Corporate Finance 2025 Release 1st edition Ross Solutions Manual

SKU: 9781265059903-SOLUTIONS

McGraw-Hill Corporate Finance
Application-Based Activities (ABA)
Implementation Guide

Table of Contents

- Overview of the Corporate Finance Application-Based Activities (ABAs)
- Assigning the Corporate Finance Application-Based Activities in Connect
- Note for LMS Integrated Courses
- Corporate Finance Application-Based Activities Walkthrough with Screen Shots
- Scoring
- Suggestions for Using Corporate Finance Application-Based Activities in Your Course
- Contacting Customer Support
- Please see additional links in the Connect Library > Instructor Resources > Application-based Activities site for a full list of ABAs and their descriptions, a McGraw Hill text and chapter key, and sample syllabi.

Copyright © 2021 McGraw-Hill Education. All rights reserved. No reproduction or distribution without the prior written consent of McGraw-Hill Education.

Corporate Finance 2025 Release 1st edition Ross Solutions Manual

Overview of the Corporate Finance Application-Based Activities

McGraw-Hill's Corporate Finance Application-Based Activities (ABAs) are available in Connect for all McGraw-Hill Corporate Finance titles. The assignable and auto-gradable ABAs immerse students in an engaging and interactive learning environment, which simulates real-world scenarios in which corporate finance concepts are applied. The ABAs have been created by corporate finance experts and professors to address key corporate finance course challenges, including improving critical thinking skills; increasing the number of assignable materials for students to apply concepts; and improving the level of student engagement and motivation by showing relevance of the course content to real life.

Each ABA features a topic that is among the "most often taught" in the one- and two-semester corporate finance courses based on our extensive surveys related to the needs of corporate finance instructors. As students begin an ABA assignment, they become one of the characters in the ABA and take an active role in the simulation--asking and answering questions to make key decisions. Other characters in the ABA offer students background information about core concepts, provide relevant information and give feedback about the students' understanding of the topics. Each ABA was designed to take students approximately 10-15 minutes to complete.

By applying their conceptual knowledge to real-world scenarios, students develop critical thinking and analytical skills. This practical application of corporate finance concepts helps engage students to achieve deeper understanding. The ABAs were also designed to connect students to the content through scenarios set in a context that is familiar to them like in a student project group, summer job, store, or concert.

McGraw-Hill's ABAs are easy to assign in Connect and are auto gradable, saving instructors time and providing students feedback on how well they're doing. ABA assignments are customizable so that instructors can select and organize them based on their own course learning outcomes and determine point values and due dates. Connect set-up policies, also determined by instructors, can allow students to have multiple attempts at completing the ABAs.

Assigning the Corporate Finance Application-Based Activities in Connect

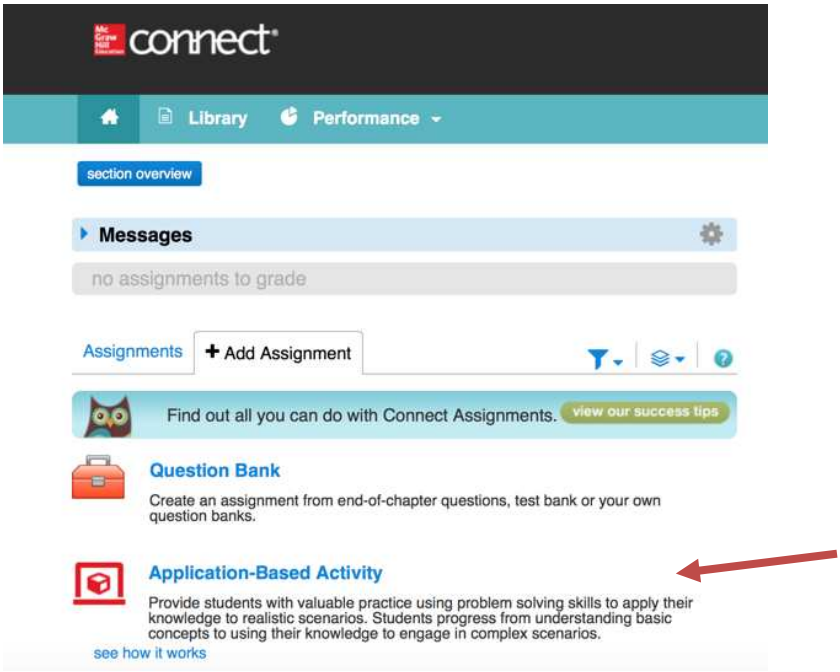
1. Sign into your McGraw-Hill Connect Instructor Account
2. Access your McGraw-Hill Corporate Finance course
3. Click on Add Assignment



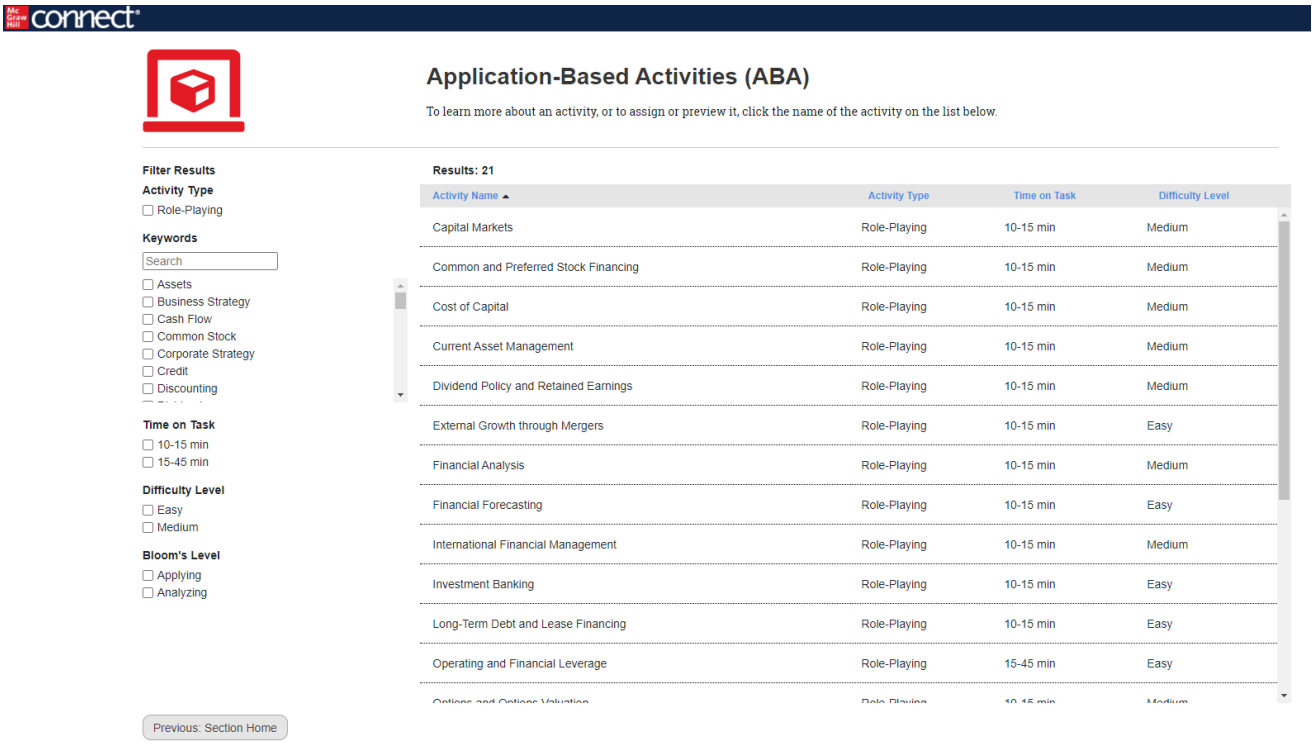
Copyright © 2021 McGraw-Hill Education. All rights reserved. No reproduction or distribution without the prior written consent of McGraw-Hill Education.

Corporate Finance 2025 Release 1st edition Ross Solutions Manual

4. Click on Application-Based Activity



5. The next screen displays the list of available Application-Based Activities (screenshot below). Please note that the Corporate Finance ABAs are listed by topic.

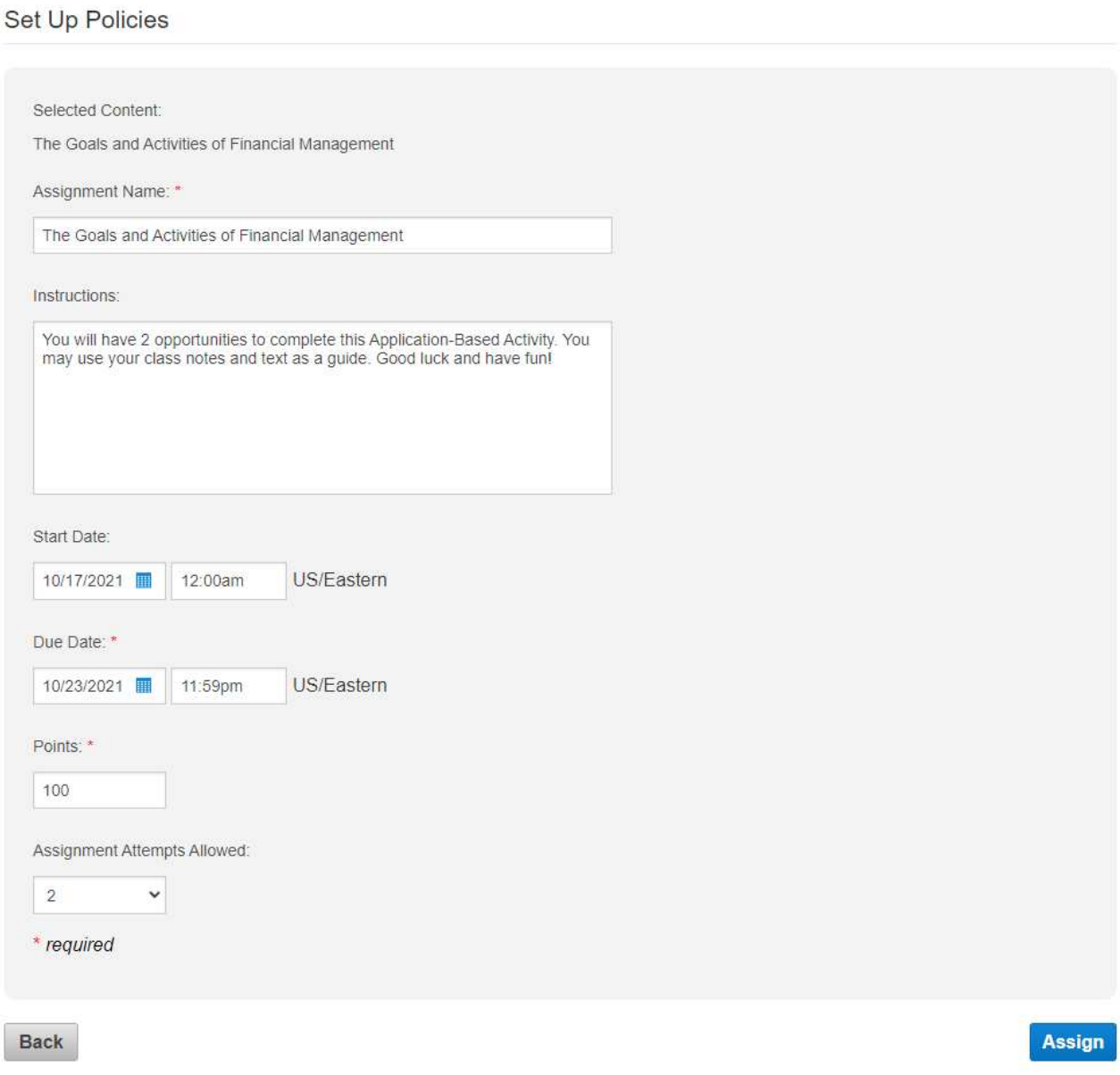


Copyright © 2021 McGraw-Hill Education. All rights reserved. No reproduction or distribution without the prior written consent of McGraw-Hill Education.

6. To preview an ABA select the activity name, then click the blue "**Preview**" button**.** Instructors may then click through the ABA experience. Please note that in Preview mode, the ABA is being previewed through the instructor Connect account and as such, progress on the ABA is not saved if the instructor exits the ABA. Instructors may create and register into the Connect course as a student using the 2-week free trial Connect access. Please contact McGraw-Hill's customer service team or local McGraw-Hill representative if assistance is needed. (Contact information is below). Instructors may also click on the button to learn more about the activity.

7. To assign the ABA, select the activity name, the section will expand then click the blue "**Assign**" button.

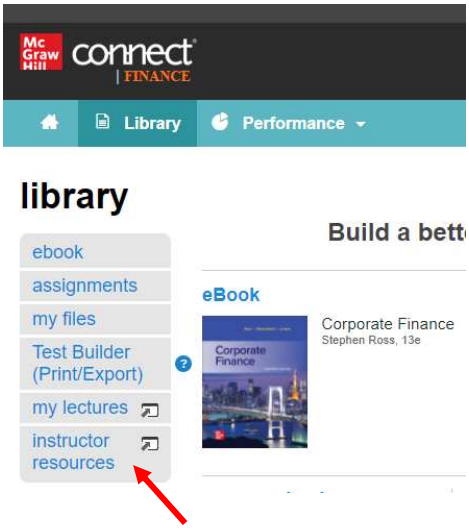
8. The next screen displays Connect's Set Up Policies (screenshot below). Items marked with a red asterisk * are required before the assignment process is completed.

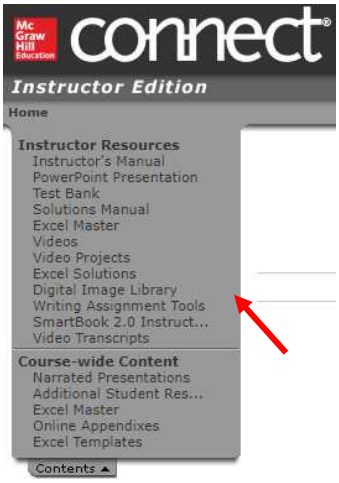


Copyright © 2021 McGraw-Hill Education. All rights reserved. No reproduction or distribution without the prior written consent of McGraw-Hill Education.

Corporate Finance 2025 Release 1st edition Ross Solutions Manual

For easy access, this Implementation Guide and associated ABA resources are also available to instructors in the Connect Library > Instructor Resources.





Note for LMS Integrated Courses

For institutions using a Learning Management System (LMS), Connect and the Corporate Finance Application-Based Activities offer deep integration/single-sign on for most LMSs:

- **Blackboard**: deep linking, grade sync and single sign-on
- **Canvas**: deep linking, grade sync and single sign-on
- **Brightspace**: deep linking, grade sync and single sign-on
- **Moodle**: grade sync and single sign-on
- **Sakai**: grade sync and single sign-on

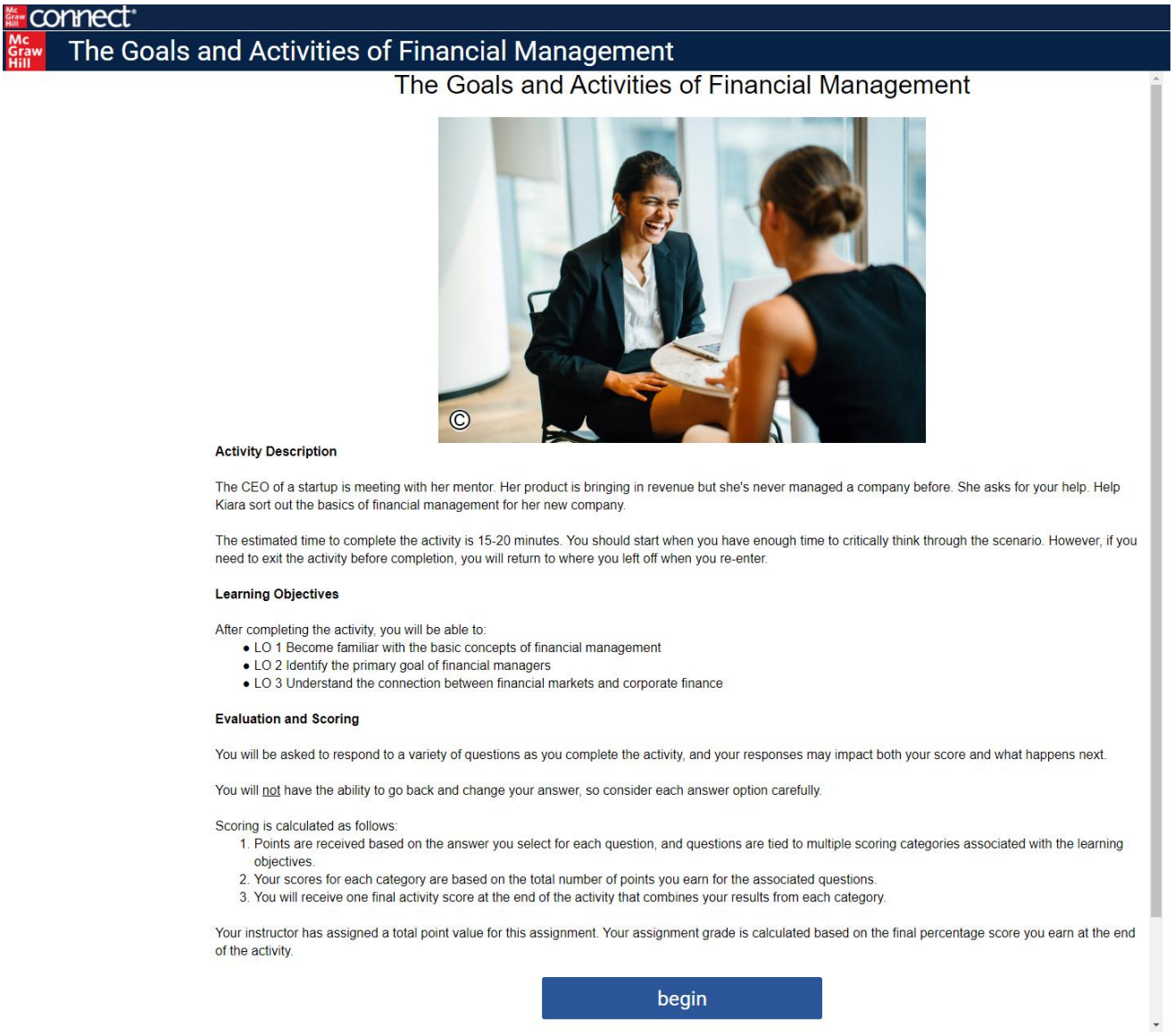
For more information on pairing a Connect course with an LMS, please contact the McGraw-Hill Customer Experience Group mpss.mhhe.com or access an online tutorial at http://createwp.customer.mheducation.com/wordpress-mu/success-academy/pairing-your-connect-course-with-your-lms/?page=Search&term=pairing%20LMS

Copyright © 2021 McGraw-Hill Education. All rights reserved. No reproduction or distribution without the prior written consent of McGraw-Hill Education.

Corporate Finance 2025 Release 1st edition Ross Solutions Manual

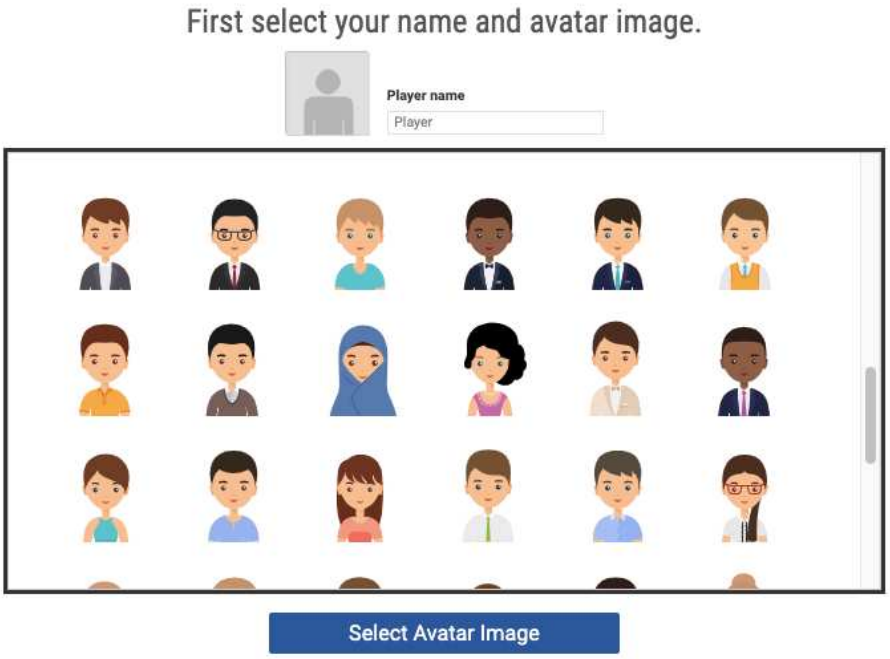
Corporate Finance Application-Based Activity Walkthrough with Screenshots

Each ABA has a welcome screen with a description of the activity and information about the learning objectives, evaluation, and scoring.



Copyright © 2021 McGraw-Hill Education. All rights reserved. No reproduction or distribution without the prior written consent of McGraw-Hill Education.

After clicking “Begin” students can type in their names and select an avatar image to represent themselves in the ABA.



When students begin the ABA assignment, they will see two panels (screenshot below):

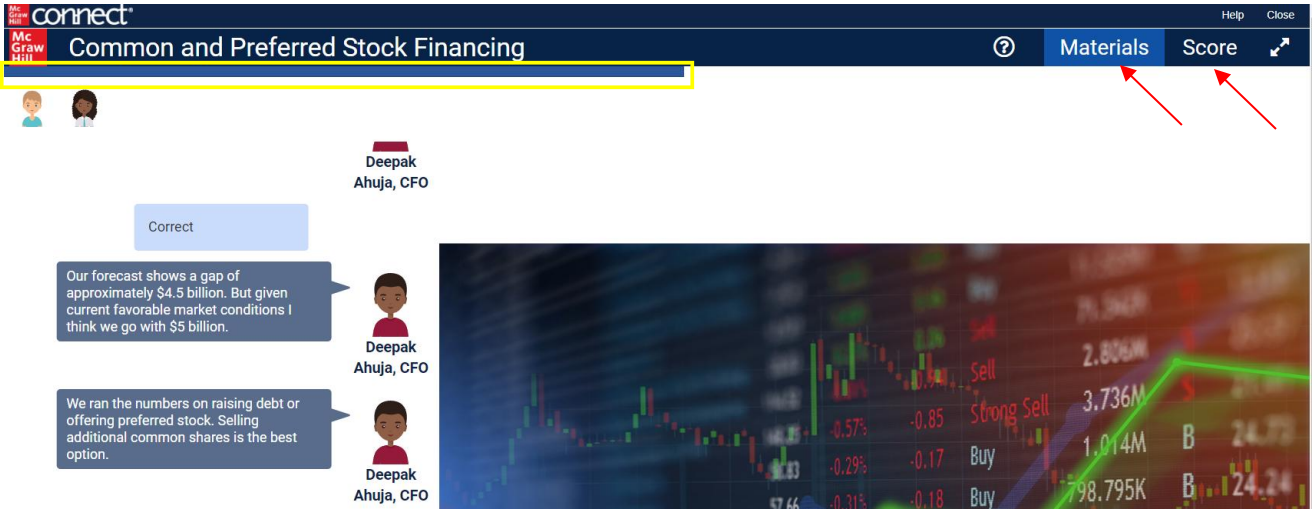
1. The left-hand panel is where students engage with various characters featured in the ABA. As stated previously in this Implementation Guide, these characters will offer students background information on core concepts and provide relevant information and periodic check-ins for understanding. Students click through the conversations, answer questions, and follow directions or click links to open a variety of resources.

2. The right-hand panel contains pertinent images, documents and other resources for students to interact with as they complete the ABA assignment.

Red arrows (screenshot below, top right) indicate boxes students click to open additional resources (Materials) or to check their Score at any point in the ABA assignment. Students can see their progress toward completion of the ABA by viewing the blue bar at the top of the ABA screen (outlined in yellow box in screenshot below).

Copyright © 2021 McGraw-Hill Education. All rights reserved. No reproduction or distribution without the prior written consent of McGraw-Hill Education.

Corporate Finance 2025 Release 1st edition Ross Solutions Manual



If a student starts an ABA assignment but clicks "Close" to exit out of that attempt, the student's progress on the ABA assignment *has been saved* up to the point where the student exited. They can reopen that attempt and pick up where they left off.

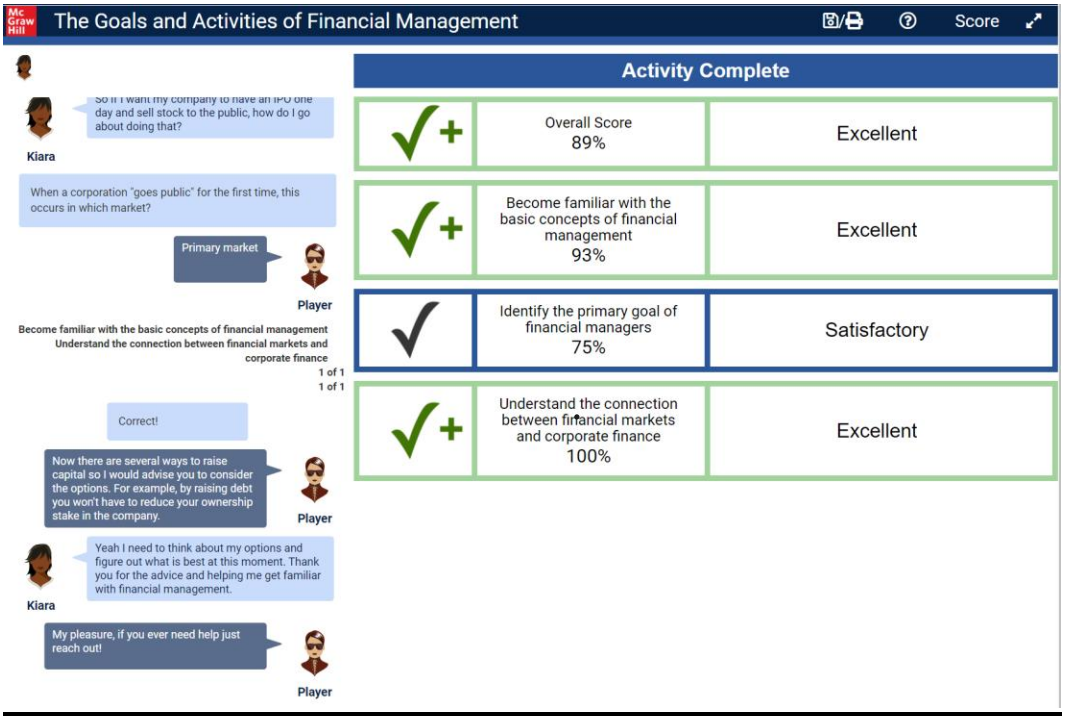
Scoring

When students complete the ABA assignment, they will receive their scores (expressed as a percentage) – an Overall Score for the entire ABA, and scores for each of the Learning Objectives contained within the ABA (screenshot below). Students will also receive feedback on their performance.

Scores are based on students' answers to the questions placed throughout the ABA. Those questions are tied to specific Learning Objectives. The score's percentage measures the students' correct answers during that attempt. If the instructor has allowed multiple attempts in the Connect Set Up Policies, students may re-launch the ABA and achieve a different score.

Students *cannot* change their responses to the questions during an attempt. Once a question response is submitted, it is locked in, so students should be very intentional in submitting their responses. An answer selection is considered final for that attempt and the conversation continues. Typically, ABA characters follow student's answers with feedback indicating whether the response is correct or incorrect. Locking the answers prevents students from easily "gaming the system" until they receive "correct" feedback. As mentioned in the previous section, an instructor may a allow multiple assignment attempts in the Connect Set Up Policies.

Copyright © 2021 McGraw-Hill Education. All rights reserved. No reproduction or distribution without the prior written consent of McGraw-Hill Education.



Grades appear in the Performance Section of the Instructor Connect Course under Reports.

Assignment Score Weight Distribution

Understand the connection between financial markets and corporate finance	**33** %
Identify the primary goal of financial managers	**33** %
Become familiar with the basic concepts of financial management	**34** %

Assignment Details

Activity: **The Goals and Activities of Financial Management**

Export Score CSV | Export Details CSV

Student	Score	Time Played	Become familiar with the basic concepts of financial management	Identify the primary goal of financial managers	Understand the connection between financial markets and corporate finance
John Smith		**0:02:03**			
Attempt 1	**89%**	**0:02:03**	**93%**	**75%**	**100%**

Copyright © 2021 McGraw-Hill Education. All rights reserved. No reproduction or distribution without the prior written consent of McGraw-Hill Education.

Suggestions for Using Corporate Finance Application-Based Activities in Your Course

Whether teaching in a face-to-face environment, an online environment, a flipped classroom, or a hybrid model, Corporate Finance ABAs can be used in a variety of ways in support of curriculum goals.

Stand-alone Assignments
Each topic covered by a Corporate Finance ABA focuses on a specific element of the Corporate Finance mix. If there is a topic that instructors feel students typically struggle with or may need additional practice on, a specific Corporate Finance ABA can be either assigned in Connect and/or worked through in real-time during class. The Corporate Finance ABAs can be assigned either in preparation for a topical discussion, as part of an in-class activity or discussion or can be assigned post-discussion.

Integrated with Other Connect Assignments
Corporate Finance ABAs are ideal to use in conjunction with other auto-gradable assignment types available in Connect. ABAs can be integrated into a full suite of weekly assignments that move students through basic understanding of concepts and definitions to higher-level critical thinking and analytical skills.

Connect offers

- Smartbook – McGraw-Hill's adaptive reading environment integrated with questions to reinforce conceptual understanding. Best practice tip – instructors assign Smartbook chapter modules to be due *before* they cover that chapter's material in the course. Attaching points to the reading assignments helps ensure students read the material and come to class prepared.
- Connect Interactives* – a variety of assignable questions in Connect reinforce course content through Comprehension Cases, Video Cases, Decision Generators, and more
- Case Repository**
- Quiz Questions and Testbanks

Contact McGraw-Hill's Customer Experience Group (CXG)

Online (24-7 chat, email) mpss.mhhe.com

Phone 1.800.331.5094

- Sunday: 12 PM to 12 AM EST
- Monday-Thursday: 24-7
- Friday: 12 AM to 9 PM EST
- Saturday: 10 AM to 8 PM EST

For help connecting to the local McGraw-Hill learning technology representative
https://shop.mheducation.com/store/paris/user/findltr.html

Copyright © 2021 McGraw-Hill Education. All rights reserved. No reproduction or distribution without the prior written consent of McGraw-Hill Education.

Corporate Finance 2025 Release 1st edition Ross Solutions Manual

* Check with your McGraw-Hill learning technology representative for more information on Connect Interactives availability for your McGraw-Hill text.

** Check with your McGraw-Hill learning technology representative for more information on Connect's Case Repository availability for your McGraw-Hill text.

*** Please see additional links in the Connect Library > Instructor Resources > Application-based Activities site for a full list of ABAs and their descriptions, a McGraw Hill text and chapter key, and sample syllabi.

Copyright © 2021 McGraw-Hill Education. All rights reserved. No reproduction or distribution without the prior written consent of McGraw-Hill Education.

Corporate Finance 2025 Release 1st edition Ross Solutions Manual

Chapter 1
INTRODUCTION TO CORPORATE FINANCE

Slides

Chapter 1: Introduction to Corporate Finance
1.1 Key Concepts and Skills
1.2 Chapter Outline
1.3 1.1 What Is Corporate Finance?
1.4 The Balance Sheet Model of the Firm
1.5 The Capital Budgeting Decision
1.6 The Capital Structure Decision
1.7 Short-Term Asset Management
1.8 The Financial Manager
1.9 Hypothetical Organization Chart
1.10 1.2 The Corporate Firm
1.11 Forms of Business Organization
1.12 A Comparison of Corporations and Partnerships
1.13 1.3 The Importance of Cash Flow
1.14 1.4 The Goal of Financial Management
1.15 1.5 The Agency Problem and Control of the Corporation
1.16 Management Goals
1.17 Do Managers Act in the Stockholders' Interests?
1.18 1.6 Regulation
1.19 Quick Quiz
1.20 End of Main Content
1.21 Accessibility Content: Text Alternatives for Images
1.22 Short-Term Asset Management - Text Alternative
1.23 Hypothetical Organization Chart - Text Alternative
1.24 1.3 The Importance of Cash Flows - Text Alternative

Chapter Web Sites

Section	*Web Address*
1.1	CFO: www.cfo.com
1.2	"Launch your Business": www.sba.gov
1.4	Business Ethics magazine: www.business-ethics.com
1.6	Sarbanes-Oxley survey: www.protiviti.com/US-en/insights/sox-compliance-survey

© McGraw Hill LLC. All rights reserved. No reproduction or distribution without the prior written consent of McGraw Hill LLC.

Corporate Finance 2025 Release 1st edition Ross Solutions Manual

CHAPTER ORGANIZATION

1.1 What Is Corporate Finance?
- The Balance Sheet Model of the Firm
- The Financial Manager

1.2 The Corporate Firm
- The Sole Proprietorship
- The Partnership
- The Corporation
- A Corporation by Another Name…

1.3 The Importance of Cash Flows
- Identification of Cash Flows
- Timing of Cash Flows
- Risk of Cash Flows

1.4 The Goal of Financial Management
- Possible Goals
- The Goal of the Financial Manager
- A More General Goal

1.5 The Agency Problem and Control of the Corporation
- Agency Relationships
- Management Goals
- Do Managers Act in the Stockholders' Interests?
- Stakeholders

1.6 Regulation
- The Securities Act of 1933 and the Securities Exchange Act of 1934
- Sarbanes-Oxley

© McGraw Hill LLC. All rights reserved. No reproduction or distribution without the prior written consent of McGraw Hill LLC.

Corporate Finance 2025 Release 1st edition Ross Solutions Manual

ANNOTATED CHAPTER OUTLINE

Slide 1.1 Chapter 1: Introduction to Corporate Finance
Slide 1.2 Key Concepts and Skills
Slide 1.3 Chapter Outline

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

1.1. What is Corporate Finance?

Slide 1.4 1.1 What Is Corporate Finance?

Corporate finance addresses several important questions:

1. In what long-term assets should the firm invest? (Capital budgeting)
2. How should the firm raise funds for required capital expenditures? (Capital structure)
3. How should short-term operating cash flows be managed? (Net working capital)

A. The Balance Sheet Model of the Firm

Slide 1.5 The Balance Sheet Model of the Firm

The Balance Sheet presents a picture of the firm at a point in time, and it provides a model by which to address the three basic questions that corporate finance managers must answer.

Slide 1.6 The Capital Budgeting Decision

1. Long-term investment decisions determine the level of fixed assets.

Slide 1.7 The Capital Structure Decision

2. Financing policy determines the liabilities and equity side of the balance sheet.

Slide 1.8 Short-Term Asset Management

3. Short-term asset management choices (e.g., conservative versus aggressive) affect the level of net working capital.

© McGraw Hill LLC. All rights reserved. No reproduction or distribution without the prior written consent of McGraw Hill LLC.

Corporate Finance 2025 Release 1st edition Ross Solutions Manual

B. The Financial Manager

Slide 1.9 The Financial Manager

Financial Managers should make decisions that increase firm value, which effectively involves three primary categories of financial decisions.

1. Capital budgeting – process of planning and managing a firm's investments in fixed assets. The key concerns are the size, timing, and risk of future cash flows.

2. Capital structure – mix of debt (borrowing) and equity (ownership interest) used by a firm. What are the least expensive sources of funds? Is there an optimal mix of debt and equity? When and where should the firm raise funds?

3. Working capital management – managing short-term assets and liabilities. How much inventory should the firm carry? What credit policy is best? Where will we get our short-term loans?

   These broad categories, however, can be summarized with two concrete responsibilities:

   a. Selecting value creating projects
   b. Making smart financing decisions

Slide 1.10 Hypothetical Organization Chart

The Chief Financial Officer (CFO) or Vice-President of Finance coordinates the activities of the treasurer and the controller.

The controller handles cost and financial accounting, taxes, and information systems (i.e., data processing).

The treasurer handles cash and credit management, financial planning, and capital expenditures.

Video Note: The Role of the Chief Financial Officer - This video looks at the changing role of the CFO.

1.2. The Corporate Firm

Slide 1.11 1.2 The Corporate Firm

© McGraw Hill LLC. All rights reserved. No reproduction or distribution without the prior written consent of McGraw Hill LLC.

Corporate Finance 2025 Release 1st edition Ross Solutions Manual

Although many forms of business organizations exist, the corporate form is the standard by which we address most large-scale problems. This approach, however, does not imply that the methods we develop are inappropriate for other business types.

Slide 1.12 Forms of Business Organization

A. The Sole Proprietorship

– A business owned by one person

Advantages include ease of start-up, lower regulation, single owner keeps all the profits, and taxed once as personal income.

Disadvantages include limited life, limited equity capital, unlimited liability and low liquidity.

B. The Partnership

– A business with multiple owners, but not incorporated

General partnership – all partners share in gains or losses; all have unlimited liability for all partnership debts.

Limited partnership – one or more general partners run the business and have unlimited liability. A limited partner's liability is limited to his or her contribution to the partnership, and they cannot help in running the business.

Advantages include more equity capital than is available to a sole proprietorship, relatively easy to start (although written agreements are essential), and income taxed once at personal tax rate.

Disadvantages include unlimited liability for general partners, dissolution of partnership when one partner dies or wishes to sell, low liquidity.

C. The Corporation

– A distinct legal entity composed of one or more owners

Slide 1.13 A Comparison of Corporations and Partnerships

Corporations account for the largest volume of business (in dollar terms) in the U.S. Advantages include limited liability, unlimited life, separation of ownership and management (ability to own shares in several companies without having to work for all of them), liquidity, and ease of raising capital.

© McGraw Hill LLC. All rights reserved. No reproduction or distribution without the prior written consent of McGraw Hill LLC.

Corporate Finance 2025 Release 1st edition Ross Solutions Manual

Disadvantages include separation of ownership and management (agency costs) and double taxation. Recent tax laws reduce the level of double taxation, but it has not been eliminated.

D. A Corporation by Another Name…

Corporations exist around the world under a variety of names. Table 1.2 lists several well-known companies, along with the type of company in the original language.

Lecture Tip: *Although the corporate form of organization has the advantage of limited liability, it has the disadvantage of double taxation. A small business of 75 or fewer stockholders is allowed by the IRS to form an S Corporation. The S Corp. organizational form provides limited liability but allows pretax corporate profits to be distributed on a pro rata basis to individual shareholders, who are only obligated to pay personal income taxes on the income. A similar form of organization is the limited liability corporation, or LLC. LLC's are a hybrid form of organization that falls between partnerships and corporations. Investors in LLC's have the protection of limited liability, but they are taxed like partnerships. LLC's first appeared in Wyoming in 1977 and have skyrocketed since. They are especially beneficial for small- and medium-sized businesses such as law firms or medical practices.*

1.3. The Importance of Cash Flows

Slide 1.14 1.3 The Importance of Cash Flow

A. Identification of Cash Flows

To create value, the firm must generate more cash than it uses. Stated differently, the firm must generate sufficient cash flow, after taxes, to compensate investors for providing the firm with financing.

B. Timing of Cash Flows

Additionally, the value of the cash flows generated by the firm must be analyzed in light of both the timing of the cash flows, as well as …

C. Risk of Cash Flows

…the risk of the cash flows.

Lecture Tip: It is an important reminder for students to reiterate that Net Income and Cash Flow can be extremely different values for various reasons, some of which are non-cash expenses (e.g., depreciation, amortization), revenue recognition principles, and credit policies.

1.4. The Goal of Financial Management

© McGraw Hill LLC. All rights reserved. No reproduction or distribution without the prior written consent of McGraw Hill LLC.

Corporate Finance 2025 Release 1st edition Ross Solutions Manual

Slide 1.15 1.4 The Goal of Financial Management

A. Possible Goals

Profit Maximization – this is an imprecise goal. Do we want to maximize long-run or short-run profits? Do we want to maximize accounting profits or some measure of cash flow? Because of the different possible interpretations, this should not be the main goal of the firm.

Other possible goals that students might suggest include minimizing costs or maximizing market share. Both have potential problems. We can minimize costs by not purchasing new equipment today, but that may damage the long-run viability of the firm. Many dot.com companies got into trouble in the late 1990's because their goal was to maximize market share. They raised substantial amounts of capital in IPO's and then used the money on advertising to increase the number of "hits" on their site. However, many firms failed to translate those "hits" into enough revenue to meet expenses, and they quickly ran out of capital. The stockholders of these firms were not happy. Stock prices fell dramatically, and it became difficult for these firms to raise funds. In fact, many of these companies have gone out of business.

B. The Goal of the Financial Manager

From a stockholder (owner) perspective, the goal of buying the stock is to gain financially. Thus, *the goal of the financial manager in a corporation is to maximize the current value per share of the existing stock.*

Lecture Tip: *The late Roberto Goizueta, former chairman and CEO of the Coca-Cola Company, wrote an essay entitled "Why Share-Owner Value?," that appeared in the firm's 1996 annual report. It is an excellent introduction to the goal of financial management at any level. It may also be useful to discuss how Mr. Goizueta's vision transferred to the stock market's valuation of the company.*

A subsequent article also illustrates the difference in strategy between Coca-Cola and Pepsi-Co during Mr. Goizueta's tenure: "How Coke is Kicking Pepsi's Can," Fortune, October 28, 1996.

Coke focused on soft drinks while Pepsi-Co diversified into other areas. Pepsi-Co's goal was to double revenues every 5 years, while Mr. Goizueta focused on return on investment and stock price. The article states that Goizueta "has created more wealth for stockholders than any other CEO in history." In mid-1996, Pepsi-Co sold at 23 times earnings with return on equity of about 23% and Coke sold at 36 times earnings with a return on equity of around 55%. The article goes on to discuss the differing strategies in more detail. It provides a nice validation of Mr. Goizueta's remarks in his letter to the shareholders.

© McGraw Hill LLC. All rights reserved. No reproduction or distribution without the prior written consent of McGraw Hill LLC.

Corporate Finance 2025 Release 1st edition Ross Solutions Manual

Lecture Tip: *The validity of this goal assumes "investor rationality." In other words, investors in the aggregate prefer more dollars to fewer and less risk to more. Rational investors will act as risk-averse, return-seekers in making their purchase and sale decisions, and, given different levels of risk aversion and wealth preferences, the only single goal suitable for all shareholders is the maximization of their wealth (which is represented by their holdings of the firm's common stock). However, the prevalence of "social responsibility" funds may make for an interesting discussion, as would the increasing focus on behavioral finance and the impact of investor emotions on trading behavior.*

Lecture Tip: *It may be worth to point out recent events about Shareholder Primacy. In 2019, the Business Roundtable redefined the purpose of a corporation to help promote an "economy that serves all Americans." The full statement can be found here (accessed on 8/1/2021: https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans)*

C. A More General Goal

The more general goal is to maximize the market value of owners' equity.

Many students think this means that firms should do "anything" to maximize stockholder wealth. It is important to point out that unethical behavior does not ultimately benefit owners.

Ethics Note: *Any number of ethical issues can be introduced for discussion. One particularly good opener to this topic that many students can relate to is the issue of the responsibility of the managers and stockholders of tobacco firms. Is it ethical to sell a product that is known to be addictive and dangerous to the health of the user even when used as intended? Is the fact that the product is legal relevant? Do recent court decisions against the companies matter? What about the way companies choose to market their product? Are these issues relevant to financial managers?*

1.5. The Agency Problem and Control of the Corporation

Slide 1.16 1.5 The Agency Problem and Control of the Corporation

A. Agency Relationships

The relationship between stockholders and management is called the agency relationship. This occurs when one party (principal) hires another (agent) to act on their behalf. The possibility of conflicts of interest between the parties is termed the agency problem.

© McGraw Hill LLC. All rights reserved. No reproduction or distribution without the prior written consent of McGraw Hill LLC.

Corporate Finance 2025 Release 1st edition Ross Solutions Manual

B. Management Goals

Slide 1.17 Management Goals

Direct agency costs – compensation and perquisites for management

Indirect agency costs – cost of monitoring and sub-optimal decisions

Lecture Tip: *In the early 1980s, the Burlington Northern Railroad sought to sell off real estate with a value of approximately $778 million. The firm was enjoined from doing so, however, by restrictions written into covenants of the firm's bonds in 1896. These were very long-term bonds with an additional fifty years to maturity. They also were not callable and did not include a sinking fund provision. Management found it necessary to negotiate with the bondholders to release some of the value tied up in the real property originally used to secure these bonds. Following a great deal of legal wrangling, the bondholders settled for payments totaling $35.5 million. Lawyers for the bondholders settled for another $3.4 million. In other words, the cost of addressing this stockholder/bondholder conflict was nearly $40 million – and this doesn't include the opportunity cost of management time spent on this issue instead of running the business. For further discussion of this case, see "Bond Covenants and Foregone Opportunities" by Gene Laber, in the Summer, 1992 issue of Financial Management.*

Ethics Note: *When shareholders elect a board of directors to oversee the corporation, the election serves as a control mechanism for management. The board of directors bears legal responsibility for corporate actions. However, this responsibility is to the corporation itself and not necessarily to the stockholders ("Sarbox," discussed below, has somewhat changed this issue).*

Although it happened several years ago, the following example still makes for an interesting discussion of directors' and managers' duties:

In 1986, Ronald Perelman engaged in an unsolicited takeover offer for Gillette. Gillette's management filed litigation against Perelman and subsequently entered into a standstill agreement with Perelman. This action eliminated the premium that Perelman offered shareholders for their stock in Gillette.

© McGraw Hill LLC. All rights reserved. No reproduction or distribution without the prior written consent of McGraw Hill LLC.

Corporate Finance 2025 Release 1st edition Ross Solutions Manual

A group of shareholders filed litigation against the board of directors in response to its actions. It was subsequently discovered that Gillette had entered into standstill agreements with ten additional companies. When questioned regarding the rejection of Perelman's offer, management responded that there were projects on line that could not be discussed (later revealed to be the "Sensor" razor, which was one of the most profitable new ventures in Gillette's history up to that time). Thus, despite appearances, management's actions may have been in the best interests of the firm, and this case indicates that management may consider factors other than the bid when considering a tender offer.

C. Do Managers Act in the Stockholders' Interests?

Slide 1.18 Do Managers Act in the Stockholders' Interests?

Managerial compensation can be used to encourage managers to act in the best interest of stockholders. One commonly cited tool is stock options. The idea is that if management has an ownership interest in the firm, they will be more likely to try to maximize owner wealth.

Lecture Tip: *A 1993 study performed at the Harvard Business School indicates that the total return to shareholders is closely related to the nature of CEO compensation. Specifically, higher returns were achieved by CEOs whose pay packages included more option and stock components. (See The Wall Street Journal, November 12, 1993, p. B1). However, this may not even be the best way to encourage managers to act in the stockholders' best interest.*

Stern Stewart & Company has developed a tool called EVA®, which measures how much "economic value" is being added to a corporation by management decisions. According to Stern-Stewart's web site (www.sternstewart.com), companies that tie management compensation to EVA® significantly outperform competitors that do not. They are conducting ongoing studies to measure this performance, but the preliminary data indicate that the stock returns for these companies have outperformed their competitors by a significant amount.

Both of these examples illustrate that carefully crafted compensation packages can reduce the conflict between management and stockholders. However, the option backdating scandal may provide a point of discussion for possible downfalls of such approaches.

© McGraw Hill LLC. All rights reserved. No reproduction or distribution without the prior written consent of McGraw Hill LLC.

Corporate Finance 2025 Release 1st edition Ross Solutions Manual

Lecture Tip: *According to The National Center for Employee Ownership, broad based stock option plans have increased dramatically, not only for technology firms, but also for non-tech firms such as Starbucks and the Gap. Some firms have found a way to provide stock-based incentive to employees without giving them equity ownership at all. As reported in the October 26, 1998, issue of Fortune, "phantom stock" is used by private companies such as Kinko's and Mary Kay, Inc., as well as public companies, to provide employees with an incentive to work harder. Generally, an employee is awarded "shares" on a bonus basis, and the share values increase if the value of the business increases. (For a private firm, this means obtaining outside appraisals of value based on earnings multiples, etc.) At some future point, the employee has the right to cash in his "shares."*

Stockholders technically have control of the firm, and dissatisfied shareholders can oust management via proxy fights, takeovers, etc. However, this is easier said than done. Staggered elections for board members often make it difficult to remove the board that appoints management. Poison pills and other anti-takeover mechanisms make hostile takeovers difficult to accomplish.

D. Stakeholders

Stakeholders are other groups, besides stockholders, that have a vested interest in the firm and potentially have claims on the firm's cash flows. Stakeholders can include creditors, employees, customers, and the government.

Lecture Tip: *A good practitioner-oriented discussion of the impact of stakeholders on decision-making is found in a 1987 Wall Street Journal article by Charles Exley, Jr., then-chairman and president of NCR Corp. The thrust of Mr. Exley's comments is that giving more consideration to the interests of non-stockholder stakeholders is good business and results in the decentralization of management. Frequently, a discussion of stakeholder interests (as opposed to a discussion exclusively geared toward stockholder interests) leads to a better understanding of the nature of the corporate form of organization, the role of the corporation in society (and the question of "corporate social responsibility"), as well as the role of contracting in the labor and financial markets.*

Ethics Note: *A discussion of stakeholder interests leads very nicely into a discussion of ethical decision making. Theories of ethical behavior focus on the rights of all parties affected by a decision, not just one or two. The "utilitarian" model defines an action as acceptable if it maximizes the benefit, or minimizes the harm, to stakeholders in the aggregate. The "golden rule" model deems a decision ethical if all stakeholders are treated as the decision maker would wish to be treated. Finally, the Kantian "basic rights" model defines acceptable actions as those that minimize the violation of stakeholders' rights.*

© McGraw Hill LLC. All rights reserved. No reproduction or distribution without the prior written consent of McGraw Hill LLC.

Corporate Finance 2025 Release 1st edition Ross Solutions Manual

Lecture Tip: *The antitrust case against Microsoft can generate a healthy discussion of ethical behavior, innovation and the government's role in monitoring business practices. The basic idea behind the case is that: (1) Microsoft stifled competition by imposing stiff penalties on computer manufacturers that chose to install operating systems other than Windows on some of their machines; (2) Microsoft tried to put Netscape out of business by incorporating Internet Explorer into the operating system; and (3) Microsoft has an unfair advantage in the applications programming area because their programmers have access to the source code for the operating system. There were other issues as well, but these were the major ones. The Judge in the case originally found that Microsoft did violate antitrust laws and that they continued to operate in a monopolistic fashion. He ordered the break-up of Microsoft into an "operating system" company and an "applications" company. The Judge also ordered that Microsoft allow programmers from the Company's competitors to come to a secured location and view the source code for Microsoft Windows. Microsoft contended that this would allow other companies to determine the direction that Microsoft is moving with their software and eliminate the competitive advantage that their research and development has afforded the company. The case was appealed, and Microsoft was still found in violation of antitrust laws, but not to the extent found in the original case.*

The Final Judgment was issued on November 12, 2002 and has the following components: (1) Microsoft cannot retaliate against an Original Equipment Manufacturer (OEM) if the OEM "is or is contemplating developing, distributing, promoting, using, selling or licensing any software that competes with Microsoft Platform Software" or ships a computer with more than one operating system; (2) Microsoft must publish and use a consistent licensing agreement schedule with all covered OEMs; (3) Microsoft cannot restrict OEMs from selling computers that include competing products, display competing product icons on the desktop, and launch competing products when a Microsoft application would normally be launched; (4) Microsoft must allow Independent Software Vendors (ISVs), Independent Hardware Vendors (ISDs), Internet Access Providers (IAPs), Internet Content Providers (ICPs) and OEMs access to Windows Operating System Product source code as necessary to develop products that will work effectively with the operating system – these companies must demonstrate why they need access and they are limited to access to that code that is required for "interoperating" with the operating system; and (5) Microsoft is not required to disclose any intellectual property rights related to security or that is designed to prevent software piracy.

© McGraw Hill LLC. All rights reserved. No reproduction or distribution without the prior written consent of McGraw Hill LLC.

Corporate Finance 2025 Release 1st edition Ross Solutions Manual

The Final Judgment called for the appointment of a technical committee that will assist in the enforcement and compliance with the judgment and Microsoft was required to appoint an internal compliance officer to make sure that all employees of the firm understand and comply with the judgment. Reports on compliance are routinely filed with the Department of Justice and can be found, along with the Final Judgment, at U.S. Department of Justice site (http://www.usdoj.gov/atr/cases/ms_index.htm).

1.6 Regulation

Slide 1.19 1.6 Regulation

Historically, most regulation has focused on the disclosure of relevant information, thereby putting all investors on an equal playing field.

A. The Securities Act of 1933 and the Securities Exchange Act of 1934

These Acts provide the basic regulatory framework for the public trading of securities in the United States. The 1933 Act focuses on the issuance of securities, while the 1934 Act established the SEC and addressed other regulatory issues, such as insider trading and corporate reporting.

B. Sarbanes-Oxley

Following the scandals at Enron, WorldCom, and Tyco, among others, "Sarbox" was enacted in 2002. This Act significantly increased the auditing and reporting requirements that public firms face, and it also explicitly placed the responsibility for any fraud on the corporate directors.

As with any law, however, there is a cost. In response to the added burden, many (particularly small) firms have delisted and others have foregone going public. For others, the cost of compliance has significantly increased, thereby reducing profits.

Slide 1.20 Quick Quiz
Slide 1.21 End of Main Content
Slide 1.22 Accessibility Content: Text Alternatives for Images
Slide 1.23 Short-Term Asset Management Text Alternative
Slide 1.24 Hypothetical Organization Chart Text Alternative
Slide 1.25 1.3 The Importance of Cash Flows Text Alternative

© McGraw Hill LLC. All rights reserved. No reproduction or distribution without the prior written consent of McGraw Hill LLC.

Corporate Finance 2025 Release 1st edition Ross Solutions Manual