, keeping track of all the receivables and payables, deciding to whom the company should extend credit, and making appropriate investments with excess cash.

1.4 Which one of the following characteristics does not pertain to companies?
a. Can enter into contracts
b. Can borrow money
c. Are the easiest type of business to form
d. Can be sued
e. Can own shares in other companies

c. Are the easiest type of business to form – companies have a complex business structure.

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Critical thinking questions

1.1 Describe the cash flows between a company and its stakeholders.

Cash flows are generated by a company's productive assets that were purchased through either issuing debt or raising equity. These assets generate revenues through the sale of goods and services. A portion of this revenue is then used to pay wages and salaries to employees, pay suppliers, pay taxes, and pay interest on the borrowed money. The leftover money, residual cash, is then either reinvested back in the business or is paid out to shareholders in the form of dividends.

1.2 What are the three fundamental decisions the financial management team is concerned with, and how do they affect the company's balance sheet?

The primary financial management decisions every company faces are capital budgeting decisions, financing decisions, and working capital management decisions. Capital budgeting addresses the question of which productive assets to buy; thus, it affects the asset side of the balance sheet. Financing decisions focus on raising the money the company needs to buy productive assets. This is typically accomplished by selling long-term debt and equity. Finally, working capital decisions involve how companies manage their current assets and liabilities. The focus here is seeing that a company has enough money to pay its bills and that any spare money is invested to earn interest.

1.3 What is the difference between shareholders and stakeholders?

Shareholders are the owners of the company. A stakeholder, on the other hand, is anyone with a claim on the assets of the company, including, but not limited to, shareholders. Stakeholders are the company's employees, suppliers, creditors, and the government.

1.4 Explain why profit maximisation is not the best goal for a company. What is an appropriate goal?

Although profit maximisation appears to be the logical goal for any company, it has many drawbacks. First, profit can be defined in a number of different ways, and variations in profit for similar companies can vary widely. Second, accounting profits do not exactly equal cash flows. Third, profit maximisation does not account for timing and ignores risk associated with cash flows. An appropriate goal for financial managers who do not have these objections is to maximise the value of the company's current share price. In order to achieve this goal, management must make financial decisions so that the total value of cash inflows exceeds the total value of cash outflows.

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1.5 In determining the price of a company's shares, what are some of the external and internal factors that affect price? What is the difference between these two types of variables?

External factors that affect the company's share price are: (1) economic shocks, such as natural disasters or wars, (2) the state of the economy, such as the level of interest rates, and (3) the business environment, such as taxes or regulations. On one hand, external factors are variables over which the management has no control. On the other hand, internal factors that affect the share price can be controlled by management to some degree, because they are company specific, such as financial management decisions, product quality and cost, and the line of business management has selected to enter. Finally, perhaps the most important internal variable that determines the share price is the expected cash flow stream: its magnitude, timing, and riskiness.

1.6 Give an example of a conflict of an interest in a business setting other than the one involving the real estate agent discussed in the text.

For example, imagine a situation in which you are a financial officer at a growing software company and your company has decided to hire outside consultants to formulate a global expansion strategy. Coincidentally, your wife works for one of the major consulting companies that your company is considering hiring. In this scenario, you have a conflict of interest, because instinctively, you might be inclined to give the business to your wife's company, because it will benefit your family's financial situation if she lands the contract, regardless of whether it makes the best sense for your company.

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Questions and problems

BASIC

1.1 Capital: What are the two basic sources of funds for all businesses?

The two basic sources of funds for all businesses are debt and equity.

1.2 Management role: What is working capital management?

It is the management of current assets, such as inventory, and current liabilities, such as money owed to suppliers.

1.3 Cash flows: Explain the difference between profitable and unprofitable companies.

A profitable company is able to generate more than enough cash through its productive assets to cover its operating expenses, taxes, and payments to creditors. Unprofitable companies fail to do this, and therefore they may be forced to declare insolvency.

1.4 Management role: What three major decisions are of most concern to financial managers?

Financial managers are most concerned about the capital budgeting decision, the financing decision, and the working capital decision.

1.5 Cash flows: What is the general decision rule for a company considering undertaking a project? Give a real-life example.

A company should undertake a capital project only if the value of its future cash flows exceeds the cost of the project**.** For example: undertaking a capital project that requires a cash outlay of $10,000 when the present value of all future cash flows from the project is more than the initial outlay of $10,000.

1.6 Management role: What is capital structure, and why is it important to a company?

Capital structure shows how a company is financed; it is the mix of debt and equity on the liability side of the balance sheet. It is important as it affects the risk and the value of the company. In general, companies with higher debt-to-equity proportions are riskier because debt comes with legal obligations to pay periodic payments to creditors and to repay the principal at the end.

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1.7 Management role: What are some of the working capital decisions that a financial manager faces?

Working capital management is the day-to-day management of a company's current assets and liabilities to make sure that there is enough cash to cover operating expenses and there is spare cash to earn interest. The financial manager has to make decisions about the inventory levels or terms of collecting payments (receivables) from customers.

1.8 Organisational form: What are the three basic forms of business organisation discussed in this module?

The three basic forms of business organisation we discussed are sole trader, partnership, and company.

1.9 Organisational form: What are the advantages and disadvantages of becoming a sole trader?

Advantages:

- It is the easiest business type to start.
- It is the least regulated.
- Owners keep all the profits and do not have to share the decision-making authority with anyone.

Disadvantages:

- The sole trader has an unlimited liability for all business debt and financial obligations of the company.
- The amount of capital that can be invested in the company is limited by the sole trader's wealth.
- It is difficult to transfer ownership (requires sale of the business).

1.10 Organisational form: What is a partnership, and what is the biggest disadvantage of this business organisation? How can this disadvantage be avoided?

A partnership consists of two or more owners legally joined together to manage a business. The major disadvantage to partnerships is that all partners have unlimited liability for the organisation's debts and legal obligations no matter what stake they have in the business. One way to avoid this is to form a limited partnership in which only general partners have unlimited liability and limited partners are only responsible for business obligations up to the amount of capital they contributed to the partnership.

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1.11 Organisational form: Who are the owners of a company, and how is their ownership represented?

The owners of a company are its shareholders, and the evidence of their ownership is represented by proportions of ordinary shares. Other types of ownership do exist and include preferred shares.

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MODERATE

1.12 Organisational form: Explain what is meant by shareholders' limited liability.

Limited Liability for a shareholder means that the shareholder's legal liability extends only to the capital contributed or the amount invested.

1.13 Organisational form: What is the business organisation form preferred by companies that require a large capital base, and why?

A company can list on securities exchange, such as the Australian Securities Exchange (ASC) as a public company to gain access to the public markets.

1.14 Finance function: What is the most important governing body within a business organisation? What responsibilities does it have?

The most important governing body within an organisation is the board of directors. Its main role is to represent the shareholders. The board also hires (and occasionally fires) the CEO and advises him or her on major decisions.

1.15 Finance function: All public companies hire a public accounting firm to perform an independent audit of the financial statements. What exactly does an audit mean?

An independent public accounting firm that performs an audit of a company ensures that the financial numbers are reasonably accurate, that accounting principles have been adhered to year after year and not in a manner that distorts the company's performance.

1.16 Company's goal: What are some of the drawbacks to setting profit maximisation as the main goal of a company?

- It is difficult to determine what is meant by profits.
- It does not address the size and timing of cash flows—it does not account for the time value of money.
- It ignores the uncertainty of risk of cash flows.

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1.17 Company's goal: What is the appropriate goal of financial managers? Can managers' decisions affect this goal in any way? If so, how?

The appropriate goal of financial managers should be to maximise the current value of the company's share price. Managers' decisions affect the share price in many ways as the value of the share is determined by the future cash flows the company can generate. Managers can affect the cash flows by, for example, selecting what products or services to produce, what type of assets to purchase, or what advertising campaign to undertake.

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CHALLENGING

1.18 Company's goal: What are the major factors affecting share price?

The following factors affect the share price: the company, the economy, economic shocks, the business environment, expected cash flows, and current market conditions.

1.19 Company's goal: What can happen if a company is poorly managed and its share price falls substantially below its maximum?

If the share price falls below its maximum potential price, it attracts corporate raiders, who look for fundamentally sound but poorly managed companies they can buy, turn around, and sell for a handsome profit.

1.20 Business ethics: How could business dishonesty and low integrity cause an economic downfall? Give an example.

Business dishonesty and lack of transparency lead to corruption, which in turn creates inefficiencies in an economy, inhibits the growth of capital markets, and slows the rate of economic growth. For example, until the mid-1990s the Russian market had a difficult time attracting investors as there was no reliable financial information on any of the companies. Only after the Russians made a conscious decision to make their records and motives transparent were they able to draw foreign investments.

1.21 Business ethics: What ethical conflict does insider trading present?

Insider trading is an example of information asymmetry. The main idea is that investment decisions should be made on an even playing field. Insider trading is morally wrong and has also been made illegal.

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