Chapter 1
Corporate Finance and the Financial Manager

Note: A box (■) indicates problems available in MyFinanceLab.

1. A corporation is a legal entity separate from its owners. This means ownership shares in the corporation can be freely traded. None of the other organizational forms share this characteristic.

2. Owners' liability is limited to the amount they invested in the firm. Stockholders are not responsible for any encumbrances of the firm; in particular, they cannot be required to pay back any debts the incurred by the firm.

3. Corporations and limited liability companies. Limited partnerships provide limited liability for the limited partners, but not for the general partners.

4. **Advantages:** Limited liability, liquidity, infinite life
Disadvantages: Double taxation, separation of ownership and control

5. C corporations must pay corporate income taxes; S corporations do not pay corporate taxes but must pass on the income to shareholders to whom it is taxable. S corporations are also limited to 75 shareholders and cannot have corporate or foreign stockholders.

6. First the corporation pays the taxes. After taxes, $\$2 \times (1 - 0.4) = \$1.20$ is left to pay dividends. Once the dividend is paid, personal tax on this must be paid leaving $\$1.20 \times (1 - 0.3) = \$0.84$. So after all the taxes are paid, you are left with 84¢.

7. An S corporation does not pay corporate income tax. So it distributes \$2 to its stockholders. These stockholders must then pay personal income tax on the distribution. So they are left with $\$2 \times (1 - 0.3) = \$1.40$.

8. The investment decision is the most important decision that a financial manager makes, as the manager must decide how to put the owners' money to its best use.

9. The goal of maximizing shareholder wealth is agreed upon by all shareholders because all shareholders are better off when this goal is achieved.

10. **Shareholders can:**
    a. Ensure that employees are paid with company stock and/or stock options.
    b. Ensure that underperforming managers are fired.
    c. Write contracts that ensure that the interests of the managers and shareholders are closely aligned.
    d. Mount hostile takeovers.

11. When your parents pay for the meal, you benefit from the food but do not take on the cost of the food. This is similar to the agency problem in corporations, when managers can benefit from taking actions in their own personal interests using money that belongs to shareholders.

12. The agent (renter) will not take the same care of the apartment as the principal (owner), because the renter does not share in the costs of fixing damage to the apartment. To mitigate this problem, having the renter pay a deposit would motivate the renter to keep damages to a minimum. The deposit forces the renter to share in the costs of fixing any problems that are caused by the renter.

13. There is an ethical dilemma when the CEO of a firm has opposite incentives to those of the shareholders. In this case, you (as the CEO) have an incentive to potentially overpay for another company (which would be damaging to your shareholders) because your pay and prestige will improve.

14. The shares of a public corporation are traded on an exchange (or “over the counter” in an electronic trading system) while the shares of a private corporation are not traded on a public exchange.

15. A primary market is where the company sells shares of itself to investors. The secondary market is where investors can buy and/or sell the company’s shares with other investors (but not the company itself).

16. Investors always buy at the ask and sell at the bid. Since ask prices always exceed bid prices, investors “lose” this difference. It is one of the costs of transacting. Since the market makers take the other side of the trade, they make up this difference.

17. You would buy at $26.95 and sell for $26.91.