Foundations of Financial Management 2025 Release 1st edition Block Solutions Manual

SKU: 9781266556555-SOLUTIONS

Chapter 1
The Goals and Functions of Financial Management

Discussion Questions

1-1 What effect did the recession of 2007-2009 have on government regulation?

It was greatly increased.

1-2 What advantages does a sole proprietorship offer? What is a major drawback of this type of organization?

A sole proprietorship offers the advantage of simplicity of decision making and low organizational and operating costs. A major drawback is that there is unlimited liability to the owner.

1-3 What form of partnership allows some of the investors to limit their liability? Explain briefly.

A limited partnership allows some of the partners to limit their liability. Under this arrangement, one or more partners are designated general partners and have unlimited liability for the debts of the firm; other partners are designated limited partners and are liable only for their initial contribution. The limited partners are normally prohibited from being active in the management of the firm.

1-4 In a corporation, what group has the ultimate responsibility for protecting and managing the stockholders' interests?

The board of directors.

1-5 What document is necessary to form a corporation?

The articles of incorporation.

1-6 What issue does agency theory examine? Why is it important in a public corporation rather than in a private corporation?

Agency theory examines the relationship between the owners of the firm and the managers of the firm. In privately owned firms, management and the owners are usually the same people. Management operates the firm to satisfy its own goals, needs, financial requirements and the like. As a company moves from private to public ownership, management now represents all owners. This places management in the agency position of making decisions in the best interest of all shareholders.

1-7 What are institutional investors important in today's business world?

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Because institutional investors such as pension funds and mutual funds own a large percentage of major U.S. companies, they are having more to say about the way publicly owned companies are managed. As a group, they have the ability to vote large blocks of shares for the election of a board of directors, which is supposed to run the company in an efficient, competitive manner. The threat of being able to replace poor performing boards of directors makes institutional investors quite influential. Since these institutions, like pension funds and mutual funds, represent individual workers and investors, they have a responsibility to see that the firm is managed in an efficient and ethical way.

1-8 Why is profit maximization, by itself, an inappropriate goal? What is meant by the goal of maximization of shareholder wealth?

The problem with a profit maximization goal is that it fails to take account of risk, the timing of the benefits is not considered, and profit measurement is a very inexact process. The goal of shareholders' wealth maximization implies that the firm will attempt to achieve the highest possible total valuation in the marketplace. It is the one overriding objective of the firm and should influence every decision.

1-9 When does insider trading occur? What government agency is responsible for protecting against the unethical practice of insider trading?

Insider trading occurs when anyone with non-public information buys or sells securities to take advantage of that private information. The Securities and Exchange Commission is responsible for protecting markets against insider trading. In the past, people have gone to jail for trading on non-public information. This has included company officers, investment bankers, printers who have information before it is published, and even truck drivers who deliver business magazines and read positive or negative articles about a company before the magazine is on the newsstands and then place trades or have friends place trades based on that information. The SEC has prosecuted anyone who profits from inside information.

1-10 In terms of the life of the securities offered, what is the difference between money and capital markets?

Money markets refer to those markets dealing with short-term securities that have a life of one year or less. Capital markets refer to securities with a life of more than one year.

1-11 What is the difference between a primary and a secondary market?

A primary market refers to the use of the financial markets to raise new funds for the corporation. After the securities are sold to the public (institutions and individuals), they trade in the secondary market between investors. It is in the secondary market that prices are continually changing as investors buy and sell securities based on the expectations of corporate prospects.

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1-12 Assume you are looking at many companies with equal risk. Which ones will have the highest stock prices?

Given companies with equal risk, those companies with expectations of high return will have higher common stock prices relative to those companies with expectations of poor returns.

1-13 How is the time value of money concept related to the valuation of stocks?

The value of an investment that is expected to earn money in the future can be calculated using time-value of money principles. Corporations are expected to pay dividends to their shareholders. The current value of these future dividends is the present value. The present value of a stock's future dividends should be the same as the stock's current price.

Problems

1. **Future value (LO6)** You invest $3,000 for three years at 12 percent.
   a. What is the value of your investment after one year? Multiply $3,000 × 1.12.
   b. What is the value of your investment after two years? Multiply your answer to part *a* by 1.12.
   c. What is the value of your investment after three years? Multiply your answer to part *b* by 1.12. This gives your final answer.
   d. Combine these steps using the formula $FV = PV \times (1 + i)^n$ to find the future value of $3,000 in three years at 12 percent interest.

1-1. Solution:

a. $\$3{,}000 \times 1.12 = \$3{,}360$

b. $\$3{,}360 \times 1.12 = \$3{,}763.20$

c. $\$3{,}763.20 \times 1.12 = \$4{,}214.78$

d. $\$3{,}000 \times (1 + 0.12)^3 = \$4{,}214.78$

2. **Future value (LO6) If you invest $9,000 today, how much will you have**
   a. In 2 years at 9 percent?
   b. In 7 years at 12 percent?

1-2. Solution:

a. $FV = \$9{,}000 \times (1 + 0.09)^2 = \$10{,}692.90$

b. $FV = \$9{,}000 \times (1 + 0.12)^7 = \$19{,}896.13$

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1. **Present value (LO6)** What is the present value of
   a. $7,900 in 10 years at 11 percent?
   b. $16,600 in 5 years at 9 percent?

1-3 Solution

a. $\$7{,}900 \times (1/\ (1 + 0.11)^{10}) = \$2{,}782.28$

b. $\$16{,}600 \times (1/\ ((1 + 0.09)^{5}) = \$10{,}789.03$

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