Essentials of Corporate Finance 2025 Release 1st edition Ross Solutions Manual

SKU: 9781265920159-SOLUTIONS

Case Solutions

Essentials of Corporate Finance

Ross, Westerfield, and Jordan
2025 release

01/31/2025

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CHAPTER 1
THE McGEE CAKE COMPANY

1. The advantages to an LLC are: 1) Reduction of personal liability. A sole proprietor has unlimited liability, which can include the potential loss of all personal assets. 2) Taxes. Forming an LLC may mean that more expenses can be considered business expenses and be deducted from the company's income. 3) Improved credibility. The business may have increased credibility in the business world compared to a sole proprietorship 4) Ability to attract investment. Corporations, even LLCs, can raise capital through the sale of equity. 5) Continuous life. Sole proprietorships have a limited life, while corporations have a potentially perpetual life. 6) Transfer of ownership. It is easier to transfer ownership in a corporation through the sale of stock.

The biggest disadvantage is the potential cost, although the cost of forming an LLC can be relatively small. There are also other potential costs, including more expensive record-keeping.

2. Forming a corporation has the same advantages as forming an LLC, but the costs are likely to be higher.

3. As a small company, changing to an LLC is probably the most advantageous decision at the current time. If the company grows, and Doc and Lyn are willing to sell more equity ownership, the company can reorganize as a corporation at a later date. Additionally, forming an LLC is likely to be less expensive than forming a corporation.

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Chapter 1
INTRODUCTION TO FINANCIAL MANAGEMENT

Introduction to Financial Management			
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		1.3	Chapter Outline
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1.5	**The Agency Problem and Control of the Corporation**		
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CHAPTER WEBSITES

Websites may be referenced more than once in a chapter. This table just includes the section for the first reference.

Chapter Section	Web Address
1.1	www.corporatefinanceinstitute.com/resources/careers/jobs
1.2	www.cfo.com
1.3	www.nolo.com
	www.corporateinformation.com
	www.benefitcorp.net
1.4	www.business-ethics.com
1.5	finance.yahoo.com
1.6	www.sec.gov
	www.nyse.com
	www.nasdaq.com
	www.jpx.co.jp/english/
	www.londonstockexchange.com

- ***PowerPoint Notes***:
  If there are slides 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.

- ***End of Annotated Chapter Outline Extended Lecture Notes:***
  - *The Coca-Cola Company*
    - *Recap of article "How Coke Is Kicking Pepsi's Can" from* Fortune*, 1996, describing the difference in strategies between the two firms.*
    - *Full text of former Coca-Cola president, Roberto C. Goizueta's, essay on "Why Share-Owner Value?"*
  - *Gillette*
    - *Ethics note regarding agency issues and a takeover effort.*
  - *Dow Corning*
    - *Ethics note on firm's handling of silicone breast implants issues.*
  - *Microsoft*
    - *The antitrust case against Microsoft as a basis for discussion of ethical behavior, innovation, and government's role in monitoring.*
- ***Videos to Complement Chapter Material:***
  1. *Advice from recent graduates on what it takes to have a career in finance.*
  2. *The changing role of the Chief Financial Officer (CFO) at Abbott Laboratories.*
  3. *"Rightsizing" at ABT Co. of Canada.*

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4. *How capital is raised in financial markets and shows an open-outcry market at the Chicago Board of Trade.*

ANNOTATED CHAPTER OUTLINE

Slide 1.1 **Chapter 1: Introduction to Financial Management**

Slide 1.2 **Key Concepts and Skills**

Slide 1.3 **Chapter Outline**

Introduce students to the website that accompanies the book, including the various features that they can access for study purposes (study guide, quizzes, web links, etc.).

Slide 1.4 **Basic Areas of Finance (Video 1: Careers)**

Each of these topics are discussed in more detail in the following slides; however, the discussion on corporate finance is deferred until later in the chapter.

Slide 1.5 **Investments**

"Money Management" discusses careers as portfolio managers, mutual fund analysts, etc. "Financial Planning" discusses careers as financial consultants.

Slide 1.6 ***Financial Institutions***

"Commercial Banking," "Insurance," and "Investment Banking" all discuss job opportunities in the Financial Institutions area.

Slide 1.7 ***International Finance***

Note that International Finance is not a separate area but more a specialized area within the three primary areas of finance: Corporate, Investments, and Institutions. With the globalization of business in general, the need to be familiar with both the domestic and international characteristics of finance has escalated.

Slide 1.8 ***Fintech***

Slide 1.9 ***Why Study Finance?***

Because this course is generally required of all business majors, it is important to emphasize that everyone needs to have a basic understanding of financial concepts so that they can communicate effectively within an organization. This is the same reason that everyone is required to take marketing courses, management courses, etc.

The field of finance is important to all students regardless of major, for both professional and personal reasons. Most companies want to see a cost/benefit analysis for an increasing number of decisions in all areas of the firm. Consequently, the business students of today will need to be able to use finance principles, even if they are not part of a "finance" functional group. At a personal level, they will be making financial decisions for themselves and their families for the rest of their lives.

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Marketing
- Marketing financial products—including entire companies through IPOs and seasoned equity offerings, as well as insurance and other basic financial products

Accounting
- In smaller businesses, accountants often perform both the accounting and finance functions.

Management
- Business strategy—have to understand the goals of the business and how cash flow works

Personal Finance
- For many students, emphasizing the personal finance issues whenever possible can make the material more relevant.

Slide 1.10 Business Finance

"Business finance" is just another name for "corporate finance." Students often get confused by the terminology, especially when different terms are used to refer to the same thing.

Slide 1.11 Financial Manager (Video 2: Role of CFO)

Slide 1.12 Corporate Organization Chart (Figure: 1.1)

The CFO or VP of Finance role is usually filled with someone with both an accounting AND finance background, because the position has responsibility for both the controller and treasury functions in a firm.

Slide 1.13 Financial Management Decisions

Capital budgeting
- Key concerns = size, timing, and riskiness of future cash flows
- Examples: What product or service the firm will sell? Should old equipment be replaced with newer equipment? Etc.

Capital structure
- Define *debt* and *equity*.
- Examples: 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?

Working capital management
- Examples: How much inventory should the firm carry? What credit policy is best? Where will the firm obtain its short-term loans?

Slide 1.14 Forms of Organization (Web link)

"Choosing the Best Ownership Structure for Your Business." Other "NOLO" links offer additional information about the legal aspects of each form of business, as well as a discussion of the advantages and disadvantages. The address is: *http://www.nolo.com/legal-encyclopedia/llc-corporations-partnerships/*

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Slide 1.15 Sole Proprietorship (Web link)

https://www.sba.gov/business-guide/launch-your-business/choose-business-structure

Slide 1.16 Partnership (Web link)

General partnership—all partners share in gains or losses; all have unlimited liability for all partnership debts. Written agreements are essential due to the unlimited liability.

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, but he or she cannot help in running the business. Limited partners cannot be actively involved in the business or else they may be deemed general partners.

Note that unlimited liability applies to all partners in a general partnership but only to the general partner(s) in a limited partnership.

https://www.sba.gov/business-guide/launch-your-business/choose-business-structure

- *additional information about limited partnerships, partnership agreements, and buy-sell agreements.*

Slide 1.17 Corporation (Web link)

Corporations account for the largest volume of business (in dollar terms) in the U.S.

Discuss how separation of ownership and management can be both an advantage and a disadvantage:

Advantages

- You can benefit from ownership in several different businesses (diversification).
- You can take advantage of the expertise of others (comparative advantage).
- It is easier to transfer ownership.

Disadvantage

- There can be agency problems if management goals and owner goals are not aligned.

https://www.sba.gov/business-guide/launch-your-business/choose-business-structure

- *additional information on corporations as well as limited liability corporations.*

Slide 1.18 International Corporate Forms (Web link)

Translation for any business type at www.corporateinformation.com

Slide 1.19 Goal of Financial Management (Video 3: Rightsizing)

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Maximize profit: An imprecise goal. Maximize what profit? Long-run or short-run profits, accounting profits, or some measure of cash flow?
Minimize costs: Reducing costs can damage the long-run viability of the firm.

Maximize market share: Many dot-com companies had a goal of maximizing market share. They raised substantial amounts of capital, using the money on advertising to increase the number of "hits" on their site. However, the hits failed to translate into enough revenue to meet expenses. Stockholders were not happy, and the stock price fell dramatically, making it difficult to raise additional funds.

The goal of financial management in a corporation is to *maximize the current value per share of the existing stock.*

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

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 12/20/2024: https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans)*

Slide 1.20 Goal of Financial Management

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.

Slide 1.21 Sarbanes-Oxley Act (SOX, 2002)

Driven by corporate scandals

Intended to strengthen protection against accounting fraud and claims by senior management of having no knowledge of misdeeds

Very costly to publicly traded firms

Slide 1.22 The Agency Problem (Ethics Notes: Gillette; Dow Corning)

Agents tend to act in their own best interest rather than the best interest of firm owners.

Firm incurs a cost, called "agency cost"

Slide 1.23 Do Managers Act in the Shareholders' Interest?

Common incentives = stock options and bonuses tied to profits. Both can have unintended results if managers "game" the system for their own advantage.

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Lecture Tip: *An extreme example of tying managerial compensation to performance occurred at Union Carbide. The CEO agreed to forfeit a year's salary if the firm failed to meet earnings goals. Further, 16 senior executives agreed to forgo 65 percent of their annual salaries.*

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 package included more option and stock components. (See* The Wall Street Journal, *November 12, 1993, p. B1).*

An article by Lisa Meulbroek, formerly of Harvard Business School, points out that if managers are undiversified, then they won't value stock and stock options as highly as investors in the market because they are not fully compensated for the stock's volatility. Therefore, firms must consider the cost of paying managers with stock that they could sell for a higher price in the market versus the incentive alignment available through using stock and stock options as partial compensation. (Meulbroek, Lisa, 2000, "The Efficiency of Equity-Linked Compensation: Understanding the Full Cost of Awarding Executive Stock Options," Harvard Business School Working Papers, *No. 00-056.)*

Corporate Control:

Stockholders technically have control of the firm and, if dissatisfied, 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.

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, and customers.

Slide 1.24 Example: Work the Web (Web link)

www: *Follow the link to Yahoo Finance. Finding information on the listed companies will give students an idea of the breadth of information easily available on the web.*

Slide 1.25 Cash Flow Between the Firm and the Financial Markets

Main point: Cash comes into the firm from the sale of debt and equity. The money is used to purchase assets. Those assets generate cash that is used to pay stakeholders, reinvest in additional assets, repay debtholders, and pay dividends to stockholders.

Slide 1.26 Financial (Video 4: Markets)

Primary market

- Market in which securities are sold by the company

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- Public and private placements of securities, SEC registration, and underwriters are all part of the primary market.
- Key feature: Money raised goes to the issuing company.

Secondary market
- Market where securities that have already been issued are traded between investors
- The stock exchanges, such as the New York Stock Exchange, and the over-the-counter market, such as NASDAQ, are part of the secondary market.
- Funds are exchanged between buyer and seller with no participation by the issuing company.

Dealer versus auction markets:

Dealer market
- One with several traders who maintain an inventory in securities they trade and provide prices at which they stand ready to buy (bid) and sell (ask) the securities
- NASDAQ is an example of a dealer market.

Auction market
- Generally has a physical location where buyers and sellers are matched by a broker, with little dealer activity
- A stock that trades on an exchange is said to be "listed."

The term "broker/dealer" is frequently used to indicate that the trader may, on some transactions, act as a dealer, trading from his own inventory, while at other times, he or she may act as a broker, bringing together a buyer and seller. NYSE specialists act as broker/dealers, while NASDAQ market makers act only as dealers.

Lecture Tip: *Students are often confused by the fact that NASDAQ is an OTC market. Explain that the NASDAQ market site is just a convenient place for reporters to show how the stocks are moving, but that trading does not actually take place there.*

www*: Click on the NYSE and NASDAQ hyperlinks to go to their websites.*

Slide 1.27 Quick Quiz

Answers are on linked slides, which have return arrows (⬅) to return to the Quick Quiz slide.

Slide 1.28 End

Slide 1.29 Accessibility Content: Text Alternatives for Images

Slide 1.30 Corporate Organization Chart Figure 1.1 – Text Alternative

Slide 1.31 Cash Flows Between the Firm and the Financial Markets – Text Alternative

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Extended Lecture Notes:

Lecture tip: **THE COCA-COLA COMPANY**

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 and is reprinted below. 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. The following article illustrates the difference in strategy between Coca-Cola and Pepsi-Co in the mid-1990s.

"How Coke Is Kicking Pepsi's Can," Fortune, *October 28, 1996. The following website provides the full text of the article:*
http://fortune.com/2015/11/10/coca-cola-pepsi-fortune-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.

Since this article was written, Pepsi-Co has divested itself of its restaurants and has performed much better. Unfortunately, Mr. Goizueta died unexpectedly and Coke has had a hard time maintaining its edge.

Ethics Note: Gillette

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. The following is an interesting springboard for a 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.

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 has proven to be one of the most profitable new ventures in Gillette's history). Thus, despite appearances, management's actions may not have been in the best interests of the firm, this case

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indicates that management may consider factors other than the bid when considering a tender offer.

Ethics Note: Dow Corning

Dow Corning, in conjunction with research done at Dow Chemical, knew that there were potential health risks associated with the rupture of silicone breast implants. It settled at least 21 cases with women complaining of health problems after their implants ruptured. Part of the agreement was that the women could not discuss the case with anyone. The potential problems finally became public when one woman refused to settle.

Dow Corning filed for Chapter 11 bankruptcy, primarily due to the class action lawsuits filed by women with silicone breast implants. The FDA forced silicone breast implants off the market, and Dow Corning filed a $3.2 billion settlement. Ironically, following further scientific research that did not find a significant link between the silicone in the breast implants and connective tissue disease, the most cited illness by the claimants, the FDA gave approval on November 17, 2006, to allow two companies to reintroduce silicone implants. The FDA did acknowledge that the implants may still lead to other complications that require surgery, and required a 10-year follow-up study.

Dow Corning made a decision early on to hide the research that indicated that there might be a medical problem and it had gag orders placed on settlements. If it had been more forthright from the start, the research that ultimately vindicated its position could have been done sooner and the company might have avoided bankruptcy. Decisions that many would view as unethical certainly did not maximize shareholder value.

Lecture Tip: Microsoft Antitrust Case

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 manufactures 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 its 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 found that Microsoft did violate antitrust laws and that it 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 its software and eliminate the competitive advantage that its research and development has afforded the company.

Microsoft appealed the ruling in November 2000. The appeals court had harsh words for the judge in the original trial, primarily for remarks that he made to the media. In June 2001, the U.S. Court of Appeals in the District of Columbia agreed that Microsoft did

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maintain a monopoly but rejected the order to break the company into two parts. It ordered a new judge to determine an appropriate remedy.

Microsoft appealed to the Supreme Court to overrule the antitrust ruling, but the request was rejected. A deal was reached with the Department of Justice in November 2001, but several states opposed the settlement. Talks continued until November 2002, when the judge finally approved a settlement between Microsoft and the government. Most of the states that opposed the earlier settlement dropped their opposition.

Some features involve the restructuring of pricing to level the playing field for resellers, sharing technical data, and allowing for the removal of Microsoft icons from the desktop in Windows XP.

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