

# Corporations: finance, forms, ethics assignment

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a. Why is corporate finance important to all managers? Answer: Corporate finance provides the skills managers need to: (1) identify and select the corporate strategies and individual projects that add value to their firm; and (2) forecast the funding requirements of their company, and devise strategies for acquiring those funds. b. Describe the organizational forms a company might have as it evolves from a start-up to a major corporation. List the advantages and disadvantages of each form.

Answer: The three main forms of business organization are (1) sole proprietorships, (2) partnerships, and (3) corporations. In addition, several hybrid forms are gaining popularity. These hybrid forms are the limited partnership, the limited liability partnership, the professional corporation, and the s corporation. The proprietorship has three important advantages: (1) it is easily and inexpensively formed, (2) it is subject to few government regulations, and (3) the business pays no corporate income taxes.

The proprietorship also has three important limitations: (1) it is difficult for a proprietorship to obtain large sums of capital; (2) the proprietor has unlimited personal liability for the business's debts, and (3) the life of a business organized as a proprietorship is limited to the life of the individual who created it. The major advantage of a partnership is its low cost and ease of formation. The disadvantages are similar to those associated with proprietorships: (1) unlimited liability, (2) limited life of the organization, (3) difficulty of transferring ownership, and (4) difficulty of raising large amounts of capital.

The tax treatment of a partnership is similar to that for proprietorships, which is often an advantage. The corporate form of business has three major advantages: (1) unlimited life, (2) easy transferability of ownership interest, and (3) limited liability. While the corporate form offers significant advantages over proprietorships and partnerships, it does have two primary disadvantages: (1) corporate earnings may be subject to double taxation and (2) setting up a corporation and filing the many required state and federal reports is more complex and time-consuming than for a proprietorship or a partnership.

In a limited partnership, the limited partners are liable only for the amount of their investment in the partnership; however, the limited partners typically have no control. The limited liability partnership form of organization combines the limited liability advantage of a corporation with the tax advantages of a partnership. Professional corporations provide most of the benefits of incorporation but do not relieve the participants of professional liability. S corporations are similar in many ways to limited liability partnerships, but LLPS frequently offer more flexibility and benefits to their owners. c.

How do corporations “ go public” and continue to grow? What are agency problems? What is corporate governance? Answer: A company goes public when it sells stock to the public in an initial public as the firm grows, it might issue additional stock or debt. An agency problem occurs when the managers of the firm act in their own self interests and not in the interests of the shareholders. Corporate governance is the set of rules that control a company’s behavior towards its directors, managers, employees,  
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shareholders, creditors, customers, competitors, and community. d. What should be the primary objective of managers?

Answer: The corporation's primary goal is stockholder wealth maximization, which translates to maximizing the price of the firm's common stock. d. 1.

Do firms have any responsibilities to society at large? Answer: Firms have an ethical responsibility to provide a safe working environment, to avoid polluting the air or water, and to produce safe products. However, the most significant cost-increasing actions will have to be put on a mandatory rather than a voluntary basis to ensure that the burden falls uniformly on all businesses. d. 2. Is stock price maximization good or bad for society?

Answer: The same actions that maximize stock prices also benefit society. Stock price maximization requires efficient, low-cost operations that produce high-quality goods and services at the lowest possible cost. Stock price maximization requires the development of products and services that consumers want and need, so the profit motive leads to new technology, to new products, and to new jobs. Also, stock price maximization necessitates efficient and courteous service, adequate stocks of merchandise, and well-located business establishments—factors that are all necessary to make sales, which are necessary for profits. . 3. Should firms behave ethically?

Answer: Yes. Results of a recent study indicate that the executives of most major firms in the United States believe that firms do try to maintain high ethical standards in all of their business dealings. Furthermore, most executives believe that there is a positive correlation between ethics and long-run profitability. Conflicts often arise between profits and ethics.

Companies must deal with these conflicts on a regular basis, and a failure to

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handle the situation properly can lead to huge product liability suits and even to bankruptcy.

There is no room for unethical behavior in the business world. e. What three aspects of cash flows affect the value of any investment? Answer: (1) amount of expected cash flows; (2) timing of the cash flow stream; and (3) riskiness of the cash flows. f. What are free cash flows? Answer: free cash flows are the cash flows available for distribution to all investors (stockholders and creditors) after paying expenses (including taxes) and making the necessary investments to support growth.

$FCF = \text{sales revenues} - \text{operating costs} - \text{operating taxes} - \text{required investments in operating capital}$ . g. What is the weighted average cost of capital? Answer: The weighted average cost of capital (WACC) is the average rate of return required by all of the company's investors (stockholders and creditors). It is affected by the firm's capital structure, interest rates, the firm's risk, and the market's overall attitude toward risk. h. How do free cash flows and the weighted average cost of capital interact to determine a firm's value?

Answer: A firm's value is the sum of all future expected free cash flows, converted into today's dollars. i. Who are the providers (savers) and users (borrowers) of capital? How is capital transferred between savers and borrowers? Answer: Households are net savers. Non-financial corporations are net borrowers. Governments are net borrowers, although the U. S. government is a net saver when it runs a surplus. Non-financial corporations

(i. e. , financial intermediaries) are slightly net borrowers, but they are almost breakeven.

Capital is transferred through: (1) direct transfer (e. g. , corporation issues commercial paper to insurance company); (2) an investment banking house (e. g. , IPO, seasoned equity offering, or debt placement); (3) a financial intermediary (e. g. , individual deposits money in bank, bank makes commercial loan to a company). j. What do we call the price that a borrower must pay for debt capital? What is the price of equity capital? What are the four most fundamental factors that affect the cost of money, or the general level of interest rates, in the economy?

Answer: The interest rate is the price paid for borrowed capital, while the return on equity capital comes in the form of dividends plus capital gains. The return that investors require on capital depends on (1) production opportunities, (2) time preferences for consumption, (3) risk, and (4) inflation. Production opportunities refer to the returns that are available from investment in productive assets: the more productive a producer firm believes its assets will be, the more it will be willing to pay for the capital necessary to acquire those assets.

Time preference for consumption refers to consumers' preferences for current consumption versus savings for future consumption: consumers with low preferences for current consumption will be willing to lend at a lower rate than consumers with a high preference for current consumption. Inflation refers to the tendency of prices to rise, and the higher the expected rate of inflation, the larger the required rate of return. Risk, in a money and capital

market context, refers to the chance that the future cash flows will not be as high as expected—the higher the perceived default risk, the higher the required rate of return.

Risk is also linked to the maturity and liquidity of a security. The longer the maturity and the less liquid (marketable) the security, the higher the required rate of return, other things constant. k. What are some economic conditions that affect the cost of money? Answer: The cost of money will be influenced by such things as fed policy, fiscal deficits, business activity, and foreign trade deficits. The cost of money for an international investment is also affected by country risk, which refers to the risk that arises from investing or doing business in a particular country.

This risk depends on the country's economic, political, and social environment. Country risk also includes the risk that property will be expropriated without adequate compensation, as well as new host country stipulations about local production, sourcing or hiring practices, and damage or destruction of facilities due to internal strife. The cost of money for an international investment is also affected by exchange rate risk. When investing overseas the security usually will be denominated in a currency other than the dollar, which means that the value of the investment will depend on what happens to exchange rates.

Changes in relative inflation or interest rates will lead to changes in exchange rates. International trade deficits/surpluses affect exchange rates. Also, an increase in country risk will also cause the country's currency to fall. l. What are financial securities? Describe some financial instruments.

Answer: Financial assets are pieces of paper with contractual obligations.

Some short-term (i. e. , they mature in less than a year) are instruments with low default risk are u. s. treasury bills, banker's acceptances, commercial paper, negotiable CDs, and eurodollar deposits.

Commercial loans (which have maturities up to seven years) have rates that are usually tied to the prime rate (i. e. , the rate that U. S. banks charge to their best customers) or LIBOR (the London Interbank Offered Rate, which is the rate that banks in the U. K. charge one another. U. S. treasury notes and bonds have maturities from two to thirty years; they are free of default risk. Mortgages have maturities up to thirty years. Municipal bonds have maturities of up to thirty years; their interest is exempt from most taxes. Corporate bonds have maturities up to forty years.

Municipal and corporate bonds are subject to default risk. Some preferred stocks have no maturity date, some do have a specific maturity date.

Common stock has no maturity date, and is riskier than preferred stock. m.

List some financial institutions. Answer: Commercial banks, savings & loans, mutual savings banks, and credit unions, life insurance companies, mutual funds, pension funds, hedge funds, and private equity funds are financial institutions or institutional investors. n. What are some different types of markets? Answer: A market is a method of exchanging one asset (usually cash) for another asset.

Some types of markets are: physical assets vs. financial assets; spot versus future markets; money versus capital markets; primary versus secondary markets. o. How are secondary markets organized? Answer: They are

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categorized by “ location” (physical location exchanges or computer/telephone networks) and by the way that orders from buyers and sellers are matched (open outcry auctions, dealers (i. e. , market makers), and electronic communications networks (ECNS)). o. 1. List some physical location markets and some computer/telephone networks.

Answer: Physical location exchanges include the NYSE, AMEX, CBOT, and Tokyo stock exchange. Computer/telephone networks include Nasdaq, government bond markets, and foreign exchange markets. o. 2. Explain the differences between open outcry auctions, dealer markets, and electronic communications networks (ECNS). Answer: The NYSE and AMEX are the two largest auction markets for stocks (NYSE is a modified auction, with a “ specialist”). Participants have a seat (or trading rights) on the exchange, meet face-to-face, and place orders for themselves or for their clients; e. . , CBOT. Some orders are market orders, which are executed at the current market price, some are limit orders, which specify that the trade should occur only at a certain price within a certain time period (or the trade does not occur at all). In dealer markets, “ dealers” keep an inventory of the stock (or other financial asset) and place bid and ask “ advertisements,” which are prices at which they are willing to buy and sell. A computerized quotation system keeps track of bid and ask prices, but does not automatically match buyers and sellers.

Some examples of dealer markets are the Nasdaq national market, the Nasdaq small cap market, the London SEAQ, and the German Neuer market. ECNS are computerized systems that match orders from buyers and sellers and automatically execute the trades. Some examples are Instinet (US, <https://assignbuster.com/corporations-finance-forms-ethics-assignment/>

stocks, owned by Nasdaq); Archipelago (US, stocks, owned by NYSE); Eurex (Swiss-German, futures contracts), sets (London, stocks). In the old days, securities were kept in a safe behind the counter, and passed “ over the counter” when they were sold.

Now the OTC market is the equivalent of a computer bulletin board, which allows potential buyers and sellers to post an offer. However, the OTC has no dealers and very poor liquidity. p. Briefly explain mortgage securitization and how it contributed to the global economic crisis. Answer: Homeowners wanted better homes than they could afford. Mortgage brokers encouraged homeowners to take mortgages that would reset to payments that the borrowers might not be able to pay because the brokers got a commission for closing the deal.

Appraisers thought the real estate boom would continue and over-appraised house values, getting paid at the time of the appraisal. Originating institutions (like Countrywide) quickly sold the mortgages to investment banks and other institutions. Investment banks created CDOs and got rating agencies to help design and then rate the new CDOs, with rating agencies making big profits despite conflicts of interest. Financial engineers used unrealistic inputs to generate high values for the CDOs. Investment banks sold the CDOs to investors and made big profits.

Investors bought the CDOs but either didn't understand or care about the risk. Some investors bought “ insurance” via credit default swaps. When mortgages reset and borrowers defaulted, the values of CDOs plummeted. Many of the credit default swaps failed to provide insurance because the

counterparty failed. Many originators and securitizers still owned sub-prime securities, which led to many bankruptcies, government takeovers, and fire sales, including New Century, Countrywide, IndyMac, Northern Rock, Fannie Mae, Freddie Mac, Bear Stearns, Lehman Brothers, and Merrill Lynch.