

INTRODUCTION TO CORPORATE FINANCE

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With millions or even billions of dollars at stake, disagreement over the direction and control of a corporation can lead to an acrimonious battle. In 2006, such a dispute took place at famed ketchup-maker H.J. Heinz. Nelson Peltz, who owned 5.5 percent of H.J. Heinz's stock, attempted to get five new members elected to Heinz's board of directors.

One of the then-current board members Peltz wanted to replace was Pete Coors of the Coors beer family. Mr. Peltz wanted Mr. Coors removed for several reasons. For example, Mr. Coors and William Johnson, the CEO of Heinz, were both members of the Augusta National Golf Club and both served on the board of the Grocery Manufacturers Association. Mr. Peltz felt these relationships were inappropriate because Mr. Coors also served on the management compensation committee of H.J. Heinz's board and thus helped determine Mr. Johnson's salary.

Directors are elected by the shareholders of a corporation. In a particularly heated battle for votes, H.J. Heinz was reported to have spent over \$12 million promoting the re-election of its current board of directors. When the votes were counted, Mr. Peltz's candidates won two of the five board seats they sought, including the one held by Mr. Coors.

Understanding the fight for board seats at H.J. Heinz takes us into issues involving the corporate form of organization, corporate goals, and corporate controls, all of which we cover in this chapter.

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Overview of Corporate Finance PART 1

To begin our study of modern corporate finance and financial management, we need to address two central issues. First, what is corporate finance and what is the role of the financial manager in the corporation? Second, what is the goal of financial management? To describe the financial management environment, we consider the corporate form of organization and discuss some conflicts that can arise within the corporation. We also take a brief look at financial markets in the United States.

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1.1 Corporate Finance and the Financial Manager

In this section, we discuss where the financial manager fits in the corporation. We start by defining *corporate finance* and the financial manager's job.

WHAT IS CORPORATE FINANCE?

Imagine that you were to start your own business. No matter what type you started, you would have to answer the following three questions in some form or another:

1. What long-term investments should you take on? That is, what lines of business will you be in and what sorts of buildings, machinery, and equipment will you need?
2. Where will you get the long-term financing to pay for your investment? Will you bring in other owners or will you borrow the money?
3. How will you manage your everyday financial activities such as collecting from customers and paying suppliers?

These are not the only questions by any means, but they are among the most important. Corporate finance, broadly speaking, is the study of ways to answer these three questions. Accordingly, we'll be looking at each of them in the chapters ahead.

THE FINANCIAL MANAGER

A striking feature of large corporations is that the owners (the stockholders) are usually not directly involved in making business decisions, particularly on a day-to-day basis. Instead, the corporation employs managers to represent the owners' interests and make decisions on their behalf. In a large corporation, the financial manager would be in charge of answering the three questions we raised in the preceding section.

The financial management function is usually associated with a top officer of the firm, such as a vice president of finance or some other chief financial officer (CFO). Figure 1.1 is a simplified organizational chart that highlights the finance activity in a large firm. As shown, the vice president of finance coordinates the activities of the treasurer and the controller. The controller's office handles cost and financial accounting, tax payments, and management information systems. The treasurer's office is responsible for managing the firm's cash and credit, its financial planning, and its capital expenditures. These treasury activities are all related to the three general questions raised earlier, and the chapters ahead deal primarily with these issues. Our study thus bears mostly on activities usually associated with the treasurer's office.

FINANCIAL MANAGEMENT DECISIONS

As the preceding discussion suggests, the financial manager must be concerned with three basic types of questions. We consider these in greater detail next.

Capital Budgeting The first question concerns the firm's long-term investments. The process of planning and managing a firm's long-term investments is called **capital budgeting**. In capital budgeting, the financial manager tries to identify investment opportunities that are worth more to the firm than they cost to acquire. Loosely speaking, this means that the value of the cash flow generated by an asset exceeds the cost of that asset.



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For current issues facing CFOs, see www.cfo.com.

capital budgeting

The process of planning and managing a firm's long-term investments.

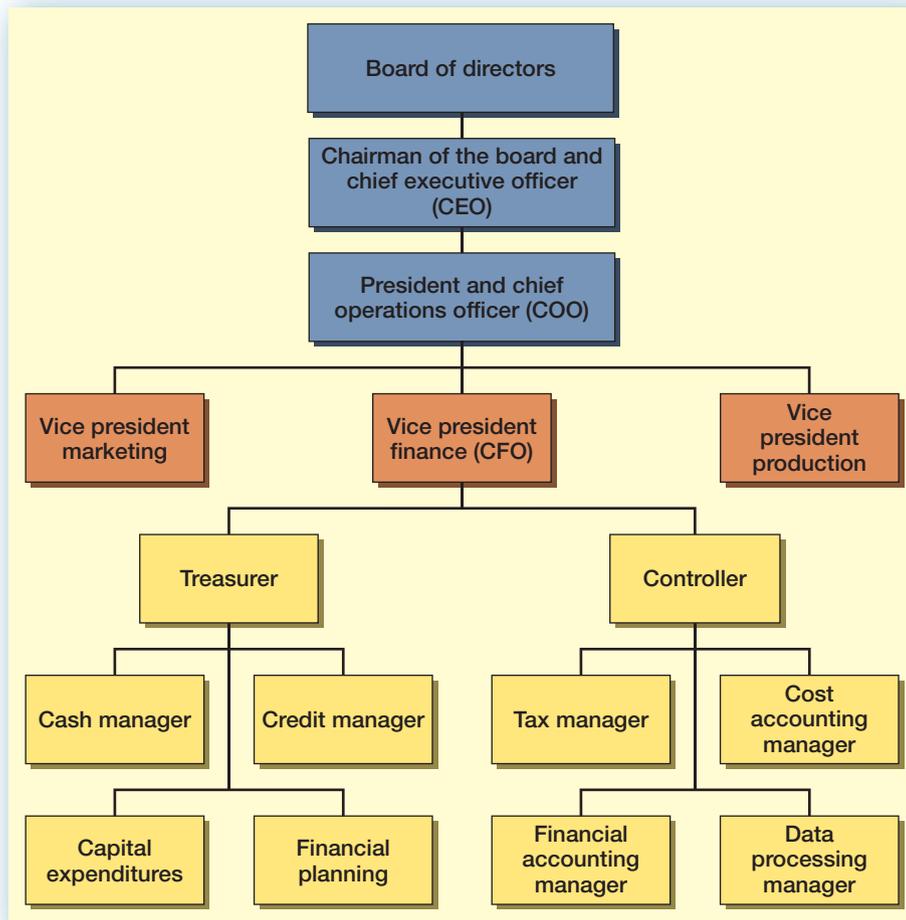


FIGURE 1.1

A Sample Simplified Organizational Chart

The types of investment opportunities that would typically be considered depend in part on the nature of the firm's business. For example, for a large retailer such as Wal-Mart, deciding whether to open another store would be an important capital budgeting decision. Similarly, for a software company such as Oracle or Microsoft, the decision to develop and market a new spreadsheet would be a major capital budgeting decision. Some decisions, such as what type of computer system to purchase, might not depend so much on a particular line of business.

Regardless of the specific nature of an opportunity under consideration, financial managers must be concerned not only with how much cash they expect to receive, but also with when they expect to receive it and how likely they are to receive it. Evaluating the *size*, *timing*, and *risk* of future cash flows is the essence of capital budgeting. In fact, as we will see in the chapters ahead, whenever we evaluate a business decision, the size, timing, and risk of the cash flows will be by far the most important things we will consider.

Capital Structure The second question for the financial manager concerns ways in which the firm obtains and manages the long-term financing it needs to support its long-term investments. A firm's **capital structure** (or financial structure) is the specific mixture of long-term debt and equity the firm uses to finance its operations. The financial manager

capital structure

The mixture of debt and equity maintained by a firm.

has two concerns in this area. First, how much should the firm borrow? That is, what mixture of debt and equity is best? The mixture chosen will affect both the risk and the value of the firm. Second, what are the least expensive sources of funds for the firm?

If we picture the firm as a pie, then the firm's capital structure determines how that pie is sliced—in other words, what percentage of the firm's cash flow goes to creditors and what percentage goes to shareholders. Firms have a great deal of flexibility in choosing a financial structure. The question of whether one structure is better than any other for a particular firm is the heart of the capital structure issue.

In addition to deciding on the financing mix, the financial manager has to decide exactly how and where to raise the money. The expenses associated with raising long-term financing can be considerable, so different possibilities must be carefully evaluated. Also, corporations borrow money from a variety of lenders in a number of different, and sometimes exotic, ways. Choosing among lenders and among loan types is another job handled by the financial manager.

working capital

A firm's short-term assets and liabilities.

Working Capital Management The third question concerns **working capital** management. The term *working capital* refers to a firm's short-term assets, such as inventory, and its short-term liabilities, such as money owed to suppliers. Managing the firm's working capital is a day-to-day activity that ensures that the firm has sufficient resources to continue its operations and avoid costly interruptions. This involves a number of activities related to the firm's receipt and disbursement of cash.

Some questions about working capital that must be answered are the following: (1) How much cash and inventory should we keep on hand? (2) Should we sell on credit? If so, what terms will we offer, and to whom will we extend them? (3) How will we obtain any needed short-term financing? Will we purchase on credit or will we borrow in the short term and pay cash? If we borrow in the short term, how and where should we do it? These are just a small sample of the issues that arise in managing a firm's working capital.

Conclusion The three areas of corporate financial management we have described—capital budgeting, capital structure, and working capital management—are very broad categories. Each includes a rich variety of topics, and we have indicated only a few questions that arise in the different areas. The chapters ahead contain greater detail.

Concept Questions

- 1.1a What is the capital budgeting decision?
- 1.1b What do you call the specific mixture of long-term debt and equity that a firm chooses to use?
- 1.1c Into what category of financial management does cash management fall?

1.2 Forms of Business Organization

Large firms in the United States, such as Ford and Microsoft, are almost all organized as corporations. We examine the three different legal forms of business organization—sole proprietorship, partnership, and corporation—to see why this is so. Each form has distinct advantages and disadvantages for the life of the business, the ability of the business to raise cash, and taxes. A key observation is that as a firm grows, the advantages of the corporate form may come to outweigh the disadvantages.

SOLE PROPRIETORSHIP

A **sole proprietorship** is a business owned by one person. This is the simplest type of business to start and is the least regulated form of organization. Depending on where you live, you might be able to start a proprietorship by doing little more than getting a business license and opening your doors. For this reason, there are more proprietorships than any other type of business, and many businesses that later become large corporations start out as small proprietorships.

The owner of a sole proprietorship keeps all the profits. That's the good news. The bad news is that the owner has *unlimited liability* for business debts. This means that creditors can look beyond business assets to the proprietor's personal assets for payment. Similarly, there is no distinction between personal and business income, so all business income is taxed as personal income.

The life of a sole proprietorship is limited to the owner's life span, and the amount of equity that can be raised is limited to the amount of the proprietor's personal wealth. This limitation often means that the business is unable to exploit new opportunities because of insufficient capital. Ownership of a sole proprietorship may be difficult to transfer because this transfer requires the sale of the entire business to a new owner.

sole proprietorship

A business owned by a single individual.



For more information about forms of business organization, see the "Small Business" section at www.nolo.com.

PARTNERSHIP

A **partnership** is similar to a proprietorship except that there are two or more owners (partners). In a *general partnership*, all the partners share in gains or losses, and all have unlimited liability for *all* partnership debts, not just some particular share. The way partnership gains (and losses) are divided is described in the *partnership agreement*. This agreement can be an informal oral agreement, such as "let's start a lawn mowing business," or a lengthy, formal written document.

In a *limited partnership*, one or more *general partners* will run the business and have unlimited liability, but there will be one or more *limited partners* who will not actively participate in the business. A limited partner's liability for business debts is limited to the amount that partner contributes to the partnership. This form of organization is common in real estate ventures, for example.

The advantages and disadvantages of a partnership are basically the same as those of a proprietorship. Partnerships based on a relatively informal agreement are easy and inexpensive to form. General partners have unlimited liability for partnership debts, and the partnership terminates when a general partner wishes to sell out or dies. All income is taxed as personal income to the partners, and the amount of equity that can be raised is limited to the partners' combined wealth. Ownership of a general partnership is not easily transferred because a transfer requires that a new partnership be formed. A limited partner's interest can be sold without dissolving the partnership, but finding a buyer may be difficult.

Because a partner in a general partnership can be held responsible for all partnership debts, having a written agreement is very important. Failure to spell out the rights and duties of the partners frequently leads to misunderstandings later on. Also, if you are a limited partner, you must not become deeply involved in business decisions unless you are willing to assume the obligations of a general partner. The reason is that if things go badly, you may be deemed to be a general partner even though you say you are a limited partner.

Based on our discussion, the primary disadvantages of sole proprietorships and partnerships as forms of business organization are (1) unlimited liability for business debts on the part of the owners, (2) limited life of the business, and (3) difficulty of transferring ownership. These three disadvantages add up to a single, central problem: the ability of such businesses to grow can be seriously limited by an inability to raise cash for investment.

partnership

A business formed by two or more individuals or entities.

corporation

A business created as a distinct legal entity composed of one or more individuals or entities.

CORPORATION

The **corporation** is the most important form (in terms of size) of business organization in the United States. A corporation is a legal “person” separate and distinct from its owners, and it has many of the rights, duties, and privileges of an actual person. Corporations can borrow money and own property, can sue and be sued, and can enter into contracts. A corporation can even be a general partner or a limited partner in a partnership, and a corporation can own stock in another corporation.

Not surprisingly, starting a corporation is somewhat more complicated than starting the other forms of business organization. Forming a corporation involves preparing *articles of incorporation* (or a charter) and a set of *bylaws*. The articles of incorporation must contain a number of things, including the corporation’s name, its intended life (which can be forever), its business purpose, and the number of shares that can be issued. This information must normally be supplied to the state in which the firm will be incorporated. For most legal purposes, the corporation is a “resident” of that state.

The bylaws are rules describing how the corporation regulates its existence. For example, the bylaws describe how directors are elected. These bylaws may be a simple statement of a few rules and procedures, or they may be quite extensive for a large corporation. The bylaws may be amended or extended from time to time by the stockholders.

In a large corporation, the stockholders and the managers are usually separate groups. The stockholders elect the board of directors, who then select the managers. Managers are charged with running the corporation’s affairs in the stockholders’ interests. In principle, stockholders control the corporation because they elect the directors.

As a result of the separation of ownership and management, the corporate form has several advantages. Ownership (represented by shares of stock) can be readily transferred, and the life of the corporation is therefore not limited. The corporation borrows money in its own name. As a result, the stockholders in a corporation have limited liability for corporate debts. The most they can lose is what they have invested.

The relative ease of transferring ownership, the limited liability for business debts, and the unlimited life of the business are why the corporate form is superior for raising cash. If a corporation needs new equity, for example, it can sell new shares of stock and attract new investors. Apple Computer is an example. Apple was a pioneer in the personal computer business. As demand for its products exploded, Apple had to convert to the corporate form of organization to raise the capital needed to fund growth and new product development. The number of owners can be huge; larger corporations have many thousands or even millions of stockholders. For example, in 2006, General Electric Corporation (better known as GE) had about 4 million stockholders and about 10 billion shares outstanding. In such cases, ownership can change continuously without affecting the continuity of the business.

The corporate form has a significant disadvantage. Because a corporation is a legal person, it must pay taxes. Moreover, money paid out to stockholders in the form of dividends is taxed again as income to those stockholders. This is *double taxation*, meaning that corporate profits are taxed twice: at the corporate level when they are earned and again at the personal level when they are paid out.¹

Today, all 50 states have enacted laws allowing for the creation of a relatively new form of business organization, the limited liability company (LLC). The goal of this entity is to operate and be taxed like a partnership but retain limited liability for owners, so an LLC is

¹An S corporation is a special type of small corporation that is essentially taxed like a partnership and thus avoids double taxation. In 2007, the maximum number of shareholders in an S corporation was 100.

essentially a hybrid of partnership and corporation. Although states have differing definitions for LLCs, the more important scorekeeper is the Internal Revenue Service (IRS). The IRS will consider an LLC a corporation, thereby subjecting it to double taxation, unless it meets certain specific criteria. In essence, an LLC cannot be too corporationlike, or it will be treated as one by the IRS. LLCs have become common. For example, Goldman, Sachs and Co., one of Wall Street's last remaining partnerships, decided to convert from a private partnership to an LLC (it later "went public," becoming a publicly held corporation). Large accounting firms and law firms by the score have converted to LLCs.

As the discussion in this section illustrates, the need of large businesses for outside investors and creditors is such that the corporate form will generally be the best for such firms. We focus on corporations in the chapters ahead because of the importance of the corporate form in the U.S. economy and world economies. Also, a few important financial management issues, such as dividend policy, are unique to corporations. However, businesses of all types and sizes need financial management, so the majority of the subjects we discuss bear on any form of business.



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A CORPORATION BY ANOTHER NAME . . .

The corporate form of organization has many variations around the world. The exact laws and regulations differ from country to country, of course, but the essential features of public ownership and limited liability remain. These firms are often called *joint stock companies*, *public limited companies*, or *limited liability companies*, depending on the specific nature of the firm and the country of origin.

Table 1.1 gives the names of a few well-known international corporations, their countries of origin, and a translation of the abbreviation that follows the company name.

Concept Questions

- 1.2a** What are the three forms of business organization?
- 1.2b** What are the primary advantages and disadvantages of sole proprietorships and partnerships?
- 1.2c** What is the difference between a general and a limited partnership?
- 1.2d** Why is the corporate form superior when it comes to raising cash?

TABLE 1.1 International Corporations

Company	Country of Origin	Type of Company	
		In Original Language	Translated
Bayerische Motorenwerke (BMW) AG	Germany	Aktiengesellschaft	Corporation
Dornier GmbH	Germany	Gesellschaft mit Beschränkter Haftung	Limited liability company
Rolls-Royce PLC	United Kingdom	Public limited company	Public limited company
Shell UK Ltd.	United Kingdom	Limited	Corporation
Unilever NV	Netherlands	Naamloze Vennootschap	Joint stock company
Fiat SpA	Italy	Società per Azioni	Joint stock company
Volvo AB	Sweden	Aktiebolag	Joint stock company
Peugeot SA	France	Société Anonyme	Joint stock company

1.3 The Goal of Financial Management

Assuming that we restrict ourselves to for-profit businesses, the goal of financial management is to make money or add value for the owners. This goal is a little vague, of course, so we examine some different ways of formulating it to come up with a more precise definition. Such a definition is important because it leads to an objective basis for making and evaluating financial decisions.

POSSIBLE GOALS

If we were to consider possible financial goals, we might come up with some ideas like the following:

- Survive.
- Avoid financial distress and bankruptcy.
- Beat the competition.
- Maximize sales or market share.
- Minimize costs.
- Maximize profits.
- Maintain steady earnings growth.

These are only a few of the goals we could list. Furthermore, each of these possibilities presents problems as a goal for the financial manager.

For example, it's easy to increase market share or unit sales: All we have to do is lower our prices or relax our credit terms. Similarly, we can always cut costs simply by doing away with things such as research and development. We can avoid bankruptcy by never borrowing any money or never taking any risks, and so on. It's not clear that any of these actions are in the stockholders' best interests.

Profit maximization would probably be the most commonly cited goal, but even this is not a precise objective. Do we mean profits this year? If so, we should note that actions such as deferring maintenance, letting inventories run down, and taking other short-run cost-cutting measures will tend to increase profits now, but these activities aren't necessarily desirable.

The goal of maximizing profits may refer to some sort of "long-run" or "average" profits, but it's still unclear exactly what this means. First, do we mean something like accounting net income or earnings per share? As we will see in more detail in the next chapter, these accounting numbers may have little to do with what is good or bad for the firm. Second, what do we mean by the long run? As a famous economist once remarked, in the long run, we're all dead! More to the point, this goal doesn't tell us what the appropriate trade-off is between current and future profits.

The goals we've listed here are all different, but they tend to fall into two classes. The first of these relates to profitability. The goals involving sales, market share, and cost control all relate, at least potentially, to different ways of earning or increasing profits. The goals in the second group, involving bankruptcy avoidance, stability, and safety, relate in some way to controlling risk. Unfortunately, these two types of goals are somewhat contradictory. The pursuit of profit normally involves some element of risk, so it isn't really possible to maximize both safety and profit. What we need, therefore, is a goal that encompasses both factors.

THE GOAL OF FINANCIAL MANAGEMENT

The financial manager in a corporation makes decisions for the stockholders of the firm. Given this, instead of listing possible goals for the financial manager, we really need to

answer a more fundamental question: From the stockholders' point of view, what is a good financial management decision?

If we assume that stockholders buy stock because they seek to gain financially, then the answer is obvious: Good decisions increase the value of the stock, and poor decisions decrease the value of the stock.

Given our observations, it follows that the financial manager acts in the shareholders' best interests by making decisions that increase the value of the stock. The appropriate goal for the financial manager can thus be stated quite easily:

The goal of financial management is to maximize the current value per share of the existing stock.

The goal of maximizing the value of the stock avoids the problems associated with the different goals we listed earlier. There is no ambiguity in the criterion, and there is no short-run versus long-run issue. We explicitly mean that our goal is to maximize the *current* stock value.

If this goal seems a little strong or one-dimensional to you, keep in mind that the stockholders in a firm are residual owners. By this we mean that they are entitled to only what is left after employees, suppliers, and creditors (and anyone else with a legitimate claim) are paid their due. If any of these groups go unpaid, the stockholders get nothing. So, if the stockholders are winning in the sense that the leftover, residual portion is growing, it must be true that everyone else is winning also.

Because the goal of financial management is to maximize the value of the stock, we need to learn how to identify investments and financing arrangements that favorably impact the value of the stock. This is precisely what we will be studying. In fact, we could have defined *corporate finance* as the study of the relationship between business decisions and the value of the stock in the business.

A MORE GENERAL GOAL

Given our goal as stated in the preceding section (maximize the value of the stock), an obvious question comes up: What is the appropriate goal when the firm has no traded stock? Corporations are certainly not the only type of business; and the stock in many corporations rarely changes hands, so it's difficult to say what the value per share is at any given time.

As long as we are dealing with for-profit businesses, only a slight modification is needed. The total value of the stock in a corporation is simply equal to the value of the owners' equity. Therefore, a more general way of stating our goal is as follows: Maximize the market value of the existing owners' equity.

With this in mind, it doesn't matter whether the business is a proprietorship, a partnership, or a corporation. For each of these, good financial decisions increase the market value of the owners' equity and poor financial decisions decrease it. In fact, although we focus on corporations in the chapters ahead, the principles we develop apply to all forms of business. Many of them even apply to the not-for-profit sector.

Finally, our goal does not imply that the financial manager should take illegal or unethical actions in the hope of increasing the value of the equity in the firm. What we mean is that the financial manager best serves the owners of the business by identifying goods and services that add value to the firm because they are desired and valued in the free marketplace.

SARBANES–OXLEY

In response to corporate scandals at companies such as Enron, WorldCom, Tyco, and Adelphia, Congress enacted the Sarbanes–Oxley Act in 2002. The act, better known as “Sarbox,” is intended to protect investors from corporate abuses. For example, one section of Sarbox prohibits personal loans from a company to its officers, such as the ones that were received by WorldCom CEO Bernie Ebbers.

One of the key sections of Sarbox took effect on November 15, 2004. Section 404 requires, among other things, that each company’s annual report must have an assessment of the company’s internal control structure and financial reporting. The auditor must then evaluate and attest to management’s assessment of these issues.

Sarbox contains other key requirements. For example, the officers of the corporation must review and sign the annual reports. They must explicitly declare that the annual report does not contain any false statements or material omissions; that the financial statements fairly represent the financial results; and that they are responsible for all internal controls. Finally, the annual report must list any deficiencies in internal controls. In essence, Sarbox makes company management responsible for the accuracy of the company’s financial statements.

Of course, as with any law, there are compliance costs, and Sarbox has increased the cost of corporate audits, sometimes dramatically. To give a couple of examples, Telecommunications Software Inc., with \$143 million in revenues, spent \$768,000 on Sarbox costs in 2005. At the same time, Hewlett-Packard spent more than \$6.8 million. Such costs have created unintended consequences. For example, in 2003, 198 firms delisted their shares from exchanges, or “went dark.” This was up from 30 delistings in 1999. In 2004, 134 companies went dark. Most of the companies that delisted stated that their reason was to avoid the cost of compliance with Sarbox. Some conservative estimates put the national Sarbox compliance tab at \$35 billion in the first year alone, which is roughly 20 times the amount originally estimated by the SEC. For a large multibillion-dollar-revenue company, the cost might be .05 percent of revenues, but it could be 4.5 percent or so for smaller companies—an enormous cost.

A company that goes dark does not have to file quarterly or annual reports. Annual audits by independent auditors are not required, and executives do not have to certify the accuracy of the financial statements, so the savings can be huge. Of course, there are costs. Stock prices typically fall when a company announces it is going dark. Further, such companies will typically have limited access to capital markets and usually will have a higher interest cost on bank loans.

Foreign companies have also been affected. Lastminute, a British online travel group, and Lion Bioscience, a German software company, have already withdrawn from U.S. exchanges. And it is not just smaller foreign companies that are considering delisting from U.S. exchanges. German conglomerate Siemens AG, with worldwide sales approaching \$100 billion, is considering delisting, and Porsche AG reportedly chose not to list its stock on the NYSE because of Sarbox requirements.



For more about
Sarbanes–Oxley, visit
www.sarbanes-oxley.com.

Concept Questions

- 1.3a** What is the goal of financial management?
- 1.3b** What are some shortcomings of the goal of profit maximization?
- 1.3c** Can you give a definition of *corporate finance*?

The Agency Problem and Control of the Corporation

1.4

We've seen that the financial manager acts in the best interests of the stockholders by taking actions that increase the value of the stock. However, we've also seen that in large corporations ownership can be spread over a huge number of stockholders. This dispersion of ownership arguably means that management effectively controls the firm. In this case, will management necessarily act in the best interests of the stockholders? Put another way, might not management pursue its own goals at the stockholders' expense? In the following pages, we briefly consider some of the arguments relating to this question.

AGENCY RELATIONSHIPS

The relationship between stockholders and management is called an *agency relationship*. Such a relationship exists whenever someone (the principal) hires another (the agent) to represent his or her interests. For example, you might hire someone (an agent) to sell a car you own while you are away at school. In all such relationships, there is a possibility of conflict of interest between the principal and the agent. Such a conflict is called an **agency problem**.

Suppose you hire someone to sell your car and agree to pay that person a flat fee when he or she sells the car. The agent's incentive in this case is to make the sale, not necessarily to get you the best price. If you offer a commission of, say, 10 percent of the sales price instead of a flat fee, then this problem might not exist. This example illustrates that the way in which an agent is compensated is one factor that affects agency problems.

agency problem

The possibility of conflict of interest between the stockholders and management of a firm.

MANAGEMENT GOALS

To see how management and stockholder interests might differ, imagine that the firm is considering a new investment. The new investment is expected to favorably impact the share value, but it is also a relatively risky venture. The owners of the firm will wish to take the investment (because the stock value will rise), but management may not because there is the possibility that things will turn out badly and management jobs will be lost. If management does not take the investment, then the stockholders may lose a valuable opportunity. This is one example of an agency cost.

More generally, the term *agency costs* refers to the costs of the conflict of interest between stockholders and management. These costs can be indirect or direct. An indirect agency cost is a lost opportunity, such as the one we have just described.

Direct agency costs come in two forms. The first type is a corporate expenditure that benefits management but costs the stockholders. Perhaps the purchase of a luxurious and unneeded corporate jet would fall under this heading. The second type of direct agency cost is an expense that arises from the need to monitor management actions. Paying outside auditors to assess the accuracy of financial statement information could be one example.

It is sometimes argued that, left to themselves, managers would tend to maximize the amount of resources over which they have control or, more generally, corporate power or wealth. This goal could lead to an overemphasis on corporate size or growth. For example, cases in which management is accused of overpaying to buy up another company just to increase the size of the business or to demonstrate corporate power are not uncommon. Obviously, if overpayment does take place, such a purchase does not benefit the stockholders of the purchasing company.

Our discussion indicates that management may tend to overemphasize organizational survival to protect job security. Also, management may dislike outside interference, so independence and corporate self-sufficiency may be important goals.

DO MANAGERS ACT IN THE STOCKHOLDERS' INTERESTS?

Whether managers will, in fact, act in the best interests of stockholders depends on two factors. First, how closely are management goals aligned with stockholder goals? This question relates, at least in part, to the way managers are compensated. Second, can managers be replaced if they do not pursue stockholder goals? This issue relates to control of the firm. As we will discuss, there are a number of reasons to think that even in the largest firms, management has a significant incentive to act in the interests of stockholders.

Managerial Compensation Management will frequently have a significant economic incentive to increase share value for two reasons. First, managerial compensation, particularly at the top, is usually tied to financial performance in general and often to share value in particular. For example, managers are frequently given the option to buy stock at a bargain price. The more the stock is worth, the more valuable is this option. In fact, options are often used to motivate employees of all types, not just top managers. For example, in 2001 Intel announced that it was issuing new stock options to 80,000 employees, thereby giving its workforce a significant stake in its stock price and better aligning employee and shareholder interests. Many other corporations, large and small, have adopted similar policies.

The second incentive managers have relates to job prospects. Better performers within the firm will tend to get promoted. More generally, managers who are successful in pursuing stockholder goals will be in greater demand in the labor market and thus command higher salaries.

In fact, managers who are successful in pursuing stockholder goals can reap enormous rewards. For example, the best-paid executive in 2005 was Terry Semel, the CEO of Yahoo!; according to *Forbes* magazine, he made about \$231 million. By way of comparison, Semel made quite a bit more than George Lucas (\$180 million), but only slightly more than Oprah Winfrey (\$225 million), and way more than Judge Judy (\$28 million). Over the period 2001–2005, Oracle CEO Larry Ellison was the highest-paid executive, earning about \$868 million. Information about executive compensation, along with lots of other information, can be easily found on the Web for almost any public company. Our nearby *Work the Web* box shows you how to get started.



Control of the Firm Control of the firm ultimately rests with stockholders. They elect the board of directors, who in turn hire and fire managers. The fact that stockholders control the corporation was made abundantly clear by Steven Jobs's experience at Apple. Even though he was a founder of the corporation and was largely responsible for its most successful products, there came a time when shareholders, through their elected directors, decided that Apple would be better off without him, so out he went. Of course, he was later rehired and helped turn Apple around with great new products such as the iPod.

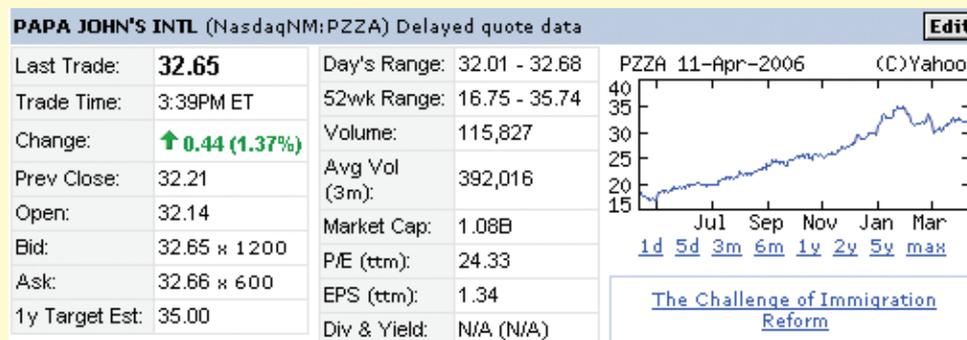
An important mechanism by which unhappy stockholders can act to replace existing management is called a *proxy fight*. A proxy is the authority to vote someone else's stock. A proxy fight develops when a group solicits proxies in order to replace the existing board and thereby replace existing managers. For example, in early 2002, the proposed merger between Hewlett-Packard (HP) and Compaq triggered one of the most widely followed, bitterly contested, and expensive proxy fights in history, with an estimated price tag of well over \$100 million. One group of shareholders, which included Walter B. Hewlett (a board

WORK THE WEB

The Web is a great place to learn more about individual companies, and there are a slew of sites available to help you. Try pointing your Web browser to finance.yahoo.com. Once you get there, you should see something like this on the page:



To look up a company, you must know its “ticker symbol” (or just ticker for short), which is a unique one- to four-letter identifier. You can click on the “Symbol Lookup” link and type in the company’s name to find the ticker. For example, we typed in “PZZA,” which is the ticker for pizza maker Papa John’s. Here is a portion of what we got:



There's a lot of information here and many links for you to explore, so have at it. By the end of the term, we hope it all makes sense to you!

member and heir to a cofounder of HP), opposed the merger and launched a proxy fight for control of HP. Another group, led by HP CEO Carly Fiorina, supported the merger. In a very close vote, Ms. Fiorina prevailed, the merger went through, and Mr. Hewlett resigned from the board.

Another way that managers can be replaced is by takeover. Firms that are poorly managed are more attractive as acquisitions than well-managed firms because a greater profit potential exists. Thus, avoiding a takeover by another firm gives management another incentive to act in the stockholders' interests. For example, in April 2006, the management of Arcelor SA was attempting to fight off a bid from rival steelmaker Mittal Steel Co. Arcelor's management undertook several steps in an attempt to defeat the €20.4 billion (\$24.8 billion) bid. First, the company transferred its lucrative Canadian operations to a Dutch foundation. Next, the company increased its dividend and promised a special dividend to shareholders when Mittal dropped its bid or the takeover failed. These payments to shareholders meant that remaining with current management or siding with Mittal would be financially equivalent.

Conclusion The available theory and evidence are consistent with the view that stockholders control the firm and that stockholder wealth maximization is the relevant goal of the corporation. Even so, there will undoubtedly be times when management goals are pursued at the expense of the stockholders, at least temporarily.

stakeholder

Someone other than a stockholder or creditor who potentially has a claim on the cash flows of the firm.

STAKEHOLDERS

Our discussion thus far implies that management and stockholders are the only parties with an interest in the firm's decisions. This is an oversimplification, of course. Employees, customers, suppliers, and even the government all have a financial interest in the firm.

Taken together, these various groups are called **stakeholders** in the firm. In general, a stakeholder is someone other than a stockholder or creditor who potentially has a claim on the cash flows of the firm. Such groups will also attempt to exert control over the firm, perhaps to the detriment of the owners.

Concept Questions

1.4a What is an agency relationship?

1.4b What are agency problems and how do they come about? What are agency costs?

1.4c What incentives do managers in large corporations have to maximize share value?

1.5 Financial Markets and the Corporation

We've seen that the primary advantages of the corporate form of organization are that ownership can be transferred more quickly and easily than with other forms and that money can be raised more readily. Both of these advantages are significantly enhanced by the existence of financial markets, and financial markets play an extremely important role in corporate finance.

CASH FLOWS TO AND FROM THE FIRM

The interplay between the corporation and the financial markets is illustrated in Figure 1.2. The arrows in Figure 1.2 trace the passage of cash from the financial markets to the firm and from the firm back to the financial markets.

Suppose we start with the firm selling shares of stock and borrowing money to raise cash. Cash flows to the firm from the financial markets (A). The firm invests the cash in current and fixed assets (B). These assets generate cash (C), some of which goes to pay corporate taxes (D). After taxes are paid, some of this cash flow is reinvested in the firm (E). The rest goes back to the financial markets as cash paid to creditors and shareholders (F).

A financial market, like any market, is just a way of bringing buyers and sellers together. In financial markets, it is debt and equity securities that are bought and sold. Financial markets differ in detail, however. The most important differences concern the types of securities that are traded, how trading is conducted, and who the buyers and sellers are. Some of these differences are discussed next.

PRIMARY VERSUS SECONDARY MARKETS

Financial markets function as both primary and secondary markets for debt and equity securities. The term *primary market* refers to the original sale of securities by governments and corporations. The *secondary markets* are those in which these securities are bought and sold after the original sale. Equities are, of course, issued solely by corporations. Debt securities are issued by both governments and corporations. In the discussion that follows, we focus on corporate securities only.

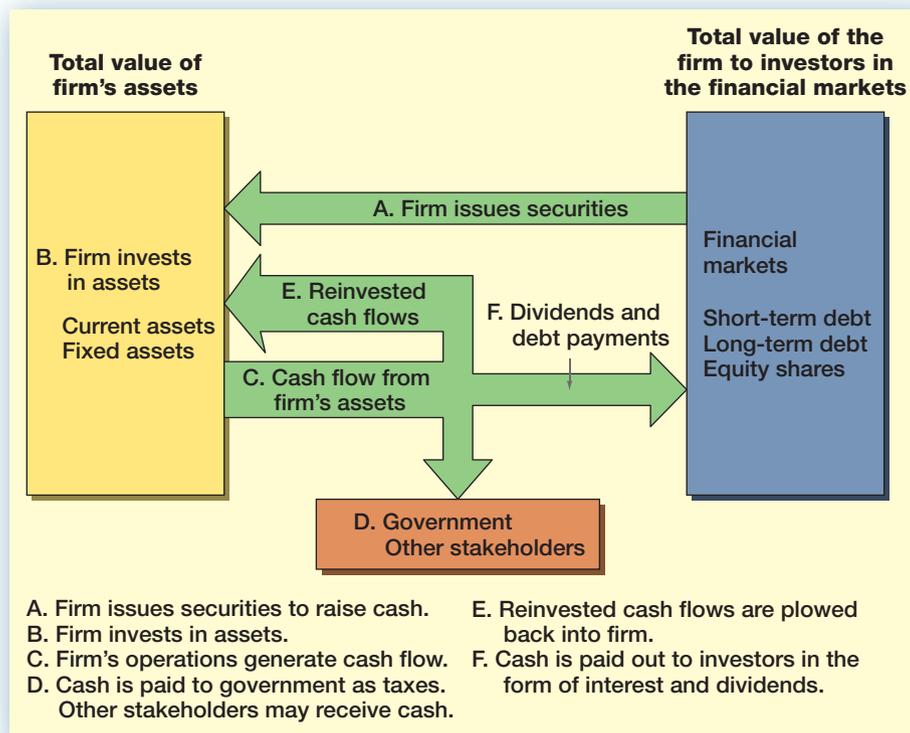


FIGURE 1.2

Cash Flows between the Firm and the Financial Markets

Primary Markets In a primary market transaction, the corporation is the seller, and the transaction raises money for the corporation. Corporations engage in two types of primary market transactions: public offerings and private placements. A public offering, as the name suggests, involves selling securities to the general public, whereas a private placement is a negotiated sale involving a specific buyer.

By law, public offerings of debt and equity must be registered with the Securities and Exchange Commission (SEC). Registration requires the firm to disclose a great deal of information before selling any securities. The accounting, legal, and selling costs of public offerings can be considerable.

Partly to avoid the various regulatory requirements and the expense of public offerings, debt and equity are often sold privately to large financial institutions such as life insurance companies or mutual funds. Such private placements do not have to be registered with the SEC and do not require the involvement of underwriters (investment banks that specialize in selling securities to the public).

Secondary Markets A secondary market transaction involves one owner or creditor selling to another. Therefore, the secondary markets provide the means for transferring ownership of corporate securities. Although a corporation is directly involved only in a primary market transaction (when it sells securities to raise cash), the secondary markets are still critical to large corporations. The reason is that investors are much more willing to purchase securities in a primary market transaction when they know that those securities can later be resold if desired.

Dealer versus Auction Markets There are two kinds of secondary markets: *auction* markets and *dealer* markets. Generally speaking, dealers buy and sell for themselves, at

 To learn more about the SEC, visit www.sec.gov.

their own risk. A car dealer, for example, buys and sells automobiles. In contrast, brokers and agents match buyers and sellers, but they do not actually own the commodity that is bought or sold. A real estate agent, for example, does not normally buy and sell houses.

Dealer markets in stocks and long-term debt are called *over-the-counter* (OTC) markets. Most trading in debt securities takes place over the counter. The expression *over the counter* refers to days of old when securities were literally bought and sold at counters in offices around the country. Today, a significant fraction of the market for stocks and almost all of the market for long-term debt have no central location; the many dealers are connected electronically.

Auction markets differ from dealer markets in two ways. First, an auction market or exchange has a physical location (like Wall Street). Second, in a dealer market, most of the buying and selling is done by the dealer. The primary purpose of an auction market, on the other hand, is to match those who wish to sell with those who wish to buy. Dealers play a limited role.

Trading in Corporate Securities The equity shares of most of the large firms in the United States trade in organized auction markets. The largest such market is the New York Stock Exchange (NYSE), which accounts for more than 85 percent of all the shares traded in auction markets. Other auction exchanges include the American Stock Exchange (AMEX) and regional exchanges such as the Pacific Stock Exchange.

In addition to the stock exchanges, there is a large OTC market for stocks. In 1971, the National Association of Securities Dealers (NASD) made available to dealers and brokers an electronic quotation system called NASDAQ (which originally stood for NASD Automated Quotation system and is pronounced “naz-dak”). There are roughly two times as many companies on NASDAQ as there are on the NYSE, but they tend to be much smaller and trade less actively. There are exceptions, of course. Both Microsoft and Intel trade OTC, for example. Nonetheless, the total value of NASDAQ stocks is much less than the total value of NYSE stocks.

There are many large and important financial markets outside the United States, of course, and U.S. corporations are increasingly looking to these markets to raise cash. The Tokyo Stock Exchange and the London Stock Exchange (TSE and LSE, respectively) are two well-known examples. The fact that OTC markets have no physical location means that national borders do not present a great barrier, and there is now a huge international OTC debt market. Because of globalization, financial markets have reached the point where trading in many investments never stops; it just travels around the world.

Listing Stocks that trade on an organized exchange are said to be *listed* on that exchange. To be listed, firms must meet certain minimum criteria concerning, for example, asset size and number of shareholders. These criteria differ from one exchange to another.

The NYSE has the most stringent requirements of the exchanges in the United States. For example, to be listed on the NYSE, a company is expected to have a market value for its publicly held shares of at least \$100 million. There are additional minimums on earnings, assets, and number of shares outstanding.

Concept Questions

- 1.5a** What is a dealer market? How do dealer and auction markets differ?
- 1.5b** What does *OTC* stand for? What is the large OTC market for stocks called?
- 1.5c** What is the largest auction market in the United States?



To learn more about the exchanges, visit www.nyse.com and www.nasdaq.com.

Summary and Conclusions

1.6

This chapter introduced you to some of the basic ideas in corporate finance:

1. Corporate finance has three main areas of concern:
 - a. Capital budgeting: What long-term investments should the firm take?
 - b. Capital structure: Where will the firm get the long-term financing to pay for its investments? In other words, what mixture of debt and equity should the firm use to fund operations?
 - c. Working capital management: How should the firm manage its everyday financial activities?
2. The goal of financial management in a for-profit business is to make decisions that increase the value of the stock or, more generally, increase the market value of the equity.
3. The corporate form of organization is superior to other forms when it comes to raising money and transferring ownership interests, but it has the significant disadvantage of double taxation.
4. There is the possibility of conflicts between stockholders and management in a large corporation. We called these conflicts *agency problems* and discussed how they might be controlled and reduced.
5. The advantages of the corporate form are enhanced by the existence of financial markets. Financial markets function as both primary and secondary markets for corporate securities and can be organized as either dealer or auction markets.

Of the topics we've discussed thus far, the most important is the goal of financial management: maximizing the value of the stock. Throughout the text, we will be analyzing many different financial decisions, but we will always ask the same question: How does the decision under consideration affect the value of the stock?

CONCEPTS REVIEW AND CRITICAL THINKING QUESTIONS

1. **The Financial Management Decision Process** What are the three types of financial management decisions? For each type of decision, give an example of a business transaction that would be relevant.
2. **Sole Proprietorships and Partnerships** What are the four primary disadvantages of the sole proprietorship and partnership forms of business organization? What benefits are there to these types of business organization as opposed to the corporate form?
3. **Corporations** What is the primary disadvantage of the corporate form of organization? Name at least two advantages of corporate organization.
4. **Sarbanes–Oxley** In response to the Sarbanes–Oxley Act, many small firms in the United States have opted to “go dark” and delist their stock. Why might a company choose this route? What are the costs of “going dark”?
5. **Corporate Finance Organization** In a large corporation, what are the two distinct groups that report to the chief financial officer? Which group is the focus of corporate finance?

6. **Goal of Financial Management** What goal should always motivate the actions of a firm's financial manager?
7. **Agency Problems** Who owns a corporation? Describe the process whereby the owners control the firm's management. What is the main reason that an agency relationship exists in the corporate form of organization? In this context, what kinds of problems can arise?
8. **Primary versus Secondary Markets** You've probably noticed coverage in the financial press of an initial public offering (IPO) of a company's securities. Is an IPO a primary market transaction or a secondary market transaction?
9. **Auction versus Dealer Markets** What does it mean when we say the New York Stock Exchange is an auction market? How are auction markets different from dealer markets? What kind of market is NASDAQ?
10. **Not-for-Profit Firm Goals** Suppose you were the financial manager of a not-for-profit business (a not-for-profit hospital, perhaps). What kinds of goals do you think would be appropriate?
11. **Goal of the Firm** Evaluate the following statement: Managers should not focus on the current stock value because doing so will lead to an overemphasis on short-term profits at the expense of long-term profits.
12. **Ethics and Firm Goals** Can our goal of maximizing the value of the stock conflict with other goals, such as avoiding unethical or illegal behavior? In particular, do you think subjects like customer and employee safety, the environment, and the general good of society fit in this framework, or are they essentially ignored? Think of some specific scenarios to illustrate your answer.
13. **International Firm Goal** Would our goal of maximizing the value of the stock be different if we were thinking about financial management in a foreign country? Why or why not?
14. **Agency Problems** Suppose you own stock in a company. The current price per share is \$25. Another company has just announced that it wants to buy your company and will pay \$35 per share to acquire all the outstanding stock. Your company's management immediately begins fighting off this hostile bid. Is management acting in the shareholders' best interests? Why or why not?
15. **Agency Problems and Corporate Ownership** Corporate ownership varies around the world. Historically individuals have owned the majority of shares in public corporations in the United States. In Germany and Japan, however, banks, other large financial institutions, and other companies own most of the stock in public corporations. Do you think agency problems are likely to be more or less severe in Germany and Japan than in the United States? Why? In recent years, large financial institutions such as mutual funds and pension funds have been becoming the dominant owners of stock in the United States, and these institutions are becoming more active in corporate affairs. What are the implications of this trend for agency problems and corporate control?
16. **Executive Compensation** Critics have charged that compensation to top managers in the United States is simply too high and should be cut back. For example, focusing on large corporations, Larry Ellison of Oracle has been one of the best-compensated CEOs in the United States, earning about \$46 million in 2005 alone and \$868 million over the 2001–2005 period. Are such amounts excessive? In answering, it might be helpful to recognize that superstar athletes such as Tiger Woods, top entertainers such as Tom Hanks and Oprah Winfrey, and many others at the top of their respective fields earn at least as much, if not a great deal more.

WEB EXERCISES

- 1.1 Listing Requirements** This chapter discussed some of the listing requirements for the NYSE and NASDAQ. Find the complete listing requirements for the New York Stock Exchange at www.nyse.com and NASDAQ at www.nasdaq.com. Which exchange has more stringent listing requirements? Why don't the exchanges have the same listing requirements?
- 1.2 Business Formation** As you may (or may not) know, many companies incorporate in Delaware for a variety of reasons. Visit Bizfilings at www.bizfilings.com to find out why. Which state has the highest fee for incorporation? For an LLC? While at the site, look at the FAQ section regarding corporations and LLCs.



MINICASE

The McGee Cake Company

In early 2001, Doc and Lyn McGee formed the McGee Cake Company. The company produced a full line of cakes, and its specialties included chess cake, lemon pound cake, and double-iced, double-chocolate cake. The couple formed the company as an outside interest, and both continued to work at their current jobs. Doc did all the baking, and Lyn handled the marketing and distribution. With good product quality and a sound marketing plan, the company grew rapidly. In early 2006, the company was featured in a widely distributed entrepreneurial magazine. Later that year, the company was featured in *Gourmet Desserts*, a leading specialty food magazine. After the article appeared in *Gourmet Desserts*, sales exploded, and the company began receiving orders from all over the world.

Because of the increased sales, Doc left his other job, followed shortly by Lyn. The company hired additional workers to meet demand. Unfortunately, the fast growth experienced by the company led to cash flow and capacity problems. The company is currently producing as many cakes as possible with

the assets it owns, but demand for its cakes is still growing. Further, the company has been approached by a national supermarket chain with a proposal to put four of its cakes in all of the chain's stores, and a national restaurant chain has contacted the company about selling McGee cakes in its restaurants. The restaurant would sell the cakes without a brand name.

Doc and Lyn have operated the company as a sole proprietorship. They have approached you to help manage and direct the company's growth. Specifically, they have asked you to answer the following questions:

1. What are the advantages and disadvantages of changing the company organization from a sole proprietorship to an LLC?
2. What are the advantages and disadvantages of changing the company organization from a sole proprietorship to a corporation?
3. Ultimately, what action would you recommend the company undertake? Why?