Chapter 1: The Corporation and the Financial Manager

7. A firm might cut its labor force dramatically which could reduce immediate expenses and increase profits in the short term. Over the long term, however, the firm might not be able to serve its customers properly or it might alienate its remaining workers; if so, future profits will decrease, and the stock price will decrease in anticipation of these problems.

   Similarly, a firm can boost profits over the short term by using less costly materials even if this reduces the quality of the product. Once customers catch on, sales will decrease and profits will fall in the future. The stock price will fall.

   The moral of these examples is that, because stock prices reflect present *and future* profitability, the firm should not necessarily sacrifice future prospects for short-term gains.

8. Agency costs are caused by conflicts of interest between managers and shareholders, the owners of the firm. In most large corporations, the principals (i.e., the stockholders) hire the agents (i.e., managers) to act on behalf of the principals in making many of the major decisions affecting the corporation and its owners. However, it is unrealistic to believe that the agents' actions will always be consistent with the objectives that the stockholders would like to achieve. Managers may choose not to work hard enough, to over-compensate themselves, to engage in empire building, to over-consume perquisites, and so on.

   Corporations use numerous arrangements in an attempt to ensure that managers' actions are consistent with stockholders' objectives. Agency costs can be mitigated by 'carrots,' linking the manager's compensation to the success of the firm, or by 'sticks,' creating an environment in which poorly performing managers can be removed.

12. The responsibilities of the treasurer include the following: supervises cash management, raising capital, and banking relationships.
    The controller's responsibilities include: supervises accounting, preparation of financial statements, and tax matters.
    The CFO of a large corporation supervises both the treasurer and the controller. The CFO is responsible for large-scale corporate planning and financial policy.

14. *Double taxation* means that a corporation's income is taxed first at the corporate tax rate, and then, when the income is distributed to shareholders as dividends, the income is taxed again at the shareholder's personal tax rate.

16. a. Increased market share can be an inappropriate goal if it requires reducing prices to such an extent that the firm is harmed financially. Increasing market share *can* be part of a well-reasoned strategy, but one should always remember that market share is not a goal in itself. The owners of the firm want managers to maximize the value of their investment in the firm.

b. Minimizing costs can also conflict with the goal of value maximization. For example, suppose a firm receives a large order for a product. The firm should be willing to pay overtime wages and to incur other costs in order to fulfill the order, as long as it can sell the additional product at a price greater than those costs. Even though costs per unit of output increase, the firm still comes out ahead if it agrees to fill the order.

c. A policy of underpricing any competitor can lead the firm to sell goods at a price lower than the price that would maximize market value. Again, in some situations, this strategy might make sense, but it should not be the ultimate goal of the firm. It should be evaluated with respect to its effect on firm value.

d. Expanding profits is a poorly defined goal of the firm. The text gives three reasons:

(i) There may be a trade-off between accounting profits in one year versus accounting profits in another year. For example, writing off a bad investment may reduce this year's profits but increase profits in future years. Which year's profits should be maximized?

(ii) Investing more in the firm can increase profits, even if the increase in profits is insufficient to justify the additional investment. In this case the increased investment increases profits, but can reduce shareholder wealth.

(iii) Profits can be affected by accounting rules, so a decision that increases profits using one set of rules may reduce profits using another.

20. a. A fixed salary means that compensation is (at least in the short run) independent of the firm's success.

b. A salary linked to profits ties the employee's compensation to this measure of the success of the firm. However, profits are not a wholly reliable way to measure the success of the firm. The text points out that profits are subject to differing accounting rules, and reflect only the current year's situation rather than the long-run prospects of the firm.

c. A salary that is paid partly in the form of the company's shares means that the manager earns the most when the shareholders' wealth is maximized. This is therefore most likely to align the interests of managers and shareholders.