Chapter 2: The Objective

1. (e) The objective of decision making in corporate finance is to maximize firm value/stock prices.

2. (e) For maximization of stock prices to be the sole objective in decision making, and to be socially desirable, all of the assumptions must hold true.

3. There is a conflict of interest between stockholders and managers. In theory, stockholders are expected to exercise control over managers through the annual meeting or the board of directors. In practice, why might these disciplinary mechanisms not work?
Ans. Directors are too closely connected to management. Furthermore, they have insufficient incentives to devote time and attention to the problems of the company. The annual meeting is also not a good disciplinary mechanism because small shareholders simply do not have the time, incentives and resources to take on management.

4. Stockholders can transfer wealth from bondholders through a variety of actions. How would the following actions by stockholders transfer wealth from bondholders?
a. An increase in dividends: this would reduce the value of the assets that implicitly serve as collateral for the promised payments to debtholders.
b. A leveraged buyout would compromise the wealth of existing debtholders by increasing the leverage of the company and creating new debtholders who would have a claim of equal priority on the firm's assets.
3. Acquiring a risky business would expose the firm's bondholders to greater risk of default, while not increasing their upside potential. This would reduce the market value of existing debt. Unless the new business were seriously overvalued, this would effectively transfer wealth from bondholders to stockholders.

Bondholders could protect themselves against such actions by inserting covenants into the bond contract controlling and limiting the ability of stockholders to take such actions.

5. Financial market prices are much too volatile for financial markets to be efficient. Comment.
Ans. Efficiency in financial markets refers to their ability to aggregate and incorporate relevant information into prices. If information generated by analysts is itself inherently volatile, financial market prices will also tend to be volatile. If markets correct themselves quickly, the volatility should not, by itself, lead to poor financial decisions.

6. Maximizing stock prices does not make sense because investors focus on short-term results, and not on the long-term consequences. Comment.
Ans. There are two parts to this statement. The first is that investors are short term in their focus. The empirical evidence is mixed on this. While there is evidence that some investors focus on the short term, markets seem to react favorably to investment and research announcement, which might have negative short term effects but positive long

term consequences. This would suggest that markets are much more long term than most people give them credit for. Second, even if investors were in fact short term, it is still possible that firms that focus on creating long term value will be treated fairly by investors. That is, investors having short time horizons does not necessarily translate into reward for companies that focus on short term results.

7. There are some corporate strategists who have suggested that firms focus on maximizing market share rather than market prices. When might this strategy work, and when might it fail?
Ans. If we assume that the real underlying objective of the firm is to maximize value, be it firm value or stockholder wealth, a focus on market share can only be thought of as a interim strategic objective. Firms will need to re-evaluate the focus on market share, when the cost of pursuing market share is too high in terms of firm value. As an interim objective, market share might make more sense to the extent that managers can relate the implications of their policies more easily to market share, rather than stock price.

8. Antitakeover amendments can be in the best interest of stockholders. Under what conditions is this likely to be true?
Ans. Corporate raiders can use devices such as two-tier tender offers to capture all the gains from a potential takeover for themselves. Antitakeover amendments by making it more difficult for such raiders to buy up the firm's stock cheaply can improve stockholders' bargaining power. If, however, these amendments make it too costly to takeover a firm, the effect on stockholder wealth would be deleterious, because it would reduce the incentive for managers to work in the interest of stockholders.