Chapter 1
An Overview of Financial Management

ANSWERS TO BEGINNING-OF-CHAPTER QUESTIONS

1-1 The primary goal is shareholder wealth maximization, which translates to stock price maximization. That, in turn, means maximizing the PV of future free cash flows.

Maximizing shareholder wealth requires that the firm produce things that customers want, and at the lowest cost consistent with high quality. It also means holding risk down, which will result in a relatively low cost of capital, which is necessary to maximize the PV of a given cash flow stream.

This also gets into the issue of capital structure—how much debt should we use? The more debt the firm uses, the lower its taxes, and the fewer the shares outstanding, hence the less the dilution of earnings. However, more debt means more risk. So, it's necessary to consider capital structure when attempting to maximize share prices.

Dividend policy is also an issue—how much of its earnings should the firm pay out as dividends? The answer to that question depends on a number of factors, including the firm's investment opportunities, its access to capital markets, its stockholders' desires (and their tax rates), and the kind of signals stockholders get from dividend actions.

Shareholder wealth maximization is partially consistent and partially inconsistent with generally accepted societal goals. It is consistent because well-run firms produce good products at low costs, sell them at competitive prices, employ people, pay taxes, and generally improve society. However, without constraints, firms would tend to form monopolies and end up charging prices that are too high and not producing enough output. They might also pollute the air and water, engage in unfair labor practices, and so on. So, constraints (antitrust, labor, environmental, etc. laws) should be and are imposed on businesses. That said, stock price maximization is consistent with a strong economy, economic progress, and "the good life" for most citizens.

In standard introductory microeconomics courses, we assume that firms attempt to maximize profits. In more advanced econ courses, the goal is broadened to value maximizing, so finance and economics are indeed consistent.

1-2 An agency relationship exists when one party (the principal) delegates authority to some other party (the agent). Stockholders delegate authority to managers, and debtholders delegate authority to stockholders (who act through managers). Any conflict between principals and agents is called an agency problem, or agency conflict. A good example of an agency conflict between stockholders and managers

Answers and Solutions: 1-1
is related to executive salaries. To some extent, top executives establish their own compensation, and if that compensation is "too high," it adversely affects stockholders.

The primary conflicts between stockholders and managers relate to (1) managerial compensation; (2) managerial perks; and (3) managerial effort. The compensation issue is obvious. Perks are less obvious, but they have the same effect as excessive salaries—they drain the firm's funds to the benefit of managers but not stockholders. The effort issue relates to managers taking too much time off for leisure activities, and also to serve (with compensation) on other corporate boards and the like.

Agency conflicts are really quite pervasive. They exist between many employees and their supervisors, and they certainly exist among government workers and perhaps especially between elected officials and the people who elected them.

Agency conflicts between stockholders and managers can obviously siphon off funds through excessive salaries and perks, and insufficient managerial effort. To deal with this, companies try to structure executive compensation so that managers do well if and when stockholders do well. This means that compensation is based in large part on operating performance and stock prices. In addition, "good" boards of directors consist largely of strong, independent, outside directors, who are not beholden to management, and who are willing and able to replace a managerial team that has not performed well.

Agency conflicts between stockholders (managers) and debtholders can also have bad consequences. Bondholders invest expecting the firm to invest in assets with a given degree of risk, and to finance with a given capital structure. If, after raising debt capital when the firm had low risk assets and a modest amount of debt, the firm then started selling low risk assets and redeploying capital into risky ventures, and borrowing extensively, then the risk of the outstanding debt would rise, and that would lead to a decline in its value. That might benefit the stockholders, because if the risky new ventures succeeded the stockholders would get most of the benefits, but if they failed, the bondholders would share fully in the losses—heads I win, tails you lose. If a firm develops a reputation for treating creditors shabbily, then it will find its access to capital markets limited, and the cost of any money it can borrow expensive. Also, creditors will (and should) build covenants into debt agreements that constrain the actions firms can take if those actions would adversely affect the creditors.