CHAPTER 2:
THE OBJECTIVE FUNCTION IN CORPORATE FINANCE

2-1. The objective of decision making in corporate finance is
(e)to maximize firm value / stock prices.

2-2. For maximization of stock prices to be the sole objective in decision making, and to be socially desirable, the following assumption or assumptions have to hold true.
(e)All of the above.

2-3. 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?

Annual Meeting: Stockholders may not show up at annual meetings or be provided with enough information to have effective oversight over incumbent management. In addition, the corporate charter is often tilted to provide incumbent managers with the advantage, if there is a context at the annual meeting.

Board of Directors: Directors are often chosen by the incumbent managers (rather than by stockholders), own few shares and lack the expertise/information to ask tough questions of incumbent managers.

2-4. Stockholders can transfer wealth from bondholders through a variety of actions. How would the following actions by stockholders transfer wealth from bondholders?

An increase in dividends: Make existing debt riskier and reduce its value. Bondholders can protect themselves by constraining dividend policy.

A leveraged buyout: If the existing debt is not refinanced at the “new” interest rate, existing bondholders will find the value of their holdings are lower after the LBO. Bondholders can protect themselves by inserting protective puts into their debt, allowing them to put the bonds back to the firm and receive face value.

Acquiring a risky business: If a risky business is acquired, existing bondholders may find themselves worse off since the underlying debt is now riskier. Bondholders can protect themselves by restricting investment policy.

2-5. Financial market prices are much too volatile, for financial markets to be efficient. Comment.

The fact that markets are volatile, by itself, does not imply that they are not efficient. If the underlying value of the investments traded in the market is changing a lot from period to period, prices should be volatile. Even if the underlying value is not moving as much as prices are, the fact that markets make mistakes (which is what the noise is) does not imply that the prices are not unbiased estimates of value.

2-6. Maximizing stock prices does not make sense because investors focus on short-term results, and not on the long term consequences. Comment.

The empirical evidence does not support the notion that all investors focus on short- term results. In particular, the evidence that high growth stocks are able to command high price-earnings multiples, and that stock prices go up, on average, on the announcement of R&D and major investments can be viewed as consistent with a market where some investors at least focus on the long term.

2-7. Some corporate strategists have suggested that firms focus on maximizing market share rather than market prices. When might this strategy work, and when might it fail?

This strategy is likely to work if higher market share leads to higher profits and cash flows in the long term. If, on the other hand, the higher market share is obtained by cutting prices and sacrificing long-term profitability, the strategy is unlikely to work.

2-8. Anti-takeover amendments can be in the best interests of stockholders. Under what conditions is this likely to be true?

If the incumbent management is efficient and runs the firm for the benefit of existing stockholders, anti-takeover amendments will help in two ways –

- it may relieve them of the distraction of unwanted takeover attempts and allow them to focus on maximizing cash flows and value, and
- it may allow incumbent managers to extract a much higher price in the case of a hostile takeover.