

BUSN3049 Corporate Finance

Tutorial 1

1. What are the three types of financial management decisions? For each type of decision, give an example of a business transaction that would be relevant.

Answer

Capital budgeting (deciding on 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. What goal should always motivate the actions of the firm's financial manager?

Answer

The financial manager is the person responsible for making decisions in the interest of shareholders of a firm. The financial manager of a firm should be motivated to make good financial management decisions. The goal to maximise the current market value (share price) of the equity of the firm (whether it's publicly traded or not) always motivates the actions of the firm's financial manager.

3. Who owns a corporation? Describe the process whereby the owners control the firm's management. What is the main reason that an agency relationship exists in the corporate form of organization? In this context, what kinds of problems can arise?

Answer

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 organisation 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 maximising the share price of the equity of the firm.

4. Suppose you own stock in a company. The current price per share is \$25. Another company has just announced that it wants to buy your company and will pay \$35 per share to acquire all the outstanding stock. Your company's management immediately begins fighting off this hostile bid. Is management acting in the shareholders' best interest? Why or why not?

Answer

The goal of management should be to maximise 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 one.