

Solutions Manual

Fundamentals of Corporate Finance 13th edition
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CHAPTER 1

INTRODUCTION TO CORPORATE FINANCE

Answers to Concepts Review and Critical Thinking Questions

1. Capital budgeting (deciding whether to expand a manufacturing plant), capital structure (deciding whether to issue new equity and use the proceeds to retire outstanding debt), and working capital management (modifying the firm's credit collection policy with its customers).
2. Disadvantages: unlimited liability, limited life, difficulty in transferring ownership, difficulty in raising capital funds. Some advantages: simpler, less regulation, the owners are also the managers, sometimes personal tax rates are better than corporate tax rates.
3. The primary disadvantage of the corporate form is the double taxation to shareholders of distributed earnings and dividends. Some advantages include: limited liability, ease of transferability, ability to raise capital, and unlimited life.
4. In response to Sarbanes-Oxley, small firms have elected to go dark because of the costs of compliance. The costs to comply with Sarbox can be several million dollars, which can be a large percentage of a small firm's profits. A major cost of going dark is less access to capital. Since the firm is no longer publicly traded, it can no longer raise money in the public market. Although the company will still have access to bank loans and the private equity market, the costs associated with raising funds in these markets are usually higher than the costs of raising funds in the public market.
5. The treasurer's office and the controller's office are the two primary organizational groups that report directly to the chief financial officer. The controller's office handles cost and financial accounting, tax management, and management information systems, while the treasurer's office is responsible for cash and credit management, capital budgeting, and financial planning. Therefore, the study of corporate finance is concentrated within the treasury group's functions.
6. To maximize the current market value (share price) of the equity of the firm (whether it's publicly traded or not).
7. In the corporate form of ownership, the shareholders are the owners of the firm. The shareholders elect the directors of the corporation, who in turn appoint the firm's management. This separation of ownership from control in the corporate form of organization is what causes agency problems to exist. Management may act in its own or someone else's best interests, rather than those of the shareholders. If such events occur, they may contradict the goal of maximizing the share price of the equity of the firm.
8. A primary market transaction.

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9. In auction markets like the NYSE, brokers and agents meet at a physical location (the exchange) to match buyers and sellers of assets. Dealer markets like NASDAQ consist of dealers operating at dispersed locales who buy and sell assets themselves, communicating with other dealers either electronically or literally over-the-counter.
10. Such organizations frequently pursue social or political missions, so many different goals are conceivable. One goal that is often cited is revenue minimization; that is, provide whatever goods and services are offered at the lowest possible cost to society. A better approach might be to observe that even a not-for-profit business has equity. Thus, one answer is that the appropriate goal is to maximize the value of the equity.
11. Presumably, the current stock value reflects the risk, timing, and magnitude of all future cash flows, both short-term *and* long-term. If this is correct, then the statement is false.
12. An argument can be made either way. At the one extreme, we could argue that in a market economy, all of these things are priced. There is thus an optimal level of, for example, ethical and/or illegal behavior, and the framework of stock valuation explicitly includes these. At the other extreme, we could argue that these are noneconomic phenomena and are best handled through the political process. A classic (and highly relevant) thought question that illustrates this debate goes something like this: "A firm has estimated that the cost of improving the safety of one of its products is \$30 million. However, the firm believes that improving the safety of the product will only save \$20 million in product liability claims. What should the firm do?"
13. The goal will be the same, but the best course of action toward that goal may be different because of differing social, political, and economic institutions.
14. The goal of management should be to maximize the share price for the current shareholders. If management believes that it can improve the profitability of the firm so that the share price will exceed \$35, then they should fight the offer from the outside company. If management believes that this bidder or other unidentified bidders will actually pay more than \$35 per share to acquire the company, then they should still fight the offer. However, if the current management cannot increase the value of the firm beyond the bid price, and no other higher bids come in, then management is not acting in the interests of the shareholders by fighting the offer. Since current managers often lose their jobs when the corporation is acquired, poorly monitored managers have an incentive to fight corporate takeovers in situations such as this.
15. We would expect agency problems to be less severe in countries with a relatively small percentage of individual ownership. Fewer individual owners should reduce the number of diverse opinions concerning corporate goals. The high percentage of institutional ownership might lead to a higher degree of agreement between owners and managers on decisions concerning risky projects. In addition, institutions may be better able to implement effective monitoring mechanisms on managers than can individual owners, based on the institutions' deeper resources and experiences with their own management. The increase in institutional ownership of stock in the United States and the growing activism of these large shareholder groups may lead to a reduction in agency problems for U.S. corporations and a more efficient market for corporate control.

16. How much is too much? Who is worth more, Mark Parker or LeBron James? The simplest answer is that there is a market for executives just as there is for all types of labor. Executive compensation is the price that clears the market. The same is true for athletes and performers. Having said that, one aspect of executive compensation deserves comment. A primary reason executive compensation has grown so dramatically is that companies have increasingly moved to stock-based compensation. Such movement is obviously consistent with the attempt to better align stockholder and management interests. In recent years, stock prices have soared, so management has cleaned up. It is sometimes argued that much of this reward is due to rising stock prices in general, not managerial performance. Perhaps in the future, executive compensation will be designed to reward only differential performance, that is, stock price increases in excess of general market increases.
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CHAPTER 2

FINANCIAL STATEMENTS, TAXES, AND CASH FLOW

Answers to Concepts Review and Critical Thinking Questions

1. Liquidity measures how quickly and easily an asset can be converted to cash without significant loss in value. It's desirable for firms to have high liquidity so that they have a large factor of safety in meeting short-term creditor demands. However, since liquidity also has an opportunity cost associated with it—namely that higher returns can generally be found by investing the cash into productive assets—low liquidity levels are also desirable to the firm. It's up to the firm's financial management staff to find a reasonable compromise between these opposing needs.
2. The recognition and matching principles in financial accounting call for revenues, and the costs associated with producing those revenues, to be “booked” when the revenue process is essentially complete, not necessarily when the cash is collected or bills are paid. Note that this way is not necessarily correct; it's the way accountants have chosen to do it.
3. Historical costs can be objectively and precisely measured whereas market values can be difficult to estimate, and different analysts would come up with different numbers. Thus, there is a trade-off between relevance (market values) and objectivity (book values).
4. Depreciation is a noncash deduction that reflects adjustments made in asset book values in accordance with the matching principle in financial accounting. Interest expense is a cash outlay, but it's a financing cost, not an operating cost.
5. Market values can never be negative. Imagine a share of stock selling for $-\$20$. This would mean that if you placed an order for 100 shares, you would get the stock along with a check for \$2,000. How many shares do you want to buy? More generally, because of corporate and individual bankruptcy laws, net worth for a person or a corporation cannot be negative, implying that liabilities cannot exceed assets in market value.

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6. For a successful company that is rapidly expanding, for example, capital outlays will be large, possibly leading to negative cash flow from assets. In general, what matters is whether the money is spent wisely, not whether cash flow from assets is positive or negative.
7. It's probably not a good sign for an established company, but it would be fairly ordinary for a start-up, so it depends.
8. For example, if a company were to become more efficient in inventory management, the amount of inventory needed would decline. The same might be true if it becomes better at collecting its receivables. In general, anything that leads to a decline in ending NWC relative to beginning would have this effect. Negative net capital spending would mean that more long-lived assets were liquidated than purchased.
9. If a company raises more money from selling stock than it pays in dividends in a particular period, its cash flow to stockholders will be negative. If a company borrows more than it pays in interest, its cash flow to creditors will be negative.
10. The adjustments discussed were purely accounting changes; they had no cash flow or market value consequences unless the new accounting information caused stockholders to revalue the derivatives.
11. Enterprise value is the theoretical takeover price. In the event of a takeover, an acquirer would have to take on the company's debt but would pocket its cash. Enterprise value differs significantly from simple market capitalization in several ways, and it may be a more accurate representation of a firm's value. In a takeover, the value of a firm's debt would need to be paid by the buyer. Thus, enterprise value provides a much more accurate takeover valuation because it includes debt in its value calculation.
12. In general, it appears that investors prefer companies that have a steady earnings stream. If true, this encourages companies to manage earnings. Under GAAP, there are numerous choices for the way a company reports its financial statements. Although not the reason for the choices under GAAP, one outcome is the ability of a company to manage earnings, which is not an ethical decision. Even though earnings and cash flow are often related, earnings management should have little effect on cash flow (except for tax implications). If the market is "fooled" and prefers steady earnings, shareholder wealth can be increased, at least temporarily. However, given the questionable ethics of this practice, the company (and shareholders) will lose value if the practice is discovered.

Solutions to Questions and Problems

NOTE: All end of chapter problems were solved using a spreadsheet. Many problems require multiple steps. Due to space and readability constraints, when these intermediate steps are included in this solutions manual, rounding may appear to have occurred. However, the final answer for each problem is found without rounding during any step in the problem.

Basic

1. To find owners' equity, we must construct a balance sheet as follows:

<u>Balance Sheet</u>			
CA	\$ 5,400	CL	\$ 4,100
NFA	<u>28,100</u>	LTD	10,600
		OE	<u>??</u>
TA	<u>\$33,500</u>	TL & OE	<u>\$33,500</u>

We know that total liabilities and owners' equity (TL & OE) must equal total assets of \$33,500. We also know that TL & OE is equal to current liabilities plus long-term debt plus owners' equity, so owners' equity is:

$$\text{Owners' equity} = \$33,500 - 10,600 - 4,100$$

$$\text{Owners' equity} = \$18,800$$

And net working capital (NWC) is:

$$\text{NWC} = \text{CA} - \text{CL}$$

$$\text{NWC} = \$5,400 - 4,100$$

$$\text{NWC} = \$1,300$$

2. The income statement for the company is:

<u>Income Statement</u>	
Sales	\$742,000
Costs	316,000
Depreciation	<u>39,000</u>
EBIT	\$387,000
Interest	<u>34,000</u>
EBT	\$353,000
Taxes (21%)	<u>74,130</u>
Net income	<u>\$278,870</u>

3. One equation for net income is:

$$\text{Net income} = \text{Dividends} + \text{Addition to retained earnings}$$

Rearranging, we get:

$$\text{Addition to retained earnings} = \text{Net income} - \text{Dividends} = \$278,870 - 125,000 = \$153,870$$

4. $\text{EPS} = \text{Net income}/\text{Shares} = \$278,870/75,000 = \$3.72$ per share

$$\text{DPS} = \text{Dividends}/\text{Shares} = \$125,000/75,000 = \$1.67$$
 per share

5. $\text{Taxes} = .10(\$9,875) + .12(\$40,125 - 9,875) + .22(\$85,525 - 40,125) + .24(\$163,300 - 85,525) + .32(\$189,000 - 163,300)$
 $\text{Taxes} = \$41,495.50$

The average tax rate is the total tax paid divided by taxable income, so:

$$\text{Average tax rate} = \$41,495.50/\$189,000$$

$$\text{Average tax rate} = .2196, \text{ or } 21.96\%$$

The marginal tax rate is the tax rate on the next \$1 of earnings, so the marginal tax rate is 32 percent.

6. To calculate OCF, we first need the income statement:

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<u>Income Statement</u>	
Sales	\$49,800
Costs	23,700
Depreciation	<u>2,300</u>
EBIT	\$23,800
Interest	<u>1,800</u>
Taxable income	\$22,000
Taxes (22%)	<u>4,840</u>
Net income	<u>\$17,160</u>

$$\text{OCF} = \text{EBIT} + \text{Depreciation} - \text{Taxes}$$

$$\text{OCF} = \$23,800 + 2,300 - 4,840$$

$$\text{OCF} = \$21,260$$

7. Net capital spending = $\text{NFA}_{\text{end}} - \text{NFA}_{\text{beg}} + \text{Depreciation}$
 Net capital spending = $\$3,100,000 - 2,300,000 + 327,000$
 Net capital spending = $\$1,127,000$
8. Change in NWC = $\text{NWC}_{\text{end}} - \text{NWC}_{\text{beg}}$
 Change in NWC = $(\text{CA}_{\text{end}} - \text{CL}_{\text{end}}) - (\text{CA}_{\text{beg}} - \text{CL}_{\text{beg}})$
 Change in NWC = $(\$5,970 - 3,240) - (\$5,320 - 2,510)$
 Change in NWC = $\$2,730 - 2,810$
 Change in NWC = $-\$80$
9. Cash flow to creditors = Interest paid – Net new borrowing
 Cash flow to creditors = Interest paid – $(\text{LTD}_{\text{end}} - \text{LTD}_{\text{beg}})$
 Cash flow to creditors = $\$305,000 - (\$2,660,000 - 2,250,000)$
 Cash flow to creditors = $-\$105,000$
10. Cash flow to stockholders = Dividends paid – Net new equity
 Cash flow to stockholders = Dividends paid – $[(\text{Common}_{\text{end}} + \text{APIS}_{\text{end}}) - (\text{Common}_{\text{beg}} + \text{APIS}_{\text{beg}})]$
 Cash flow to stockholders = $\$654,000 - [(\$965,000 + 5,040,000) - (\$780,000 + 4,780,000)]$
 Cash flow to stockholders = $\$209,000$

Note, APIS is the additional paid-in surplus.

11. Cash flow from assets = Cash flow to creditors + Cash flow to stockholders
 = $-\$105,000 + 209,000 = \$104,000$

$$\begin{aligned} \text{Cash flow from assets} &= \$104,000 = \text{OCF} - \text{Change in NWC} - \text{Net capital spending} \\ &= \$104,000 = \text{OCF} - (-\$55,000) - 1,500,000 \end{aligned}$$

$$\text{Operating cash flow} = \$104,000 - 55,000 + 1,500,000$$

$$\text{Operating cash flow} = \$1,549,000$$

Intermediate

12. To find the book value of current assets, we use: $\text{NWC} = \text{CA} - \text{CL}$. Rearranging to solve for current assets, we get:

$$\text{CA} = \text{NWC} + \text{CL}$$

$$\begin{aligned} \text{CA} &= \$275,000 + 945,000 \\ \text{CA} &= \$1,220,000 \end{aligned}$$

The market value of current assets and fixed assets is given, so:

Book value CA	= \$1,220,000	Market value NWC	= \$1,250,000
Book value NFA	= <u>3,500,000</u>	Market value NFA	= <u>5,400,000</u>
Book value assets	= <u>\$4,720,000</u>	Total	= <u>\$6,650,000</u>

13. To find the OCF, we first calculate net income.

<u>Income Statement</u>	
Sales	\$336,000
Costs	194,700
Other expenses	9,800
Depreciation	<u>20,600</u>
EBIT	\$110,900
Interest	<u>14,200</u>
Taxable income	\$96,700
Taxes	<u>21,275</u>
Net income	<u>\$ 75,425</u>
Dividends	\$21,450
Additions to RE	\$53,975

- a. $\text{OCF} = \text{EBIT} + \text{Depreciation} - \text{Taxes}$
 $\text{OCF} = \$110,900 + 20,600 - 21,275$
 $\text{OCF} = \$110,225$
- b. $\text{CFC} = \text{Interest} - \text{Net new LTD}$
 $\text{CFC} = \$14,200 - (-5,400)$
 $\text{CFC} = \$19,600$

Note that the net new long-term debt is negative because the company repaid part of its long-term debt.

- c. $\text{CFS} = \text{Dividends} - \text{Net new equity}$
 $\text{CFS} = \$21,450 - 7,100$
 $\text{CFS} = \$14,350$
- d. We know that $\text{CFA} = \text{CFC} + \text{CFS}$, so:

$$\begin{aligned} \text{CFA} &= \$19,600 + 14,350 \\ \text{CFA} &= \$33,950 \end{aligned}$$

CFA is also equal to $\text{OCF} - \text{Net capital spending} - \text{Change in NWC}$. We already know OCF. Net capital spending is equal to:

$$\begin{aligned} \text{Net capital spending} &= \text{Increase in NFA} + \text{Depreciation} \\ \text{Net capital spending} &= \$53,200 + 20,600 \\ \text{Net capital spending} &= \$73,800 \end{aligned}$$