ross46733_ch01.qxd 7/15/05 07:35 PM Page 1

Apple Computer began as a two-man partnership in a garage. It grew rapidly and, by 1985, became a large publicly traded corporation with 60 million shares of stock and a total market value in excess of $1 billion. At that time, the firm's more visible cofounder, 30-year-old Steven Jobs, owned 7 million shares of Apple stock worth about $120 million.

Despite his stake in the company and his role in its founding and success, Jobs was forced to relinquish operating responsibilities in 1985 when Apple's financial performance turned sour, and he subsequently resigned altogether.

1 Introduction to Financial Management

Of course, you can't keep a good entrepreneur down. Jobs went on to found Pixar Animation Studios, the company that is responsible for the animation in the hit movies *Toy Story, A Bug's Life,* and *Finding Nemo.* And just to show that what goes around comes around, Apple found itself struggling for relevance in a "Wintel" world and decided to go the sequel route when it hired a new interim chief executive officer (CEO): Steven Jobs! How successful was he at his new (old) job? In January 2000, Apple's board of directors granted Jobs stock options worth $200 million and threw in $90 million for the purchase and care of a Gulfstream V jet. Board member Edgar Woolard stated, "This guy has saved the company." By 2005, Jobs really had Apple on a roll, with a slew of innovative and highly successful products, including a very cool special edition iPod that is signed by all members of the band U2.

TO GET THE MOST OUT OF THE CHAPTER, WHEN YOU ARE FINISHED STUDYING IT, MAKE SURE YOU HAVE A GOOD UNDERSTANDING OF:

- The basic types of financial management decisions and the role of the financial manager.
- The goal of financial management.
- The financial implications of the different forms of business organization.
- The conflicts of interest that can arise between managers and owners.

Understanding Jobs's journey from garage-based entrepreneur to corporate executive to ex-employee and, finally, to CEO takes us into issues involving the corporate form of organization, corporate goals, and corporate control, all of which we discuss in this chapter.

Slide 1.1
Key Concepts and Skills

Slide 1.2
Chapter Outline

To begin our study of financial management, we address two central issues. First: What is corporate, or business, finance and what is the role of the financial manager? Second: What is the goal of financial management?

1.1 FINANCE: A QUICK LOOK

Check out the companion Web site for this text at **www.mhhe.com/rwj**.

Before we plunge into our study of "corp. fin.," we think a quick overview of the finance field might be a good idea. Our goal is to clue you in on some of the most important areas in finance and some of the career opportunities available in each. We also want to illustrate some of the ways finance fits in with other areas such as marketing, management, and accounting.

The Four Basic Areas

Traditionally, financial topics are grouped into four main areas:

Slide 1.3
Basic Areas of Finance

1. Corporate finance
2. Investments
3. Financial institutions
4. International finance

We discuss each of these next.

Concept Q
Answer 1.1a

For job descriptions in finance and other areas, visit **www.careers-in-business.com**.

Corporate Finance The first of these four areas, corporate finance, is the main subject of this book. We begin covering this subject with our next section, so we will wait until then to get into any details. One thing we should note is that the term *corporate finance* seems to imply that what we cover is only relevant to corporations, but the truth is that almost all of the topics we consider are much broader than that. Maybe *business finance* would be a little more descriptive, but even this is too narrow because at least half of the subjects we discuss in the pages ahead are really basic financial ideas and principles applicable across all the various areas of finance and beyond.

Investments Broadly speaking, the investments area deals with financial assets such as stocks and bonds. Some of the more important questions include:

Video Note:
Careers—This video provides advice from recent graduates on what it takes to have a career in finance.

1. What determines the price of a financial asset such as a share of stock?
2. What are the potential risks and rewards associated with investing in financial assets?
3. What is the best mixture of the different types of financial assets to hold?

Students who specialize in the investments area have various career opportunities. Being a stockbroker is one of the most common. Stockbrokers often work for large companies such as Merrill Lynch, advising customers on what types of investments to consider and helping them make buy and sell decisions. Financial advisers play a similar role, but are not necessarily brokers.

Slide 1.4
Investments

Portfolio management is a second investments-related career path. Portfolio managers, as the name suggests, manage money for investors. For example, individual investors frequently buy into mutual funds. Such funds are simply a means of pooling money that is then invested by a portfolio manager. Portfolio managers also invest and manage money for pension funds, insurance companies, and many other types of institutions.

Security analysis is a third area. A security analyst researches individual investments, such as stock in a particular company, and makes a determination as to whether the price is right. To do so, an analyst delves deeply into company and industry reports, along with a variety of other information sources. Frequently, brokers and portfolio managers rely on security analysts for information and recommendations.

These investments-related areas, like many areas in finance, share an interesting feature. If they are done well, they can be very rewarding financially (translation: You can make a lot of money). The bad news, of course, is that they can be very demanding and very competitive, so they are definitely not for everybody.

Financial Institutions Financial institutions are basically businesses that deal primarily in financial matters. Banks and insurance companies would probably be the most familiar to you. Institutions such as these employ people to perform a wide variety of finance-related tasks. For example, a commercial loan officer at a bank would evaluate whether a particular business has a strong enough financial position to warrant extending a loan. At an insurance company, an analyst would decide whether a particular risk was suitable for insuring and what the premium should be.

Slide 1.5
Financial Institutions

International Finance International finance isn't so much an area as it is a specialization within one of the main areas we described above. In other words, careers in international finance generally involve international aspects of either corporate finance, investments, or financial institutions. For example, some portfolio managers and security analysts specialize in non-U.S. companies. Similarly, many U.S. businesses have extensive overseas operations and need employees familiar with such international topics as exchange rates and political risk. Banks frequently are asked to make loans across country lines, so international specialists are needed there as well.

Slide 1.6
International Finance

Why Study Finance?

Who needs to know finance? In a word, you. In fact, there are many reasons you need a working knowledge of finance even if you are not planning a finance career. We explore some of these next.

Slide 1.7
Why Study Finance?

Marketing and Finance If you are interested in marketing, you need to know finance because, for example, marketers constantly work with budgets, and they need to understand how to get the greatest payoff from marketing expenditures and programs. Analyzing costs and benefits of projects of all types is one of the most important aspects of finance, so the tools you learn in finance are vital in marketing research, the design of marketing and distribution channels, and product pricing, just to name a few areas.

Financial analysts rely heavily on marketing analysts, and the two frequently work together to evaluate the profitability of proposed projects and products. As we will see in a later chapter, sales projections are a key input in almost every type of new product analysis, and such projections are often developed jointly between marketing and finance.

Beyond this, the finance industry employs marketers to help sell financial products such as bank accounts, insurance policies, and mutual funds. Financial services marketing

ross46733_ch01.qxd 7/15/05 07:35 PM Page 4

is one of the most rapidly growing types of marketing, and successful financial services marketers are very well compensated. To work in this area, you obviously need to understand financial products.

Accounting and Finance For accountants, finance is required reading. In smaller businesses in particular, accountants are often required to make financial decisions as well as perform traditional accounting duties. Further, as the financial world continues to grow more complex, accountants have to know finance to understand the implications of many of the newer types of financial contracts and the impact they have on financial statements. Beyond this, cost accounting and business finance are particularly closely related, sharing many of the same subjects and concerns.

Financial analysts make extensive use of accounting information; they are some of the most important end users. Understanding finance helps accountants recognize what types of information are particularly valuable and, more generally, how accounting information is actually used (and abused) in practice.

Management and Finance One of the most important areas in management is strategy. Thinking about business strategy without simultaneously thinking about financial strategy is an excellent recipe for disaster, and, as a result, management strategists must have a very clear understanding of the financial implications of business plans.

In broader terms, management employees of all types are expected to have a strong understanding of how their jobs impact profitability, and they are also expected to be able to work within their areas to improve profitability. This is precisely what studying finance teaches you: What are the characteristics of activities that create value?

You and Finance Perhaps the most important reason to know finance is that you will have to make financial decisions that will be very important to you personally. Today, for example, when you go to work for almost any type of company, you will be asked to decide how you want to invest your retirement funds. We'll see in a later chapter that what you choose to do can make an enormous difference in your future financial well-being. On a different note, is it your dream to start your own business? Good luck if you don't understand basic finance before you start; you'll end up learning it the hard way. Want to know how big your student loan payments are going to be before you take out that next loan? Maybe not, but we'll show you how to calculate them anyway.

Concept Q
Answer 1.1b

These are just a few of the ways that finance will affect your personal and business lives. Whether you want to or not, you are going to have to examine and understand financial issues, and you are going to have to make financial decisions. We want you to do so wisely, so keep reading.

CONCEPT QUESTIONS

1.1a What are the major areas in finance?

1.1b Besides wanting to pass this class, why do you need to understand finance?

1.2 BUSINESS FINANCE AND THE FINANCIAL MANAGER

Critical Thinking Question 1

Now we proceed to define business finance and the financial manager's job.

ross46733_ch01.qxd 7/15/05 07:35 PM Page 5

What Is Business Finance?

Slide 1.8
Business Finance

Imagine 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, but they are among the most important. Business finance, broadly speaking, is the study of ways to answer these three questions. We'll be looking at each of them in the chapters ahead.

The Financial Manager

Slide 1.9
Financial Manager

The financial management function is usually associated with a top officer of the firm, often called the chief financial officer (CFO) or vice president of finance. 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

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

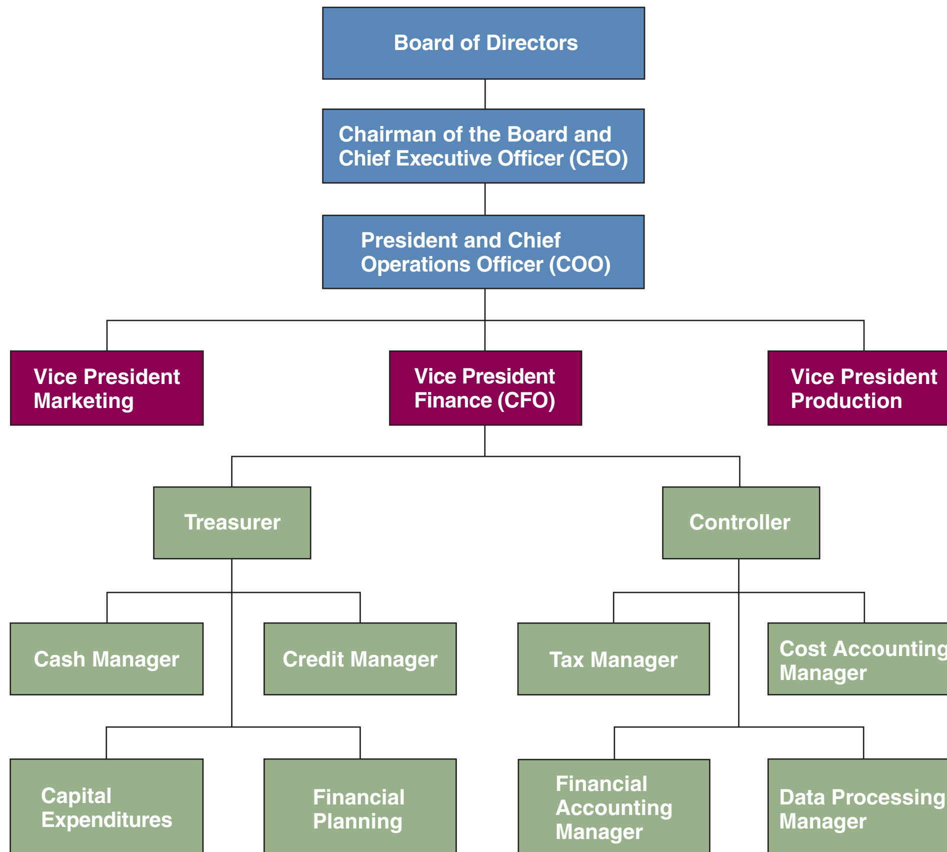


FIGURE 1.1

A simplified organizational chart. The exact titles and organization differ from company to company.

ross46733_ch01.qxd 7/15/05 07:35 PM Page 6

Video Note: The Role of the Chief Financial Officer—This video looks at the changing role of the CFO at the Fortune 500 company Abbott Laboratories.

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 above, and the chapters ahead deal primarily with these issues. Our study thus bears mostly on activities usually associated with the treasurer's office. In a smaller firm, the treasurer and controller might be the same person, and there would be only one office.

Slide 1.10 Financial Management Decisions

Financial Management Decisions

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

Concept Q Answer 1.2a

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

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.

Regardless of the specific investment under consideration, financial managers must be concerned with how much cash they expect to receive, 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, 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 mixture of debt and equity maintained by a firm.

Capital Structure The second question for the financial manager concerns how the firm obtains the financing it needs to support its long-term investments. A firm's **capital structure** (or financial structure) refers to the specific mixture of long-term debt and equity the firm uses to finance its operations. The financial manager has two concerns in this area. First: How much should the firm borrow? Second: What are the least expensive sources of funds for the firm?

Concept Q Answer 1.2b

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, businesses borrow money from a variety of lenders in a number of different 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 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.

Concept Q Answer 1.2c

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 to our customers? (3) How will we obtain any needed short-term financing? If we borrow in the short term, how and where should we do it? This is 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

ross46733_ch01.qxd 7/15/05 07:35 PM Page 7

categories. Each includes a rich variety of topics, and we have indicated only a few of the questions that arise in the different areas. The chapters ahead contain greater detail.

CONCEPT QUESTIONS

1.2a What is the capital budgeting decision?

1.2b What do you call the specific mixture of long-term debt and equity that a firm chooses to use?

1.2c Into what category of financial management does cash management fall?

FORMS OF BUSINESS ORGANIZATION 1.3

Large firms in the United States, such as IBM and Exxon, 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.

Concept Q Answer 1.3a

Slide 1.11 Forms of Organization

Critical Thinking Questions 1.2, 1.3, 1.4

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. 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.

sole proprietorship
A business owned by a single individual.

Slide 1.12 Sole Proprietorship

Concept Q Answer 1.3b

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 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, importantly, the amount of equity that can be raised is limited to 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 since this requires the sale of the entire business to a new owner.

For more information on forms of business organization, see the "ownership structures" section under "business and human resources" 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.

partnership
A business formed by two or more individuals or entities.

Slide 1.13 Partnership

Concept Q Answer 1.3c

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 do 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 for 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

For more in-depth legal information concerning partnerships, go to **www.business-law.freeadvice.com/partnerships/**.

ross46733_ch01.qxd 7/15/05 07:35 PM Page 8

Concept Q
Answer 1.3b

as personal income to the partners, and the amount of equity that can be raised is limited to the partners' combined wealth. Ownership by a general partner is not easily transferred because a new partnership must 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.

Corporation

corporation
A business created as a distinct legal entity owned by one or more individuals or entities.

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.

Slide 1.14
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 own existence. For example, the bylaws describe how directors are elected. 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. Management is 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.

Concept Q
Answer 1.3d

The relative ease of transferring ownership, the limited liability for business debts, and the unlimited life of the business are the reasons why the corporate form is superior when it comes to raising cash. If a corporation needs new equity, it can sell new shares of stock and attract new investors. The number of owners can be huge; larger corporations have many thousands or even millions of stockholders. For example, the General Electric Company (better known as GE) has about 10 billion shares outstanding and 4 million shareholders.

ross46733_ch01.qxd 7/15/05 07:35 PM Page 9

TABLE 1.1
International corporations

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

You can find the translation for any business type at: **www.corporateinformation.com/definitions.html**.

The corporate form has a significant disadvantage. Since 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.

Today all 50 states had 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 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.

How hard is it to form an LLC? Visit **www.llc.com** to find out.

A Corporation by Another Name . . .

The corporate form has many variations around the world. Exact laws and regulations differ, 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.*

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

CONCEPT QUESTIONS

1.3a What are the three forms of business organization?

1.3b What are the primary advantages and disadvantages of sole proprietorships and partnerships?

1.3c What is the difference between a general and a limited partnership?

1.3d Why is the corporate form superior when it comes to raising cash?

ross46733_ch01.qxd 7/15/05 07:35 PM Page 10

1.4 THE GOAL OF FINANCIAL MANAGEMENT

Slide 1.15
Goal of Financial Management

Concept Q
Answer 1.4b

Critical Thinking Questions 1.5, 1.9–1.11

Lecture Tip: Roberto Goizueta's well-known essay on the role of shareholder value appears in the Chapter 1 appendix in the IM. A discussion of an article that addresses the success of Coca-Cola under Mr. Goizueta's tenure is also included.

Find a business finance magazine site that discusses current issues facing the financial executive at **www.businessfinancemag.com**.

To study financial decision making, we first need to understand the goal of financial management. Such an understanding is important because it leads to an objective basis for making and evaluating financial decisions.

Profit Maximization

Profit maximization would probably be the most commonly cited business goal, but this is not a very precise objective. Do we mean profits this year? If so, then actions such as deferring maintenance, letting inventories run down, and 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 unclear exactly what this means. First, do we mean something like accounting net income or earnings per share? As we will see, these 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 the appropriate trade-off between current and future profits.

The Goal of Financial Management in a Corporation

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 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 it.

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 in a corporation can thus be stated quite easily:

Concept Q
Answer 1.4a

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

Lecture Tip:
You may wish to emphasize the general applicability of the principles of finance by reminding students that in a not-for-profit organization "maximizing the value of owners' equity" is equivalent to maximizing the value of benefits available to those served (example: policyholders in a Blue Cross/Blue Shield organization).

The goal of maximizing the value of the stock avoids the problems associated with the different goals we discussed above. 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. Of course, maximizing stock value is the same thing as maximizing the market price per share.

A More General Financial Management Goal

Given our goal as stated above (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:

REALITY BYTES

Corporate Ethics

Large companies are sometimes guilty of unethical behavior. Often this unethical behavior takes the form of false or misleading financial statements. In one of the largest corporate fraud cases in history, energy giant Enron Corporation was forced to file for bankruptcy in December 2001 amid allegations that the company's financial statements were deliberately misleading and false. Enron's bankruptcy not only destroyed that company, but its auditor Arthur Andersen as well.

Of course, ethical problems are not confined to the United States. For example, in late 2003 the Italian dairy firm Parmalat SpA announced it had liquidity problems. What followed was an investigation into the largest corporate fraud scandal in European history. At one point, the company was forced to disclose that it did not actually have a $4.8 billion bank account it had claimed on its financial statements.

The difference between ethical and unethical behavior can sometimes be murky. For example, many U.S. companies have relocated to Bermuda for reasons beyond the beautiful pink beaches; namely, Bermuda has no corporate income taxes. With a population of less than 65,000, the island is home to more than 13,000 international companies. Stanley Works, the well-known maker of Stanley tools, was among the U.S. corporations that chose to move to the island paradise. By doing so, Stanley estimated that it would save $30 million per year in taxes. Since the goal of the corporation is to maximize shareholder wealth, this would seem like a good move, and the practice is entirely legal. But is it ethical? What are the issues?

Another recent corporate activity that has generated much controversy is the practice of outsourcing, or offshoring, jobs to other countries. U.S. corporations engage in this practice when labor costs in another country are substantially lower than they are domestically. Again, this is done to maximize shareholder wealth. But the ethical dilemma in this case is even trickier. Some U.S. workers do lose jobs when offshoring occurs. On the other hand, the Milken Institute estimated that every $1 spent on offshoring a service job to India generated a net value to the United States of $1.13, along with another $.33 to India. And it gets even more complicated: What about foreign companies such as BMW and Toyota who "insource" jobs by building plants in the United States? Is it unethical to outsource U.S. jobs while, at the same time, insourcing jobs from other countries?

> Maximize the market value of the existing owners' equity.

With this goal 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.

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. Our nearby *Reality Bytes* box discusses some recent ethical issues and problems faced by well-known corporations.

Video Note: Rightsizing—This video focuses on how one company handled the tough decision to cut jobs and managed to successfully increase shareholder value. It features ABT Co. in Canada.

Business ethics are considered at **www.businessethics.com**.

Sarbanes-Oxley Act

In response to corporate scandals involving companies such as Enron, WorldCom, Tyco, and Adelphia, Congress enacted the Sarbanes-Oxley Act in 2002. The Act, which is better known as "Sarbox," is intended to strengthen protection against corporate accounting fraud and financial malpractice. Key elements of Sarbox took effect on November 15, 2004.

Sarbox contains a number of requirements designed to insure that companies tell the truth in their financial statements. For example, the officers of a public corporation must review and sign the annual report. They must attest that the annual report does not contain false statements or material omissions and also that the financial statements fairly represent the company's financial results. In essence, Sarbox makes management personally responsible for the accuracy of a company's financial statements.

To find out more about Sarbanes-Oxley, go to: **www.sarbanes-oxley.com**.

ross46733_ch01.qxd 7/15/05 07:35 PM Page 12

Because of its extensive requirements, compliance with Sarbox can be very costly, which has led to some unintended results. For example, in 2003 about 200 public firms chose to "go dark," meaning that their shares would no longer be traded in the major stock markets, in which case Sarbox does not apply. Most of these companies stated that their reason was to avoid the cost of compliance. Ironically, in such cases, the law had the effect of eliminating public disclosure instead of improving it.

CONCEPT QUESTIONS

1.4a What is the goal of financial management?

1.4b What are some shortcomings of the goal of profit maximization?

1.5 THE AGENCY PROBLEM AND CONTROL OF THE CORPORATION

Critical Thinking Questions 1.6, 1.12–1.14

Slide 1.16 The Agency Problem

We've seen that the financial manager in a corporation acts in the best interests of the stockholders by taking actions that increase the value of the firm's 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? We briefly consider some of the arguments below.

Agency Relationships

Concept Q Answer 1.5a

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 interest. For example, you might hire someone (an agent) to sell a car that 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**.

agency problem The possibility of conflict of interest between the owners and management of a firm.

Suppose you hire someone to sell your car and you agree to pay her a flat fee when 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 paid 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 an agent is compensated is one factor that affects agency problems.

Management Goals

Ethics Note: See IM 1.5 for a look at the agency problem using the case of Gillette.

To see how management and stockholder interests might differ, imagine that a corporation is considering a new investment. The new investment is expected to favorably impact the stock price, but it is also a relatively risky venture. The owners of the firm will wish to take the investment (because the share 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.*

Concept Q Answer 1.5b

Ethics Note: See IM 1.5 for a discussion of Dow-Corning and the silicone breast implant lawsuit.

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, business power or wealth. This goal could lead to an overemphasis on business size or growth. For example, cases where management is accused of overpaying to buy 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 owners of the purchasing company.

ross46733_ch01.qxd 7/15/05 07:35 PM Page 13

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.

Slide 1.17 Managing Managers

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 to the way managers are compensated. Second, can management 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.

Lecture Tip: See IM 1.5 for a discussion of examples and empirical evidence on the use of executive stock options to align the incentives of management and stockholders to mitigate agency problems.

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 oftentimes to share value in particular. For example, managers are frequently given the option to buy stock at a fixed price. The more the stock is worth, the more valuable is this option. The second incentive managers have relates to job prospects. Better performers within the firm will tend to get promoted. More generally, those managers who are successful in pursuing stockholder goals will be in greater demand in the labor market and thus command higher salaries.

Concept Q Answer 1.5c

In fact, managers who are successful in pursuing stockholder goals can reap enormous rewards. For example, Rueben Mark, CEO of consumer products maker Colgate-Palmolive, received about $148 million in 2004 alone, which is less than Mel Gibson ($210 million), but way more than Beyoncé Knowles ($21 million). For the five-year period ending 2004, Larry Ellison of software giant Oracle was one of the top earners, receiving over $835 million.

Lecture Tip: An extreme example of tying managerial compensation to performance occurred at Union Carbide. The CEO agreed to forfeit a year's salary if the firm failed to meet earnings goals. Further, 16 senior executives agreed to forgo 65 percent of their annual salaries. This is truly the "stick" in the "carrot or stick" approach to employee motivation!

Control of the Firm Control of the firm ultimately rests with stockholders. They elect the board of directors, who, in turn, hires and fires management. The 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 management.

Another way that management can be replaced is by takeover. Those 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. Information on executive compensation, along with a ton 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.

Sometimes it's hard to tell if a company's management is really acting in the shareholders' best interests. Consider the 2005 merger of software giants Oracle and PeopleSoft. PeopleSoft repeatedly rejected offers by Oracle to purchase the company. In November 2004, the board rejected a "best and final" offer, even after 61 percent of PeopleSoft's shareholders voted in favor of it. So was the board really acting in shareholders' best interests? At first, it may not have looked like it, but Oracle then increased its offer price by $2 per share, which the board accepted. So, by holding out, PeopleSoft's management got a much better price for its shareholders.

Ethics Note: Classical approaches to ethical decision making vis-à-vis the stakeholder model are described in IM 1.5.

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.

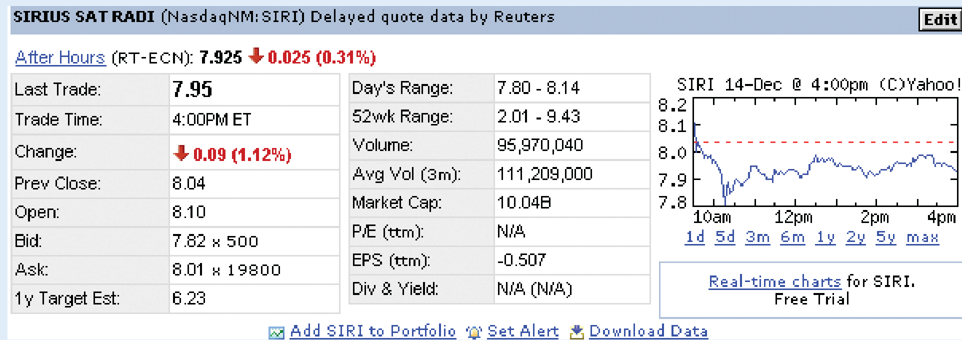
ross46733_ch01.qxd 7/15/05 07:35 PM Page 14

WORK THE WEB

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

Slide 1.18 Example: Work the Web

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 a company's name to find the ticker. For example, we typed in "SIRI," which is the ticker symbol for Sirius Radio, the satellite radio provider. Here is a portion of what we got:



SIRIUS SAT RADI (NasdaqNM:SIRI) Delayed quote data by Reuters — Edit

After Hours (RT-ECN): 7.925 0.025 (0.31%)

Last Trade:	7.95	Day's Range:	7.80 - 8.14
Trade Time:	4:00PM ET	52wk Range:	2.01 - 9.43
Change:	0.09 (1.12%)	Volume:	95,970,040
Prev Close:	8.04	Avg Vol (3m):	111,209,000
Open:	8.10	Market Cap:	10.04B
Bid:	7.82 x 500	P/E (ttm):	N/A
Ask:	8.01 x 19800	EPS (ttm):	-0.507
1y Target Est:	6.23	Div & Yield:	N/A (N/A)

Add SIRI to Portfolio Set Alert Download Data

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

Agency problems are not unique to corporations; they exist whenever there is a separation of ownership and management. This separation is most pronounced in corporations, but it certainly exists in partnerships and proprietorships as well.

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.

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

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.

Lecture Tip: See IM 1.5 for a discussion of the Microsoft antitrust case.

CONCEPT QUESTIONS

1.5a What is an agency relationship?

1.5b What are agency problems and how do they arise? What are agency costs?

1.5c What incentives do managers in large corporations have to maximize share value?

ross46733_ch01.qxd 7/15/05 07:35 PM Page 15

FINANCIAL MARKETS AND THE CORPORATION 1.6

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.

Critical Thinking Questions 1.7, 1.8

Video Note: Financial Markets—This video discusses how capital is raised in financial markets and shows an open-outcry market at the Chicago Board of Trade.

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 (or long-term) assets (B). These assets generate some 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.

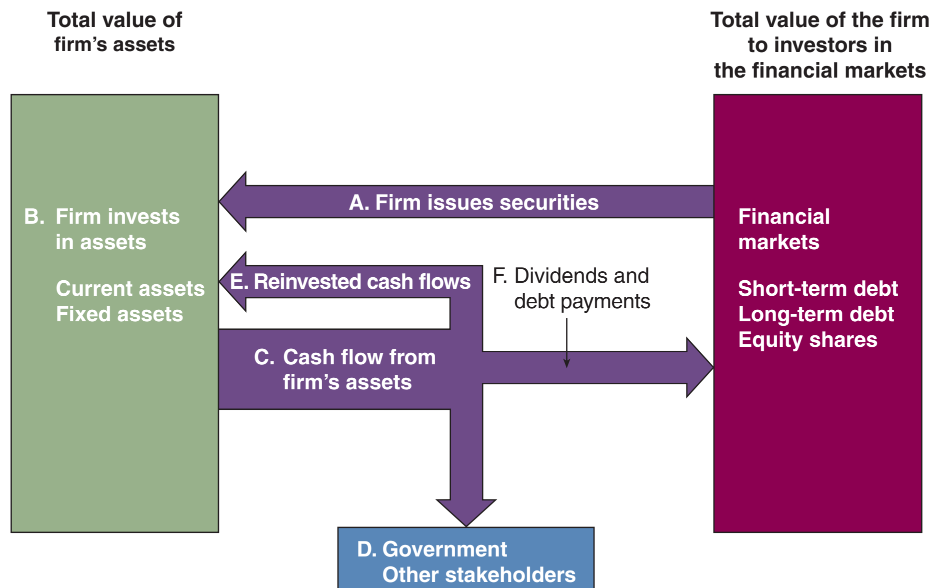


FIGURE 1.2

Cash flows between the firm and the financial markets

Slide 1.19

ross46733_ch01.qxd 7/15/05 07:35 PM Page 16

Slide 1.20
Financial Markets

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.

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

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.

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

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. It is therefore the secondary markets that provide the means for transferring ownership of corporate securities. Although a corporation is only directly involved 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.

Concept Q
Answer 1.6a

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 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.

Concept Q
Answer 1.6c

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.

Concept Q
Answer 1.6b

The Tokyo Stock Exchange in English: **www.tse.or.jp/english**.

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 (NASD Automated Quotations system, pronounced "naz-dak"). There are roughly three times as many companies on NASDAQ as there are on NYSE, but they tend to be much smaller in size 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 significantly 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 instruments never stops; it just travels around the world.

Lecture Tip: Students are often confused by the fact that NASDAQ is an OTC market. Explain that the NASDAQ market site is just a convenient place for reporters to show how the stocks are moving, but that trading does not actually take place there.

The London Stock Exchange: **www.londonstockexchange.com**.

Listing Stocks that trade on an organized exchange (or market) are said to be *listed* on that exchange. In order to be listed, firms must meet certain minimum criteria concerning, for example, asset size and number of shareholders. These criteria differ for different exchanges.

NYSE has the most stringent requirements of the stock markets in the United States. For example, to be listed on NYSE, a company is expected to have a market value for its publicly held shares of at least $60 million and a total of at least 2,000 shareholders with at least 100 shares each. There are additional minimums on earnings, assets, and number of shares outstanding.

Lecture Tip: See IM 1.6 for a discussion about an October 1999 *BusinessWeek* article concerning the move by the NYSE and NASDAQ toward for-profit companies, and the possible impact on investors, as well as an update on what has happened since.

CONCEPT QUESTIONS

1.6a What is a dealer market? How do dealer and auction markets differ?

1.6b What is the largest auction market in the United States?

1.6c What does *OTC* stand for? What is the large OTC market for stocks called?

Lecture Tip: Use the Quick Quiz (Slide 1.21) to check student understanding of the key topics in this chapter.

SUMMARY AND CONCLUSIONS

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

1. Business 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.

ross46733_ch01.qxd 7/15/05 07:35 PM Page 18

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.

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

www.mhhe.com/rwj

CRITICAL THINKING AND CONCEPTS REVIEW

1.1 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.

1.2 Sole Proprietorships and Partnerships. What are the four primary disadvantages to 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?

1.3 Corporations. What is the primary disadvantage of the corporate form of organization? Name at least two of the advantages of corporate organization.

1.4 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?

1.5 Goal of Financial Management. What goal should always motivate the actions of the firm's financial manager?

1.6 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?

1.7 Primary versus Secondary Markets. You've probably noticed coverage in the financial press of an initial public offering (IPO) of a company's securities. Web search company Google is a relatively recent example. Is an IPO a primary-market transaction or a secondary-market transaction?

1.8 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?

1.9 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?

1.10 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 such as 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.

ross46733_ch01.qxd 7/15/05 07:35 PM Page 19

1.11 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?

1.12 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?

1.13 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?

1.14 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, Lee Raymond of ExxonMobil earned about $25 million in 2004 and about $111 million over the 2000–2004 period. Are such amounts excessive? In answering, it might be helpful to recognize that superstar athletes such as Tiger Woods, top entertainers such as Jim Carrey and Julia Roberts, and many others at the top of their respective fields earn at least as much, if not a great deal more.

1.15 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?"

WHAT'S ON THE WEB?

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 has more stringent listing requirements? Why don't they 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.

www.mhhe.com/rwj