

1.6

SUMMARY AND CONCLUSIONS

This chapter introduced you to some of the basic ideas in corporate finance. In it, we saw that:

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 we use to fund our 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 of the advantages of corporate organization.
4. **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?
5. **Goal of Financial Management** What goal should always motivate the actions of the firm's financial manager?
6. **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?

7. **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?
8. **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?
9. **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?
10. **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.
11. **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? Try to think of some specific scenarios to illustrate your answer.
12. **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?
13. **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?
14. **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?
15. **Executive Compensation** Critics have charged that compensation to top management in the United States is simply too high and should be cut back. For example, focusing on large corporations, Millard Drexler of clothing retailer The Gap has been one of the best compensated CEOs in the United States, earning about \$13 million in 2001 alone and almost \$400 million over the 1996–2001 period. Are such amounts excessive? In answering, it might be helpful to recognize that superstar athletes such as Tiger Woods, top entertainers such as Bruce Willis and Oprah Winfrey, and many others at the top of their respective fields earn at least as much, if not a great deal more.

S&P Problems

STANDARD & POOR'S

What's On the Web?

1. **Industry Comparison** On the Market Insight Home Page, follow the “Industry” link at the top of the page. You will be on the industry page. You can use the drop down menu to select different industries. Answer the following questions for these industries: Airlines, Automobiles, Biotechnology, Computers (Software & Services), Homebuilding, Manufacturing (Diversified), Restaurants, Retail (General Merchandise), and Telecommunications (Cellular/Wireless).
 - a. How many companies are in each industry?
 - b. What are the total sales for each industry?
 - c. Do the industries with the largest total sales have the most companies in the industry? What does this tell you about competition in the various industries?

- 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.
- 1.3 **Organizational Structure** The organizational structure chart in the text is a simplified version. Go to www.conference-board.org, follow the “Organization Charts” link, and then the “Click here to see a sample chart” link. What are the differences in the two diagrams? Who reports to the chief financial officer? How many vice presidents does this company have?