Chapter 1
Financial Management

Questions

1. **What is the cycle of money? Who participates in the cycle of money? What is the objective of a financial transaction?**

   The cycle of money is the movement of funds from a lender to a borrower and back to the lender.

   The participants are the original lender, usually an individual (or household) through direct investment or through a financial institution, the financial institution that matches the lender with a borrower or bundles up a set of lenders for a single borrower, and the borrower such as a company that is using the funds for operating the business or expanding the business.

   The objective of every financial transaction is to make all parties in the transaction better off.

2. **Construct an example of the cycle of money, identify all the players involved, and identify their individual benefits from participating in the cycle of money.**

   **Example One:** An individual opens a savings account at a local commercial bank with a $200 deposit. The bank loans out the $200 with other funds from other savings accounts to a local business man who is expanding his business. The local business man pays back the loan over time with interest and the bank credits the savings account with interest. The individual withdraws money from the savings account to buy a new bike.

   **Example Two:** An individual deposits his monthly paycheck in a checking account. The bank accumulates the funds from many checking accounts and loans money to an individual buying a house. The new homeowner makes monthly mortgage payments to the bank. The bank uses the mortgage payments to cover the checks written by the person with the checking account.

   **Example Three:** An individual buys a municipal bond for an airport improvement project. The individual usually buys a municipal bond from a bond dealer, or an investment banker marketing the bond, and the funds from the sale of the bond are delivered to the city minus a fee from the investment banker. The city uses the funds to build new facilities at the airport, for example a new parking lot. Once finished the fees received from parking are used to payback the buyer of the bond with interest.

3. **What are the four areas of finance? Give an example of a financial activity that would fall into each area.**

   **Area One:** Corporate Finance – the financial activities that support the operations of a business. A typical financial activity in this area is borrowing funds to support a plant expansion or supplementing short term cash needs.

   **Area Two:** Investments – the activities around the buying and selling of financial assets. A typical activity is the selling of a bond issue such as a school bond for building a new school.
Area Three: Financial Institutions – the organizations that promote and facilitate the cycle of money. A typical financial activity is issuing checking and savings accounts as well as selling securities such as certificates of deposit, stocks and bonds.

Area Four: International Finance – the financial activities performed in foreign countries for a domestic company. A typical financial activity is the changing of currency from one country to another country.

4. What is the difference between the primary market and the secondary market?

The primary market is the market of first sale of common stock by a company. The proceeds of the sale go to the company for the newly issued stock.

The secondary market is the sale of “used” stock in that the current owner sells it to a new owner and the proceeds go to the current owner, not the company.

5. What is the general definition of the financial management function? Give an example of a financial management function that an individual might perform.

The financial management function is generally defined as the activities that create or preserve the economic value of the assets of an individual or company.

An individual might set a monthly budget to insure that incoming funds are sufficient to make payments on all personal obligations such as rent payment, car payment, utilities, food, clothing, insurance, and still allow for entertainment.

6. List a capital budgeting decision, a capital structure decision, and a working capital management decision a business might make.

Here are 3 examples of financial decisions that a business might make:

1. The company chooses a new product to introduce into the market (capital budgeting).

2. The company chooses to sell a bond to finance the new product (capital structure).

3. The company sets production and inventory levels on the new product (working capital management).

7. List the advantages and disadvantages of the three different types of business organizations.

See Section 1.7.

8. What is the goal of the financial manager? How does the surrounding community where a business operates fit into this goal?

The goal of the financial manager is to maximize the current share price or equity value of the firm. This goal encompasses many good business practices such as a good working relationship with the surrounding community.

If the firm pollutes local streams, abuses local facilities such as roads, and in general does not participate in the economic advancement of the local community its share price or equity value will suffer.

The local community may sue the company for its damages and the best local workforce members may choose not to work for the company. Employees may not be loyal to the company causing high turnover and increased personal costs for recruiting and training. Finally, facilities such as roads and utilities may not be repaired or modernized by the local community impacting the company’s ability to produce a
profit. A good community relationship is embedded in the goal of maximizing current share price or the equity value of the company.

9. **With what players in an organization does the finance manager work to ensure proper financial controls are in place? Can you give a real-world example of a situation in which this relationship was absent and ultimately brought down the company?**

One of the key player(s) that the financial manager works with is the auditing firm of the company. Together with the controller a financial manager works with the Auditing Company to ensure that proper controls are in place for the economic activities of the firm. Auditors review the process of checks and balances within the company to insure that access to funds and information is appropriate and that financial transactions are recorded and reported in such a manner as to provide potential investors and current owners accurate information about the performance and condition of the company.

An example of a major failure in this area is Enron and Anderson Accounting. Here the lack of proper recording of financial transactions and the lack of appropriate reporting of financial transactions ultimately led to the failure of Enron and the loss of jobs and pensions for thousands of Enron employees.

10. **Name a natural conflict between a principal and an agent. How could this conflict be reduced?**

**Principal-Agent pair:** Shareholder – Chief Executive Officer

Conflict is the “perk” the CEO elects to take, a personal jet for flying to and from business activities instead of flying commercial carriers. The cost of the jet outweighs the expense of commercial carriers so it hurts the company profits. However, the CEO feels that the private jet allows for greater supervision of the operations and hence a more efficient operation.

**Solution:** This conflict could be reduced by the board of directors reviewing the travel needs and frequency of the CEO and the inconvenience of using commercial carriers. Once the pros and cons of the different travel options have been reviewed a company policy can be issued so that shareholders understand the rationale if a private jet is elected for the CEO.

**Agent Pair:** Supervisor – Employee.

The conflict is over the overtime assignment of the employee. The employee wants sufficient lead time on overtime work while the supervisor assigns the work whenever the situation arises. The employee is disgruntled when working overtime and does not produce quality work. The cost of this is rework on some of the production items.

**Solution:** a policy on overtime and selection for overtime worked out between the supervisor and all employees subject to selection for overtime.

11. **Employees at the Jackson Hole Corporation typically take 45 minutes for lunch when the allocated time is only 30 minutes. Employees are encouraged to eat at the company cafeteria located in the middle of the company facilities. Most employees choose to eat their lunch in the cafeteria. Is there an agency cost here? If so, how can management eliminate or reduce this agency cost?**
The first issue is why do employees take forty-five minutes for lunch? The forty-five minutes may be the time natural time required to go through the line, purchase a lunch and then eat the lunch at an appropriate pace. If this is the case then it will be necessary to determine how to “speed” up the process to allow the employees to meet the 30 minute lunch time frame.

The agency cost here is the lost 15 minutes of employee production time each day. In order to eliminate this agency cost it may be necessary to significantly modify the cafeteria or the serving procedure. If the management wants to maintain the thirty minute lunch period it may have to look into the serving procedure in their cafeteria to see how to shorten lines and speed up purchasing meals. Any cost to redesign the cafeteria process is an agency cost. Any additional employees added to the cafeteria staff to speed up the process is an agency cost.

Another possibility is to extend the work day by fifteen minutes. The cost to negotiate a new work day schedule is an agency cost. Any turnover caused by the new workday is also an agency cost.

It may be more costly to enforce the thirty minute lunch time than to accept the standard 45 minute break currently used by employees. Not all agency costs can be eliminated or reduced. The norms of the employees and the ability of current facilities to support a policy need to be considered when setting policies and in this case lunch time in the first place.

Then again, if the facilities are sufficient to handle a 30 minute lunch it may be as simple as reaffirming the lunch break time with the employees.

### Prepping for Exams

1. a.
2. b.
3. a.
4. b.
5. c.
6. b.
7. c.
8. b.
9. c.
10. d

### Solutions to Mini-Case Questions

**Richards’ Tree Farm Grows Up**

This case requires students to review the major financial decisions faced by any business, and the advantages and disadvantages of various forms of business organization with emphasis on incorporation. It introduces the agency problem and ethical decisions, using examples that will be familiar to most students.
1. **Major financial management decisions involve capital budgeting, capital structure, and working capital management. Give an example of each that relates to Richards’ Tree Farm.**

**Capital Budgeting:** Whether they know it or not, when the Richards decide to purchase any asset with a significant cost and a useful life of more than a year, they are making a capital budgeting decision. Examples include the purchase of digging and packaging equipment, tractors, trucks, and buildings.

**Capital Structure:** The Richards had to decide whether to finance these purchases with their savings, by reinvesting profits, or with loans and leases. All of these financing decisions involved the overall capital structure decision of how much debt and how much of their personal equity they were willing to use.

**Working Capital:** The Richards always have inventories of trees at various stages of maturity and available for sale. They sell to commercial clients on credit and purchase supplies used in their operations on credit. They need cash to pay their suppliers and employees. In other words, the Richards need to decide on a day-to-day basis the proper levels of working capital accounts such as cash, inventory, accounts receivable, and accounts payable.

2. **Should the Richards form a regular corporation or choose one of the hybrid forms? Whichever form they use, they intend to distribute ownership equally among Jake, his wife, and their two children so that each party will own 25% of the shares. Consider the tax consequences of their decision.**

The major advantage to incorporating is the separation of personal income and assets from business income and assets. Either a regular corporation or one of the alternative forms (LLC or Subchapter S) will accomplish this goal. The distribution of shares more or less assures that Jake Richards and his wife will maintain a controlling interest in the business, but they might have kept a small majority just to be sure. The Richards want to share some of their wealth with their children now, and probably hope that they will remain involved in the business, but there is no guarantee of that. As their children marry, their spouses may also become part owners of significant shares of the business. Disharmony anywhere in the immediate family has the potential to create a difficult situation potentially requiring the sale of the business or some its assets. The distribution of shares could make the business more difficult to sell because potential buyers will have to deal with several parties who may each have a different agenda.

In theory, basic incorporation subjects the Richards to double taxation, because income could be taxed once at the corporate level, and again when it is distributed as dividends. By taking appropriate salaries from the business, however, they might be able to have lower marginal rates on both personal and business income. If they use dividends as a means of sharing wealth with their children, double taxation could be an issue.

Smaller businesses often choose hybrid forms of organization, such as a Subchapter S Corporation or a Limited Liability Company. These are so-called “pass through” organizations that are taxed like partnerships. These organizations avoid the “double
taxation” problem, but could require principals to pay taxes on money that has not been withdrawn from the business.

3. **How does incorporating affect the family’s overall risk exposure?**

   In theory, at least, any problems with the business will leave the Richards liable only for the value of their investment. The worst that could happen would be a forced liquidation of the business, which would be unfortunate, but would leave any personal wealth intact. However, in smaller businesses like this one, loans often require personal guarantees from the principal owners.

4. **How does incorporating affect the ability of the business to expand?**

   Although incorporating a relatively small business would not automatically give it easy access to the capital markets, the Richards might be able to obtain additional equity by selling shares to outside investors. Additional equity would make it easier to borrow larger amounts. Because of limited liability protection, the Richards also may be more willing to take on additional debt.

5. **Jake is concerned that if the business gets much bigger or if he should just decide to slow down and enjoy life a little more, he will need to hire professional management and possibly lose control over key business decisions. Are his concerns justified?**

   Corporations do create the possibility of separating ownership and management, but as long as the Richards retain a clear majority of the shares, hired managers will serve at their discretion. The Richards would have to decide how much money and effort they would be willing to spend to detect and prevent agency problems.

6. **Jake occasionally hires day workers, who may or may not be in the United States legally. What are his legal and ethical obligations with respect to this decision?**

   Jake has a clear legal and ethical responsibility to verify the immigration status of all employees, even temporary ones. Such a choice could lead to serious penalties that would jeopardize the business. By doing so, Jake is also unwittingly exerting downward pressure on the wages and employment benefits of legal agricultural workers.

7. **The Richards are deeply concerned with environmental issues and know that the best practices for pesticide and fertilizer usage increase production costs. Will incorporating affect their ability to give up a small amount of profit in exchange for protecting the environment?**

   Again, as long as the Richards maintain a controlling interest in the firm, they can establish and enforce whatever policies they wish regarding the use of fertilizers and pesticides. If they become minority shareholders or simply stop playing an active role in the management of the business, profit pressures could make it difficult to follow best environmental practices. At times, best practices such as avoiding unnecessary pesticide applications can actually lower costs. Some customers may also be willing to pay a higher price for responsibly farmed crops.

8. **How does incorporating affect the Richards’ ability to transfer ownership of the tree farm to their children?**
Incorporating creates many convenient options for transferring ownership of the business. The Richards can gradually sell or give their children increasing numbers of shares as they see fit. If they hold shares at the time of their deaths, their will can arrange to distribute them according to their wishes. Inherited shares are not subject to capital gains taxes at the time they are received. Shares could also be sold to outside parties. If they choose the LLC form of organization, which retains more features of partnerships, provisions for transferring ownership will need to be carefully spelled out in the original agreement.

9. **Suppose at some point in the future, this business has an opportunity to become much larger. How might it obtain more equity funding and perhaps create considerable wealth for the Richards family in the process?**

A handful of similar businesses are publicly traded on NASDAQ (which will be discussed in more detail in Chapter 7 on stocks), so it is possible to imagine that by acquiring other properties and employing professional managers, the business could eventually become big enough to warrant an initial public offering (which will be discussed in more detail in Chapter 15 on raising capital). Such an event could raise large amounts of capital for the business and allow the Richards to sell their shares at the market price. At present, however, such an event seems rather unlikely. If the Richards have any such ambitions, they would be better off organizing as a regular corporation rather than choosing one of the hybrid forms.