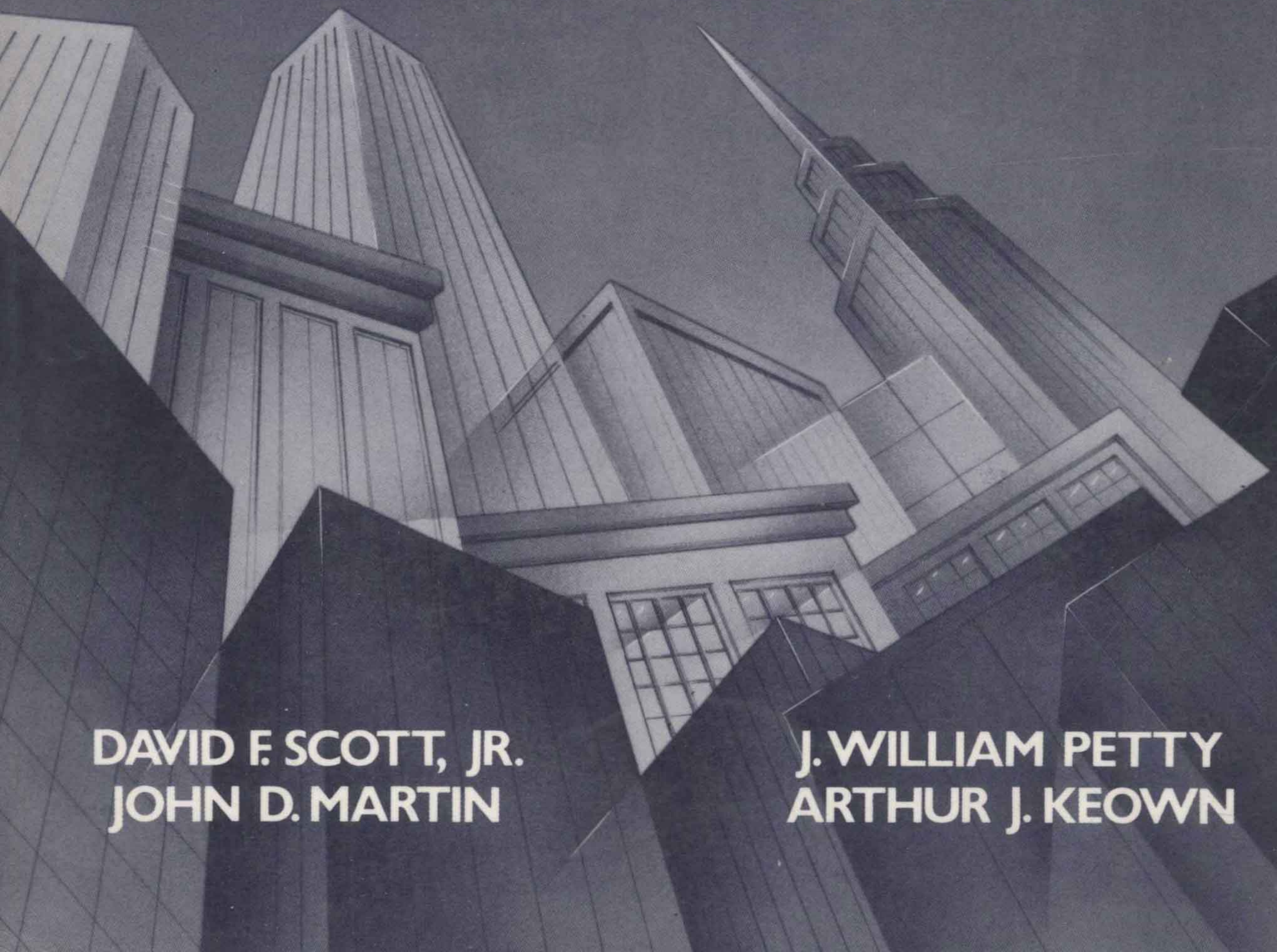
STUDY GUIDE

BASIC FINANCIAL MANAGEMENT

FOURTH EDITION



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Basic Financial Management

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PREFACE

The objective of this Study Guide is to provide a student-oriented supplement to <u>Basic Financial Management</u>. There are two basic ways in which we have attempted to accomplish that end. The first involves providing a condensation of each chapter in the form of a detailed sentence outline. This overview of the key points of the chapter can serve both as a preview and quick survey of the chapter content and as a review. A second way in which we have attempted to accomplish our overall objective is through providing problems (with detailed solutions) and self-tests which can be used to aid in the preparation of outside assignments and in studying for examinations. The problems were keyed to the end-of-chapter problems in the text in order to provide a direct and meaningful student aid. Both multiple-choice and true-false questions are used to provide a self-test over the descriptive chapter material. The outline, problems and solutions, and self-tests combined provide what we believe is a valuable learning tool for the student of financial management.

CONTENTS

1

The Role of Financial Management

<u>Orientation</u>: The role of the financial manager has undergone dramatic changes during this century. Currently the financial manager has a major voice in all aspects of both the raising and allocation of financial capital. This chapter focuses on the development of financial thought, the goal of the firm, the financial decision-making process and a brief preview of the book.

I. Development of financial thought

A. To a large extent, the economic and business activity of the time determined what was of primary importance in the field of finance.

1. During the early 1900's financial and economic news emphasized consolidations, mergers, and public regulation. Thus, these topics received the majority of attention in the field of finance.

2. As the economy began to expand in the 1920's emphasis in finance shifted to methods and procedures for acquiring funds.

3. The business failures of the 1930's caused an increased emphasis to be placed on bankruptcy, liquidity management, and avoidance of financial problems.

4. During the 1940's and early 1950's an increased emphasis was given to liquidity management and cash budgeting.

B. While the economic environment continued to affect financial thought, many factors together helped to bring about dramatic changes in the mid-1950's. During this time the field of finance evolved to one dealing with all aspects of acquiring and efficiently utilizing those funds.

C. The field of finance continues to develop, being reshaped by economic activity, primarily increased inflationary worries, and new theoretical developments.

II. Goal of the firm

A. In this book we will designate maximization of shareholder wealth, by which we mean maximization of the total market value of the firm's common stock, to be the goal of the firm. To understand this goal and its inclusive nature it is first necessary to understand the difficulties involved with the frequently suggested goal of profit maximization.

B. While the goal of profit maximization stresses the efficient use of capital resources, it assumes away many of the complexities of the real world and for this reason is unacceptable.

1. One of the major criticisms of profit maximization is that it assumes away uncertainty of returns. That is, projects are compared by examining their expected values or weighted average profit.

2. Profit maximization is also criticized because it assumes away timing differences of returns.

C. Profit maximization is unacceptable and a more realistic goal is needed.

III. Maximization of shareholder wealth

A. We have chosen the goal of shareholder wealth maximization because the effects of all financial decisions are included in this goal.

B. In order to employ this goal we need not consider every price change to be a market interpretation of the worth of our decisions. What we do focus on is the effect that our decision <u>should</u> have on the stock price if everything were held constant.

C. The agency problem is a result of the separation between the decision makers and the owners of the firm. As a result managers may make decisions that are not in line with the goal of maximization of shareholder wealth.

IV. Financial decisions and risk-return relationships

A. Almost all financial decisions involve some sort of risk-return tradeoff.

B. In general, the more risk the firm is willing to assume, the higher will be the expected return from the given course of action.

Self-Tests

TRUE-FALSE

_____ 1. Profit maximization is considered to be a more appropriate goal than shareholder wealth maximization because it considers the timing of the expected returns of the firm.

_____ 2. Shareholder wealth maximization considers the effects of the riskiness of a prospective earnings stream.

_____ 3. Originally, the role of the financial manager of a firm was very extensive (covering many areas of the firm); recently, however, the manager's responsibilities have been narrowed so that he or she might devote more time to raising funds.

_____ 4. Two major criticisms of the profit maximization goal are that it does not deal adequately with the uncertainty and the timing of returns.

_____ 5. Historically, economic activity and business activity have strongly affected the development of financial thought.

_____ 6. During the mid-1950's the point of view of finance shifted from that of an insider charged with the management and control of the firm's operations to that of an outsider assessing the condition and performance of a firm.

_____ 7. In general, the less risk a firm is willing to assume, the higher the expected return will be from a given course of action.

_____ 8. Business failures of the 1930's caused an increased emphasis to be placed on bankruptcy, liquidity management, and avoidance of financial problems.

_____ 9. The business expansion of the 1920's caused a shift in the emphasis in finance from mergers and regulation to methods and procedures for acquiring funds.

_____ 10. In order to employ the goal of shareholder wealth maximization, every stock price change should be considered to be a market interpretation of the worth of our financial decisions.

_____ 11. The agency problem is a result of a separation of management and the owners of the firm.

MULTIPLE CHOICE

1. The long-run goal of the firm is to

   a. Hold large quantities of cash.
   b. Increase sales regularly.
   c. Maximize earnings per share.
   d. Maximize shareholder wealth.

2. Maximizing shareholder wealth means maximizing the

   a. Value of the firm's assets.
   b. Value of the firm's cash.
   c. Value of the firm's investments.
   d. Value of the firm's profits.
   e. Market value of the firm's common stock.

3. The financial manager is concerned with which of the following

   a. Determining the proper amount of funds to employ in the firm.
   b. Seeing that the financial statements of the firm are properly presented.
   c. Raising funds for the firm on the most favorable terms possible.
   d. a and b.
   e. a and c.

4. Important functions of financial management are

   a. To provide for adequate financing.
   b. Long-range planning.
   c. To control costs.
   d. To identify desirable investment projects.
   e. All of the above.

5. Profit maximization is not the proper objective of a firm because

   a. It is not as inclusive a goal as the maximization of shareholder wealth.
   b. It does not consider the uncertainty of the return.
   c. It does not consider the timing of the returns.
   d. All of the above.
   e. None of the above.

6. The market price of a share of stock is determined by

   a. The New York Stock Exchange.
   b. The Federal Reserve.
   c. The company's management.
   d. Individuals buying and selling the stock.

7. The management of working capital deals with

   a. The management of long-term assets.
   b. The management of long-term liabilities.
   c. The management of current assets.
   d. All of the above.
   e. None of the above.

8. The agency problem is:

   a. Associated with insuring the firm.
   b. No longer important.
   c. Invalidates the goal of maximization of shareholder wealth.
   d. Is a result of the separation of the decision makers and the owners of the firm.
   f. All of the above.

2

Legal Forms of Organization and the Tax Environment

Orientation: The objective of this chapter is to afford the student a familiarity with the legal setting in which the firm operates. In this regard, the basic forms of business organization are reviewed. Also, a highlight of the basic tax implications relating to financial decisions is given consideration.

I. Legal forms of business organization

A. Sole proprietorship: A business owned by a single person and that has a minimum amount of legal structure.

1. Advantages

a. Easily established with few complications.
b. Minimal organizational costs.
c. Does not have to share profits or control with others.

2. Disadvantages

a. Unlimited liability for the owner.
b. Owner must absorb all losses.
c. Equity capital limited to the owner's personal investment.
d. Business terminates immediately upon death of owner.

B. Partnership: An association of two or more individuals coming together as co-owners to operate a business for profit.

1. Two types of partnerships

a. General partnership: Relationship between partners is dictated by the partnership agreement.

(1) Advantages

(a) Minimal organizational requirements.
(b) Negligible government regulations.

(2) Disadvantages

(a) All partners have unlimited liability.
(b) Difficult to raise large amounts of capital.
(c) Partnership dissolved by the death or withdrawal of general partner.

b. Limited partnership

(1) Advantages

(a) For the limited partners, liability is limited to the amount of capital invested in the company.
(b) Withdrawal or death of a limited partner does not affect the continuity of the business.
(c) Stronger inducement in raising capital.

(2) Disadvantages

(a) There must be at least one general partner who has unlimited liability in the partnership.
(b) Names of limited partners may not appear in the name of the firm.
(c) Limited partners may not participate in the management of the business.

(d) More expensive to organize than general partnership, as a written agreement is mandatory.

C. The corporation: An "impersonal" legal entity having the power to purchase, sell, and own assets and to incur liabilities while existing separately and apart from its owners.

1. Ownership is evidenced by shares of stock.

2. Advantages

a. Limited liability of owners.
b. Ease of transferability of ownership, i.e., by the sale of one's shares of stock.
c. The death of an owner does not result in the discontinuity of the firm's life.
d. Ability to raise large amounts of capital is increased.

3. Disadvantages

a. Most difficult and expensive form of business to establish.
b. Control of corporation not guaranteed by partial ownership of stock.

II. Federal income taxation

A. Objectives of federal income taxation

1. Provide government revenues.
2. Achieve socially desirable goals.
3. Stabilize the economy

B. Income taxes for sole proprietorship

1. All income and expenses for the business are reported on the owner's personal income tax forms.
2. Taxation of the business income is the same as for the owner's personal income.

C. Income taxes for partnerships

1. Partnership tax return reports every transaction that has a tax consequence and allocates the transactions as specified by the partnership agreement.

2. The individual partners report their portions of the partnership income within their personal tax returns.

D. Income taxes for corporations

1. A tax return must be filed and the resulting taxes paid by the corporation.
2. Taxable income is basically determined as income less allowable exclusions and tax deductible expenses.
3. Eighty percent of any dividends received from another corporation are tax exempt.
4. Dividends paid by the corporation to its stockholders are not tax deductible.
5. Corporate rate structure:

15%	\$0 - 50,000
25%	\$50,001 - 75,000
34%	\$75,001 - 100,000
39%	\$100,001 - 335,000
34%	\$335,001 and over

6. Depreciation

a. For assets acquired prior to 1981, two depreciation methods, among others, may be used for tax purposes.

(1) Straight-line.
(2) Double-declining balance.

b. For assets acquired in 1981 or later, the Accelerated Cost Recovery Systems, ACRS, should be used.

(1) Allows for a more rapid depreciation schedule.
(2) Assigns property to a 3, 5, 10, or 15-year property class.
(3) Allows for the alternative use of straight-line depreciation.

c. Effective January 1, 1987 the Accelerated Cost Recovery System, ACRS, was modified to include:

(1) The Asset Depreciation Range
(2) The method of depreciation
(3) The averaging convention

d. There are two averaging conventions based upon the type of asset being depreciated:

(1) Half-year convention
(2) Mid-month convention

7. Net operating loss: If a corporation has an operating loss in any year, the loss may be applied against the profits in the 3 prior years. If the loss has not been completely absorbed by the profits in these 3 years, the loss may be carried forward to each of the 15 following years.

8. If after deducting all capital gains and capital losses the company has a net capital loss, such losses may be carried back for 3 years and forward for 5 years to offset any capital gains occurring during those periods.

9. Accumulated earnings tax is a penalty surtax assessed on the corporation on any accumulation of earnings by a corporation for the purpose of avoiding taxes by its shareholders.

10. Subchapter S corporation

a. Subchapter S of the Internal Revenue Code permits the owners of a small corporation with 35 or fewer stockholders to use the corporation organizational form but be taxed as though the firm were a partnership.
b. This treatment eliminates the double taxation normally associated with the corporate entity, yet provides limited personal liability and other favorable features of the corporate structure.
c. This provision became even more important in 1987 when individual tax rates fell below corporate tax rates.

D. Implications of taxes in financial decision making

1. Taxes and capital investment decisions

a. When a plant or equipment acquisition is being considered, the returns from the investment should be measured on an after-tax basis using the marginal not average tax rate in the computations.

b. The depreciation method will have an impact on the timing of taxes.

c. The estimated salvage value also may have a tax impact; the greater the anticipated salvage value, the less the amount of annual depreciation charges.

2. Taxes and the firm's capital structure: The tax deductibility of interest payments gives debt financing a definite cost advantage over preferred and common stock financing.

3. Taxes and corporate dividend policies: The differential tax treatment for the firm's common stockholders might influence the firm's preference between stock price appreciation, i.e., capital gains for the investor, and dividends, i.e., ordinary income for the investor.

Study Problems

1. A corporation had $145,000 in taxable earnings. What is the tax liability?

SOLUTION

Income		Marginal Tax Rate	Tax Liability
$ 50,000	X	15%	$ 7,500
25,000	X	25%	6,250
25,000	X	34%	8,500
45,000	X	39%	17,550
$145,000		Total tax liability =	$39,800

2. A corporation has earnings before interest and taxes of $86,000, dividend income of $8,000, and interest expenses of $9,000. Also, a contribution to a university was made in the amount of $1,000. What is the corporation's (a) taxable income and (b) tax liability?

SOLUTION

(a)

Operating income		$86,000
Dividend income	$8,000	
Dividend exclusion		
80% X $8,000	(6,400)	
Taxable dividend income		1,600
Interest expense		(9,000)
Contribution		(1,000)
Taxable income		$77,600

(b)	15%	X	$50,000	=	$ 7,500	
	25%	X	25,000	=	6,250	
	34%	X	2,600	=	884	
			$77,600		$14,634	= Tax liability

3. The taxable income of Broghm Corporation is as follows (losses are shown in parentheses):

1982	$(125,000)
1983	150,000
1984	300,000
1985	(150,000)
1986	(20,000)
1987	350,000
1988	400,000

What is Broghm's tax payment or tax refund in each year?

SOLUTION

Year	Taxable Income Before Carry-Back or Carry-Forward	Tax Payment	Carry-Back	Carry-Forward	Tax Refunds
1982	$(125,000)	$ 0			
1983	150,000	3,750	$ 25,000 from 1985	$125,000 from 1982	
1984	300,000	100,250	$125,000 from 1985 $ 20,000 from 1986		
1985	(150,000)	0			$55,250[a]
1986	(20,000)	0			7,800[b]
1987	350,000	119,000			
1988	400,000	136,000			

[a] 1985 refund = $3,750 (1980 taxes) + $51,500 (correction of 1984 taxes from $300,000 to $175,000).

[b] 1986 refund = $7,800 (correction of 1984 taxes from $175,000 to $155,000).

Self-Tests

TRUE-FALSE

_____ 1. Many businesses are formed as corporations because of the ease of establishment.