CHAPTER 1

The Corporation

Chapter Synopsis

1.1 The Four Types of Firms

A **sole proprietorship** is a business owned by one person who has unlimited liability for the debt and other liabilities incurred by the firm. The business itself pays no income taxes; instead, the owner is responsible for paying tax on the firm's profits. An estimated 71% of businesses in the United States are organized as sole proprietorships, but they account for only 5% of business revenue.

A **partnership** is a business with at least two owners who have unlimited liability for the debt and other liabilities of the firm. Similar to sole proprietorships, the partners are responsible for paying taxes on the profits the firm generates, but the partnership pays no business (or corporation) taxes. An estimated 4% of businesses in the United States are partnerships, and they account for about 5% of revenue. A **limited partnership** is a partnership with two kinds of owners: general partners, who are responsible for overseeing the firm's activities and have unlimited liability; and limited partners, who have limited liability but cannot legally be involved in making managerial decisions for the business.

A **limited liability company** is a firm with one or more owners in which there is limited liability for the owner(s). There are two types of limited liability companies: private companies and public companies. The owners of private liability companies are not allowed to trade their shares on an organized exchange.

A **corporation (or company)** is a legal entity separate from its owners, whose liability is limited to the amount they have invested in the firm. Corporations make up 19% of all U.S. businesses and account for 84% of revenue. Ownership in a corporation is divided into shares (or stock) and owners are called stockholders or shareholders. A corporation is generally more complicated to form, and its governance is dictated by its corporate charter and corporate laws. In the United States, a corporation meeting certain restrictions can elect to be treated as an S-corporation and be taxed like a sole proprietorship or partnership. Otherwise, the corporations pay corporate taxes on profits and are referred to as C-corporations in the United States. If a C-corporation elects to pay dividends from its after-tax net income, the stockholders receiving the dividends are generally taxed on the dividends received, which results in double taxation.

1.2 Ownership Versus Control of Corporations

Shareholders exercise control over the firm's operations by voting for the **board of directors** who are responsible for overseeing the firm's operation. The board delegates most daily decision making authority to the firm's management, which is headed by the chief executive officer (CEO).

Within the corporation, financial managers are responsible for three main tasks: making investment decisions, making financing decisions, and managing the firm's cash flows.

In theory, the goal of a firm should be determined by the firm's owners. A sole proprietorship has a single owner who runs the firm, so the goals of a sole proprietorship are the same as the owner's goals. But in organizational forms with multiple owners, the appropriate goal of the firm—and thus of its managers—is not as clear.

Since corporations frequently have thousands of shareholders, ownership and control of the firm are separated. Potentially, most of the stock is owned by a widely diffused group of shareholders who aren't on the board of directors or management team, but the board of directors and senior managers have direct control of the corporation. The separation of ownership and control in this context is generally referred to as an **agency** (or **principal-agent**) **problem:** The board and managers are agents of the principals (the shareholders), and there is a problem if the two have different interests. The shareholders can try and reduce any agency problems by ensuring that managers' compensation is tied to firm performance and that underperforming managers are fired. They can also mount a hostile takeover (or threaten a hostile takeover) by acquiring a controlling interest in the firm's stock and replacing the existing board.

1.3 The Stock Market

Since shares in a corporation can be widely held, many public companies are often listed on a **stock exchange** and their shares are traded in the **stock market.** Publicly traded stock often has a high level of **liquidity,** which refers to the ability to sell shares close to the price you can contemporaneously buy them for.

When a listed company itself issues new shares and sells them to investors, it does so in the **primary market.** After this initial transaction between the corporation and investors, the shares continue to trade in a **secondary market** between investors without the involvement of the corporation.

The New York Stock Exchange (NYSE) is a physical exchange in which **market makers** known as **specialists** match buyers and sellers by posting prices at which they are willing to buy shares (the **bid price**) and prices at which they will sell shares (the **ask price**). In general, the lower the **bid-ask spread**, the greater the liquidity of a given stock. While the bid-ask spread is a **transaction cost** to traders, it is a source of profit for the market makers.

The NASDAQ is a non-physical stock exchange in which multiple market makers are able to post bid and ask prices on a computer network.

Selected Concepts and Key Terms

Sole Proprietorship

A business owned by one person who has unlimited liability for the debt and other liabilities incurred by the firm. The business itself pays no income taxes; instead, the owner is responsible for paying tax on the firm's profits.

Partnership

A business with at least two owners who have unlimited liability for the debt and other liabilities of the firm. It is similar to a sole proprietorship in that the partners are responsible for paying taxes on the profits the firm generates but the partnership pays no business taxes.

Limited Partnership

A partnership with two kinds of owners: **general partners** who are responsible for overseeing the firm's activities and have unlimited liability; and **limited partners** who have limited liability but cannot legally be involved in making managerial decision for the business.

Limited Liability Company

A firm with one or more owners in which there is limited liability to the owner(s). There are two types of limited liability companies: private companies and public companies.

Corporation (or Company)

A legal entity separate from its owners, who have limited liability. Ownership in a corporation is divided into shares (or stock) and owners are called stockholders or shareholders. In the United States, a corporation meeting certain restrictions can elect to be treated as an **S-corporation** and be taxed like sole proprietorship or partnership. Otherwise the corporation must pay corporate taxes on profits every year and is referred to as a **C-corporation** in the United States. If a C-corporation elects to pay dividends from its after-tax net income, the stockholders receiving the dividends are generally taxed on the dividend, which results in double taxation.

Chief Financial Officer (CFO)

The most senior financial manager in a corporation who often reports directly to the CEO.

Agency Problem or Principal-Agent Problem

A problem that may arise in a corporation because of the separation of ownership and control: Managers may have little incentive to work in the interests of the shareholders when this means working against their own self-interest.

Primary Market

The stock market in which a corporation itself issues new shares and sells them directly to investors.

Secondary Market

After the initial transaction between the corporation and investors in the primary market, the shares continue to trade in the secondary market between investors without the involvement of the corporation.

Liquidity

The ability to sell shares close to the price you can contemporaneously buy them for. **Market makers** match buyers and sellers by posting prices at which they are willing to buy shares (the **bid price**) and prices at which they will sell shares (the **ask price**). In general, the lower the **bid-ask spread,** the greater the liquidity of a given stock. While the bid-ask spread is a **transaction cost** to traders, it is a source of profit for the market makers.

Concept Check Questions and Answers

1.1.1. What is a limited liability company? How does it differ from a limited partnership?

A limited liability company is a company where the owners have limited liability and therefore cannot be personally liable for the firms' debts. A limited partnership, in contrast, has two kinds of owners: general partners and limited partners. General partners run the business and are personally liable for the firm's debt obligations. Limited partners cannot run the business, and their liability is limited to their investment in the limited partnership.

1.1.2. What are the advantages and disadvantages of organizing a business as a corporation?

A corporation has the following advantages: 1) Shareholders have limited liability; 2) it is easy to transfer ownership; 3) the corporation has unlimited life; and 4) outside funding is only limited by the corporation's future business prospects. The disadvantage of a corporation is double taxation: The corporation pays tax on its profits, and when the profits are distributed to the shareholders, the shareholders pay their own personal income tax on this income.

1.2.1. What are the three main tasks of a financial manager?

Financial managers are responsible for three main tasks: making investment decisions, making financing decisions, and managing the firm's cash flows.

1.2.2. What is a principal-agent problem that may exist in a corporation?

The principal-agent problem arises from the separation of ownership and control in a corporation. Managers may pursue their own self-interest instead of working for the interests of the shareholders.

1.2.3. How may a corporate bankruptcy filing affect the ownership of a corporation?

In bankruptcy, management is given the opportunity to reorganize the firm and renegotiate with debt holders. If this process fails, control of the corporation generally passes from equity holders to debt holders. In most cases, the end result is often a change in ownership of the corporation.

1.3.1. What is the New York Stock Exchange (NYSE)?

The NYSE is the largest stock exchange in the world. Billions of dollars of stocks are exchanged every day on the NYSE. The NYSE is a physical place located in New York City. On the floor of the NYSE, market makers, known as specialists, match buyers and sellers.

1.3.2. What advantage does a stock market provide to corporate investors?

The advantage a stock market provides to corporate investors is liquidity. Investors in a public company can easily and quickly turn their investments into cash by simply selling their shares on one of the organized stock markets.