# Chapter 1

# The Goals and Functions of Financial Management

### Discussion Questions

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| 1-1. | How did the recession of 2007–2009 compare with other recessions since the Great Depression in terms of length?  It was the longest. |
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| 1-2. | What effect did the recession of 2007–2009 have on government regulation?  It was greatly increased. |
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| 1-3. | 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. |
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| 1-4. | 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. |
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| 1-5. | In a corporation, what group has the ultimate responsibility for protecting and managing the stockholders' interests?  The board of directors. |
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| 1-6. | What document is necessary to form a corporation?  The articles of incorporation. |
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| 1-7. | | 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. |
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| 1-8. | Why are institutional investors important in today's business world?  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. | |
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| 1-9. | 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. | |
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| 1-10. | 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. |
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| 1-11. | 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. |
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| 1-12. | 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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| 1-13. | | 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. |

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| 1-14. | What changes can take place under restructuring? In recent times, what group of investors has often forced restructuring to take place?  Restructuring can result in changes in the capital structure (liabilities and equity on the balance sheet). It can also result in the selling of low-profit-margin divisions with the proceeds reinvested in better investment opportunities, and sometimes restructuring results in the removal of the current management team or large reductions in the workforce. Restructuring has also included mergers and acquisitions.  Institutional investors have been very influential in forcing restructuring to take place in recent years. |
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| 1-15. | How did the Sarbanes–Oxley Act impact corporations’ financial reports?  The Sarbanes–Oxley Act of 2002 set up a five-member Public Company  Accounting Oversight Board with the responsibility for establishing auditing standards within companies, controlling the quality of audits, and setting rules and standards for the independence of the auditors. It also puts great responsibility on the internal audit committee of each publicly traded company to enforce compliance with the act. The major focus of the act is to make sure that publicly traded corporations accurately present their assets, liabilities, and equity and income on their financial statements. |
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| 1-16. | Name the departments, offices, or agencies that were created by the Dodd–Frank legislation.  1) The act created the Financial Stability Oversight Council within the Treasury Department.  2) The act created the Office of Financial Research within the Treasury Department.  3) Dodd–Frank established the Federal Insurance Office within the Treasury Department to oversee the insurance industry and streamline state-based insurance regulation.  4) The act created the Bureau of Consumer Financial Protection. The oversight given to the Bureau of Consumer Financial Protection allows it to dictate the fees that banks charge and the types of products they offer. |