Modigliani and miller’s theory

Science

INTRODUCTION:

Many quarters believe that the earnings power of a firms assets is a priority in their decision -making activities. In fact, this is what Modigliani and Miller advocate. Many people have their own biases in making their decision whether to invest in company A or in Company B listed in the London stock exchange. Some people make decisions to invest in stocks just for the fun of it. The following paragraphs explain in detail the reasons behind the logic of Modigliani and Miller's theory.

BODY:

Modigliani and Miller rightfully argued that it is the earnings power of a firm's asset which affect value and all other decisions are irrelevant. The stockholders of the company would put additionalmoneyinto the business if its assets generates profits. Further, the stockholder do not give priority if the company sets up a new branch in uncharted territory. Also, the suppliers base their terms on the company's profits. In addition, the creditors will base their loan cap on the company's profits. And, the managers will need the financial statements to determine if they did well.

And, the managers will need the financial statements to determine if they did well. Plus, the employees will apply for salary increases if profits permit. And, the customers need the income statement to determine how long the company can supply their needs. Plus, many companies window dress to falsely show they are generating profits. As proof, Enron's income statement was window dressed. Further, Enron's assets were fraudulently window -dressed to show it generated profits.

Also, Enron and Arthur Andersen knew that recording fictitious sales and profits would increase stockholder investments. Furthermore, the WorldCom and Enron accounting scandals are two of the reasons that triggered the approval of the Sabarnes -Oxley Law.

The stockholders of the company would put additional money into the business if its assets generates profits. The stockholders are part owners of the company. Their company share of the equity depends on the number of shares they buy. In turn, the also receive their shares' worth of the company's profits. Company profits are distributed in the form of dividends. The stockholders are hopeful that the company will generate profits. This is the primary and even the only objective of many stockholders.

The stockholder would be better of if they sell their stocks if the company does not generate profits for the past year or years of operation. The current stockholders may even infuse additional money in the company it generates profits. Definitely, the stockholders of the company would put additional money into the business if its assets generate profits. Convincingly, the stockholders of the company would put additional money into the business if its assets generates profits (Roy 1997, 84).

Further, the stockholders do not give priority if the company sets up a new branch in uncharted territory. As discussed above, profit is the bottom line of business transactions. the stockholders will not care if the company sets up a new branch in Germany or a new factory in India. This is trivial as compared to stockholder' determining if the new branch or factory will be able to generate profits for the company. All the more, many of the

stockholders would be too busy to read through the company's detailed plans for the setting up of the new branch.

Some of the stockholders would not care whether the branch manager is an accountant or a lawyer. Many of the stockholder will not waste their time determining if the branch manager installed two or four or seven factory equipments. All the stockholders care about is whether he or she can earn dividend money from the setting up of the new branch or factory. Evidently, the stockholders do not give priority if the company sets up a new branch in uncharted territory (Roe 2000, 539).

Also, the suppliers base their terms on the company's profits. The suppliers are determined to get a company of the company's income statement. His main goal is to know if the company had generated profits for the past year or years of business operations. The suppliers know that businesses that generates profits consistently for two or more years will generally not close shop in the near future. On the other hand, suppliers fear that companies have been on the red for two or more consecutive years have a high probability of shutting down operations.

On the red is a technical term that means generating net loss. The supplier would increase their production because it knows that its client has been generating profits for the past year or years of operations. On the other hand, the supplier would try to search for another client to replace its current client who is in the red. Surely, the suppliers base their terms on the company's profits (Sorensen, and Kyle 2007).

In addition, the creditors will base the loan cap on the company's profits. Creditors are in the business to make money. Creditors prefer to loan money to individuals and persons who will be able to dish out the payments when the collection agent knocks on the credit client's door. Many creditors would require the loan applicant to present an income tax return, and incomes statement, a collateral before releasing the money to their credit client. Banks are very good examples of credit facilities.

The creditors may grant small loan amounts if the loan applicant has only a low net take home pay. The creditors would grant a higher loan amount to companies that show that they a higher net income. The creditors would surely grant a higher loan amount to credit applicants if they present an income statement indicating they are earning huge profits. In the same manner, the creditor can give a high value loan to the credit client if the client furnishes the creditor a collateral for equal to or more than the amount of the loan applied for.

A collateral is an asset that will take the place of the loan amount in case the credit client will not be able to pay for the loan when the due date for the payment arrives. The collateral transaction is a safer loan transaction than a loan that is based on the character of the person applying for the loan. Perfectly, the creditors will base the loan cap on the company's profits (Amernic, and Robb 2003).

And, the managers will need the financial statements to determine if they did well. The managers will use the income statement as the benchmark for their jobs performance. The marketing manager knows he has done well if his group has generated sales way above the monthly quotas that have been

predetermined in the monthly departmental brainstorming. The manager will use the income statement to determine which product has sold the most. The manager will also need the income statement to determine which product name generated the least sales volume for the month or months of operation.

The manager will also use the income statement to determine who generated the highest sales volume for the month, quarter or year. The manager will interested also to know the marketing representative that he or she will fire for not reaching the sales quota for two or more months. The manager needs to get a copy of the income statement to determine how much he or she should be allowed to increase in terms of advertising and promotion cash outflows.

The manage needs the income statement to determine which products to increase in terms of volume and which products to reduce time selling because of there is a lesser demand for such products. Indisputably, the managers will need the financial statements to determine if Plus, the employees will apply for salary increases if profits permit. All employees would love to hear his or her superior state that there will be a ten percent increase in per hour salaries. However, some managers try to control the company's operating expenses. One such operating expenses is the salary expense. The managers will try to prevent the employee's request for salary increase as long as possible.

The employees would like to get a copy of the company's income statement. They would like to know if the company generated profits for the past year or years of operation. The employees will use the income statement as the

basis for their clamor for management to increase their salaries. On the other hand, management will try their best to hide the income statement from the prying eyes of their employees in the guise of confidentiality. Many employees band themselves together as a labor union. The labor union will be a stronger voice in term of requesting the management of the company to increase their take home pay.

The labor union may call for a sit down or stop work strike to press their demands for better working wages and conditions. Their claim would be bolder and reasonable if they present to management a copy of the income statements stating that the company has been wallowing deep in profits for the past year or years of operations while the employees are earning the minimum per hour wage. Obviously, the employees will apply for salary increases if profits permit (Huy 2002).

And, the customers need the income statement to determine how long the company can supply their needs. The customers also have their preferences. Many of the customer prefer to buy one product and discard the idea of even touching a competing product. Customers are influenced by the price of the product. Many customers prefer to buy products that are cheaper but have almost similar quality. Many customers prefer to buy high quality expensive products. Other customers are not interested in the price of the product but on the products' usefulness.

Other customers prefer to buy products that are more accessible. Some customers feel that it is more costly in terms of transportation cost and time lost if he or she buys a cheaper product in another city than buying it at the community grocery. Going back, the customers need the income statement

to know if their favorite store, grocery or establishment will not close down within the year or two. The income statement showing a loss would create caution on the customers.

For, the customer may wake up one day and see the store, grocery or establishment padlocked due to bankruptcy. The customers need to know the income statement of the company in order to prepare for the worst. the worst here is the customer has to trek to another city to buy his products because the company has closed its doors to the public. Unquestionably, the customers need the income statement to determine how long the company can supply their needs (John 2003, 15).

Plus, many companies window dress to falsely show they are generating profits. Window dressing is described as presenting a more beautiful picture of the company than what is actual picture. This situation can be best described as a store displaying on its windows the best selling products of the company in order to entice the store passers -by to enter the store and buy the displayed products. usually, the window -displayed products are the low -priced ones. This is what happened to Enron and WorldCom. Evidently, many companies window dress to falsely show they are generating profits (Fox 2003, 247).

As proof, Enron's income statement was window dressed. The company had recorded sales transactions that had never happened. Consequently, these fraudulent transactions would translate to higher sales. Higher sales would give a higher net income. a higher net income would give us a higher net assets. a higher sales would generate a higher stockholders' equity. In addition, the company did not record some of its losses.

Enron had fraudulently window -dressed by presenting these Enron losses as losses of its off -shore companies. as a result, the unrecorded losses resulted to a net income that is higher than what the real net income should be. Convincingly, Enron's income statement was window dressed (Fusaro, and Miller 2002, 107).

Further, Enron's assets were fraudulently window -dressed to show it generated profits. Enron's balance sheet falsely presented its assets to be more than what they actually are. The increase in assets was done by recording fictitious sales and profits generated from the assets. This enticed the wall street prospective investors of Enron to invest more of their hard - earned money on this fraud -laden company.

The window dressing occurred because Enron recorded sales in its accounting books even though there were no actual sales transacted. A sales transaction would give us a credit to revenues or sales. Thus, the assets were inflated from the debits to an cash or accounts receivable accounts for sales that never happened. This violates the United States generally accepted accounting principles that asset like cash and receivables should be recorded only if an exchange transaction takes place. Clearly, Enron's business assets were window -dressed to show it generated profits (Chandra, Ettredge, and Stone 2006).

Also, Enron and Arthur Andersen knew that recording fictitious sales and profits would increase stockholder investments. Enron and Arthur Andersen knew that recording fictitious sales and profits would increase stockholder investments. The senior management officers connived with the accounting officers of Enron to prepare the fraud -ladenfinancial statementin complete

violation the harmonization standards set by violating the international accounting standards accomplish this fraudulent goal. Clearly, Enron and Arthur Andersen knew that recording fictitious sales and profits would increase stockholder investments (Madrick 2002).

Further, the final outcome was that both Enron and its external auditing firm finally were charged in court and had to dissolve their business. The ending of this real -life story showed that that Enron finally shut down its business. The officers and employees of Enron were responsible for falsification for window -dressing their income statements to show that the company generated profits were charged in court. The external auditors of Enron, Arthur Andersen, fell out of the top five auditing firms after their part in the fraud.

For, Arthur Andersen had lost the trust and confidence of the government, the general public and the other direct and indirect users of the financial statements. All external auditors are paid auditing fees to give an unbiased audit opinion on the financial statements. Generally, the auditors give credence to the financial statements specifically in terms of generating real business profits. Evidently, the final outcome was that both Enron and its external auditing firm finally were charged in court and had to dissolve their business (Thomas 2002).

Furthermore, the WorldCom and Enron accounting scandals are two of the reasons that triggered the approval of the Sabarnes -Oxley Law. The company was a communications company that had risen to profitability during the 1990s. However, the company found its profitability had slowly declined in the early 2000s. This is the largest accounting scandal in history.

The officers of WorldCom entered tried to window dress their stock market price. The company's stock market price had decreased because company profits started to decline.

The officers, specifically CEO Bernie Ebbers and CPA Scott Sullivan had to prepare false financial statements indicating that their sale and profits were higher than the real sales and profits would show in order to stave the decline of its stock market share price Zekany, Braun, and Warder 2004).

Similar to Enron, the company's external auditor, Arthur Andersen, did not comply with generally accepted auditing standards to prevent or curtail material misstatements of the income statement and the corresponding balance sheet. The WorldCom fraudulent activities occurred from 1999 to 2002. Convincingly, the WorldCom and Enron accounting scandals are two of the reasons that triggered the approval of the Sabarnes -Oxley Law (Stack 2003).

CONCLUSION:

Modigliani and Miller rightfully argued that it is the earnings power of a firm's asset which affect value and all other decisions are irrelevant. Convincingly, the stockholders of the company would put additional money into the business if its assets generates profits. Evidently, the stockholders do not give priority if the company sets up a new branch in uncharted territory. Surely, the suppliers base their terms on the company's profits. Perfectly, the creditors will base the loan cap on the company's profits.

Unquestionably, the customers need the income statement to determine how long the company can supply their needs. Evidently, many companies

window dress to falsely show they are generating profits. Convincingly, Enron's income statement was window dressed. Clearly, Enron's business assets were window -dressed to show it generated profits. Clearly, Enron and Arthur Andersen knew that recording fictitious sales and profits would increase stockholder investments.

Evidently, the final outcome was that both Enron and its external auditing firm finally were charged in court and had to dissolve their business. Convincingly, the WorldCom and Enron accounting scandals are two of the reasons that triggered the approval of the Sabarnes -Oxley Law. Conclusively, Modigliani and Miller rightfully argued that it is the earnings power of a firm's asset which affect value and all other decisions are irrelevant.

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