1 Introduction to Finance

Figure 1.1 Finance is the linchpin that connects and directs many parts of a business or organization. (credit: modification of work “Finance behind the Glass” by Max London/flickr, CC BY 2.0)

Chapter Outline

Why It Matters

Finance is essential to the management of a business or organization. Without good financial protocol, safeguards, and tools, running a successful business is more difficult. In 1978, Bacon Signs was a family-owned, regional Midwestern sign company engaged in the manufacture, sale, installation, and maintenance of commercial signage. The company was about to transition from the second to third generation of family ownership. Bacon Signs, established in 1901, had weathered the Great Depression, World War II, the Vietnam War, and the oil embargo and was working its way through historically high rates of inflation and interest rates. The family business had successfully struggled through the ebb and flow of the regional and national economy by providing quality products and service to its regional clients.

In the early 1980s, the company’s fortunes changed permanently for the better. The owner recognized that the custom signs built by his firm were superior in quality to the signs it installed for national franchises. The owner worked with the company’s banker and vice president of finance and operations to develop a production, sales, and financing plan that could be offered to the larger national sign companies. The larger companies agreed to subcontract manufacturing of midsize orders to Bacon Signs. The firm then made a commitment to build and deliver these signs on time and under budget. As Bacon Signs’ reputation for quality grew, so did demand for its products. The original financing plan anticipated this potential growth and was designed to meet anticipated capital requirements so that the firm could expand how and when it needed to.

Bacon Signs' ability to manufacture and deliver a high-quality product at a good price was the true value of the firm. However, without the planning and ability to raise capital facilitated by the financing plan, the firm would not have been able to act on its strengths at the critical moment. Financing was the key to expansion and financial stability for the firm.[1]

In this book, we demonstrate that business finance is about developing and understanding the tools that help people make consistently good and repeatable decisions.

1.1 What Is Finance?

Learning Outcomes

By the end of this section, you will be able to:

- Describe the main areas in finance.
- Explain the importance of studying finance.
- Discuss the concepts of risk and return.

Definition of Finance

Finance is the study of the management, movement, and raising of money. The word *finance* can be used as a verb, such as when the First National Bank agrees to finance your home mortgage loan. It can also be used as a noun referring to an entire industry. At its essence, the study of finance is about understanding the uses and sources of cash, as well as the concept of risk-reward trade-off. Finance is also a tool that can help us be better decision makers.

Basic Areas in Finance

Finance is divided into three primary areas in the domestic market: business finance, investments, and financial markets and institutions (see Figure 1.2). We look at each here in turn.

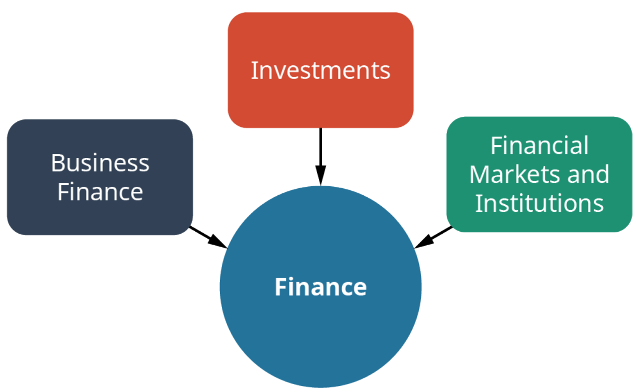

Figure 1.2 The Three Basic Areas of Study in Finance

Business Finance

Business finance looks at how managers can apply financial principles to maximize the value of a firm in a risky environment. Businesses have many stakeholders. In the case of corporations, the shareholders own the company, and they hire managers to run the company with the intent to maximize shareholder wealth. Consequently, all management decisions should run through the filter of these questions: "How does this decision impact the wealth of the shareholders?" and "Is this the best decision to be made for shareholders?"

In business finance, managers focus on three broad areas (see Figure 1.3).

1 Dun & Bradstreet. "Bacon Signs, Inc." *D&B Business Directory.* https://www.dnb.com/business-directory/company-profiles.bacon_signs_inc.90df737e33956dd7c76717a20e9d56ad.html#financials-anchor

1. **Working capital management** (WCM) is the study and management of short-term assets and liabilities. The chief financial officer (CFO) and the finance team are responsible for establishing company policy for how to manage WCM. The finance department determines credit policy, establishes minimum criteria for the extension of credit to clients, terms of lending, when to extend, and when to take advantage of short-term creditor financing. The accounting department basically implements the finance department's policies. In many firms, the accounting and finance functions operate in the same department; in others, they are separate.
2. **Capital budgeting** is the process of determining which long-term or fixed assets to acquire in an effort to maximize shareholder value. Capital budgeting decisions add the greatest value to a firm. As such, capital budgeting is thought to be one of the most important financial functions within a firm. The capital budgeting process consists of estimating the value of potential investments by forecasting the size, timing, and risk of cash flows associated with the investments. The finance department develops and compiles cash flow estimates with input from the marketing, operations, accounting, human resources, and economics departments to develop a portfolio of investment projects that collectively maximize the value of the firm.
3. **Capital structure** is the process by which managers focus more specifically on long-term debt and increasing shareholder wealth. Capital structure questions require financial managers to work with economists, lenders, underwriters, investment bankers, and other sources of external financial information and financial capital. When Bacon Signs developed its financial plan, the executives included each of these three aspects of business finance into the plan.

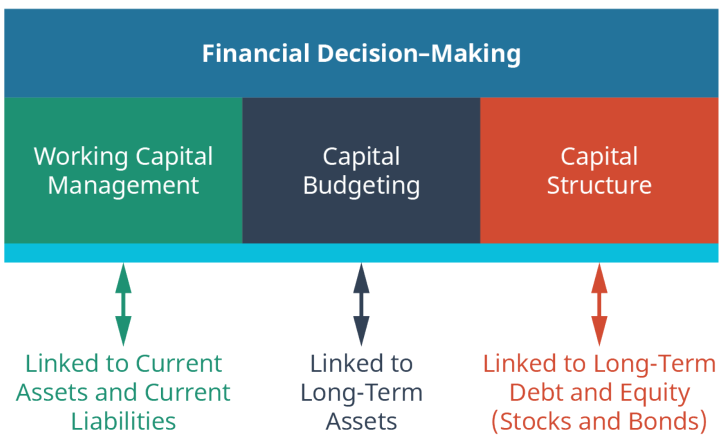

Figure 1.3 How Corporate Finance Decision-Making Activities Relate to the Balance Sheet

Figure 1.3 demonstrates how the three essential decision-making activities of the financial manager are related to a balance sheet. Working capital management focuses on short-term assets and liabilities, capital budgeting is focused on long-term assets, and capital structure is concerned with the mix of long-term debt and equity financing.

Investments

Investments are products and processes used to create and grow wealth. Most commonly, investment topics include the discussion and application of the different types of financial instruments, delivery vehicles, regulation, and risk-and-return opportunities. Topics also include a discussion of stocks, bonds, and derivative securities such as futures and options. A broad coverage of investment instruments would include mutual funds, exchange-traded funds (ETFs), and investment vehicles such as 401k plans or individual retirement accounts (IRAs). In addition, real assets such as gold, real estate, and commodities are also common discussion topics and investment opportunities.

Investments is the most interesting area of finance for many students. Television programs such as *Billions* and movies such as *Wall Street* make investing appear glamorous, dangerous, shady, or intoxicating, depending on the situation and the attitude of the viewer. In these programs, the players and their decisions can lead to tremendous wealth or tremendous losses. In reality, most of us will manage our portfolios well shy of the extremes portrayed by the entertainment industry. However, we will need to make personal and business investment decisions, and many students reading this material will work in the investment industry as personal investment advisers, investment analysts, or portfolio managers.

Financial Markets and Institutions

Financial markets and institutions are the firms and regulatory agencies that oversee our financial system. There is overlap in this area with investments and business finance, as the firms involved are profit seeking and need good financial management. They also are commonly the firms that facilitate investment practices in our economy. A financial institution regulated by a federal or state agency will likely handle an individual investment such as the purchase of a stock or mutual fund.

Much of the US regulatory structure for financial markets and institutions developed in the 1930s as a response to the stock market crash of 1929 and the subsequent Great Depression. In the United States, the desire for safety and protection of investors and the financial industry led to the development of many of our primary regulatory agencies and financial regulations. The Securities and Exchange Commission (SEC) was formed with the passage of the Securities Act of 1933 and Securities Exchange Act of 1934. Major bank regulation in the form of the Glass-Steagall Act (1933) and the Banking Act of 1935 gave rise to government-backed bank deposit insurance and a more robust Federal Reserve Bank.

These regulatory acts separated investment banking from commercial banking. Investment banks and investment companies continued to underwrite and facilitate new bond and equity issues, provide financial advice, and manage mutual funds. Commercial banks and other depository institutions such as savings and loans and credit unions left the equity markets and reduced their loan portfolios to commercial and personal lending but could purchase insurance for their primary sources of funds, checking, and savings deposits.

Today, the finance industry barely resembles the structure your parents and grandparents grew up and/or worked in. Forty years of deregulation have reshaped the industry. Investment and commercial bank operations and firms have merged. The separation of activities between investment and commercial banking has narrowed or been eliminated. Competition from financial firms abroad has increased, and the US financial system, firms, and regulators have learned to adapt, change, and innovate to continue to compete, grow, and prosper.

The **Financial Industry Regulatory Authority (FINRA)** formed in 2007 to consolidate and replace existing regulatory bodies. FINRA is an independent, nongovernmental organization that writes and enforces the rules governing registered brokers and broker-dealer firms in the United States. The **Securities Investor Protection Corporation (SIPC)** is a nonprofit corporation created by an act of Congress to protect the clients of brokerage firms that declare bankruptcy. SIPC is an insurance that provides brokerage customers up to $500,000 coverage for cash and securities held by the firm.

The regulation of the financial industry kicked into high gear in the 1930s and for those times and conditions was a necessary development of our financial industry and regulatory oversight. Deregulation of the finance industry beginning in the 1970s was a necessary pendulum swing in the opposite direction toward more market-based and less restrictive regulation and oversight. The Great Recession of 2007–2009 resulted in the reregulation of several aspects of the financial industry. Some would argue that the regulatory pendulum has swung too far toward deregulation and that the time for more or smarter regulation has returned.

CONCEPTS IN PRACTICE

The Great Recession

The Great Recession of 2007–2009 exposed many of the weaknesses of our financial system. The ease with which banks could lower credit standards to allow ill-prepared consumers to purchase real estate and the resulting speed with which the world economy plunged into recession is astounding.

Regulation to address the economic crisis was also swift. Fortunately, Ben Bernanke, chairman of the Federal Reserve at the time, had throughout his career conducted extensive research into the causes of and potential resolution of the Great Depression of the 1930s.[2] He was uniquely qualified to lead the economic response to the crisis. Some resulting laws moved to address the immediate needs and others to correct the underlying causes of the recession.

One immediate fix was the Troubled Asset Relief Program (TARP). TARP authorized the Treasury to buy illiquid assets in order to save the financial institutions so important to lubricating our economy. Politically this was a tough decision, as it appeared that the government bailed out greedy bankers. In the end, however, the program was justified because the economy immediately began a slow but steady recovery, most financial institutions did not fail, and the Treasury recouped all of its investment used in the bailout. However, individual homeowners suffered greatly.

The Dodd-Frank Act of 2008 attempted to address many of the underlying causes of the Great Recession by reorganizing and toughening the regulatory framework, including tighter oversight of critically important financial institutions. Dodd-Frank also created the Consumer Financial Protection Bureau (CFPB) to protect consumers from harm caused by unscrupulous banking activities. Today, the hope is that financial institutions will be stopped short of the gross negligence evident prior to 2007 and consumers won't be left out in the cold due to actions beyond their control.

Sources: History Channel. "Here's What Caused the Great Recession." *YouTube*. May 15, 2018. https://www.youtube.com/watch?v=yM0uonkloXY. Accessed April 18, 2021; Randall D. Guynn, Davis Polk, and Wardwell LLP, "The Financial Panic of 2008 and Financial Regulatory Reform." *Harvard Law School Forum on Corporate Governance*. November 20, 2010. https://corpgov.law.harvard.edu/2010/11/20/the-financial-panic-of-2008-and-financial-regulatory-reform/. Accessed April 18, 2021; Sean Ross. "What Major Laws Were Created for the Financial Sector Following the 2008 Crisis?" *Investopedia*. Updated March 31, 2020. https://www.investopedia.com/ask/answers/063015/what-are-major-laws-acts-regulating-financial-institutions-were-created-response-2008-financial.asp. Accessed April 18, 2021.

Why We Study Finance

Finance is the lubricant that keeps our economy running smoothly. Issuing a mortgage can be profitable for a bank, but it also allows people to live in their own homes and to pay for them over time. Do MasterCard, Venmo, and PayPal make money when you use their product? Sure, but think how much more convenient and safer it is to carry a card or use an app instead of cash. In addition, these services allow you to easily track where and how you spend your money. A well-regulated and independent financial system is important to capital-based economies. Our smoothly functioning financial system has removed us from the days of strictly bartering to our system today, where transactions are as simple as a tap on your mobile phone.

There are any number of professional and personal reasons to study finance. A search of the internet provides a long list of finance-related professions. Interviews with senior managers reveal that an understanding of financial tools and concepts is an important consideration in hiring new employees. Financial skills are among

2 Brookings Institution. "Ben S. Bernanke." *Brookings Institute*. https://www.brookings.edu/experts/ben-s-bernanke/; Ben S. Bernanke. "On Milton Friedman's 90th Birthday." *The Federal Reserve Board*. November 8, 2002. https://www.federalreserve.gov/boarddocs/speeches/2002/20021108/

the most important tools for advancement toward greater responsibility and remuneration. Government and work-guaranteed pension benefits are growing less common and less generous, meaning individuals must take greater responsibility for their personal financial well-being now and at retirement. Let's take a closer look at some of the reasons why we study finance.

There are many career opportunities in the fields of finance. A single course in finance such as this one may pique your interest and encourage you to study more finance-related topics. These studies in turn may qualify you for engaging and high-paying finance careers. We take a closer look at financial career opportunities in Careers in Finance.

A career in finance is just one reason to study finance. Finance is an excellent decision-making tool; it requires analytical thinking. Further, it provides a framework for estimating value through an assessment of the timing, magnitude, and risk of cash flows for long-term projects. Finance is important for more immediate activities as well, such as the development of budgets to assure timely distribution of cash flows such as dividends or paychecks.

An understanding of finance and financial markets opens a broader world of available financial investment opportunities. At one time, commercial bank deposits and the occasional investment in stocks, bonds, real estate, or gold may have provided sufficient coverage of investment opportunities, portfolio diversification, and adequate returns. However, in today's market of financial technology, derivative securities, and cryptocurrencies, an understanding of available financial products and categories is key for taking advantage of both new and old financial products.

LINK TO LEARNING

Job Information

The internet provides a wealth of information about types of jobs in finance, as well as reasons to study it. Investigate the *Occupational Outlook Handbook (https://openstax.org/r/bls-gov)* issued by the Bureau of Labor Statistics to see how many of the career opportunities in finance look interesting to you. Think about the type of people you want to work with, the type of work-related activities you enjoy, and where you would like to live. Read "5 Reasons Why You Should Study Finance" at Harvard Business School Online (https://openstax.org/r/why-study-finance) to gain a better understanding of why finance offers a broad career path and is intellectually stimulating and satisfying.

Risk and Return in Finance

Finance tells us that an increase in risk results in an increase in expected return. The study of historical financial markets demonstrates that this relationship generally holds true and that riskier investments over time have provided greater returns. Of course, this is not true all the time and under all conditions; otherwise, where's the risk?

At its most basic level, risk is uncertainty. The study of finance attempts to quantify risk in a way that helps individuals and organizations assess an appropriate trade-off for risk. Risk-return tradeoffs are all around us in our everyday decision-making. When we consider walking across the street in the middle of a city block or walking down to the marked intersection, we are assessing the trade-off between convenience and safety. Should you buy the required text for your class or instead rely on the professor's notes and the internet? Should you buy that new-to-you used car sight unseen, or should you spend the money for a mechanic to assess the vehicle before you buy? Should you accept your first job offer at graduation or hold out for the offer you really want? A better understanding of finance makes these types of decisions easier and can provide you, as the decision maker, with statistics instead of just intuition.

Return is compensation for making an investment and waiting for the benefit (see Figure 1.4). Return could be the interest earned on an investment in a bond or the dividend from the purchase of stock. Return could be the higher income received and the greater job satisfaction realized from investing in a college education. Individuals tend to be risk averse. This means that for investors to take greater risks, they must have the expectation of greater returns. Investors would not be satisfied if the average return on stocks and bonds were the same as that for a risk-free savings account. Stocks and bonds have greater risk than a savings account, and that means investors expect a greater average return.

The study of finance provides us with the tools to make better and more consistent assessments of the risk-return trade-offs in all decision-making, but especially in financial decision-making. Finance has many different definitions and measurements for risk. Portfolios of investment securities tend to demonstrate the characteristics of a normal return distribution, or the familiar "bell-shaped" curve you studied in your statistics classes. Understanding a security's average and variability of returns can help us estimate the range and likelihood of higher- or lower-than-expected outcomes. This assessment in turn helps determine appropriate prices that satisfy investors' required return premiums based on quantifiable expectations about risk or uncertainty. In other words, finance attempts to measure with numbers what we already "know."

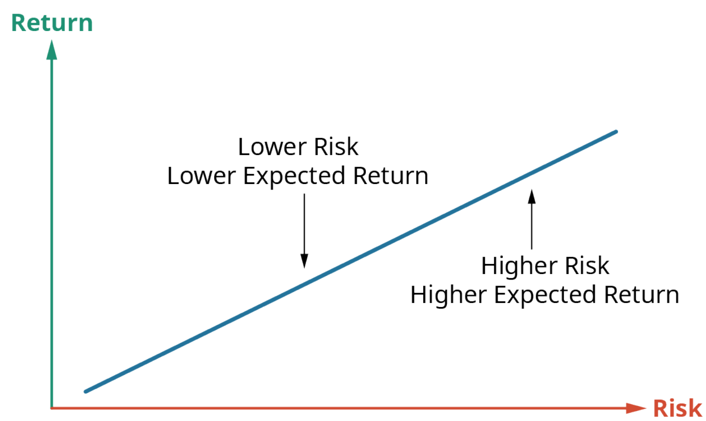

Figure 1.4 Risk and Expected Return This describes the trade-off that invested money can bring higher profits if the investor is willing to accept the risk of possible loss.

The overall uncertainty of returns has several components.

- **Default risk** on a financial security is the chance that the issuer will fail to make the required payment. For example, a homeowner may fail to make a monthly mortgage payment, or a corporation may default on required semiannual interest payments on a bond.
- **Inflation risk** occurs when investors have less purchasing power from the realized cash flows from an investment due to rising prices or inflation.
- **Diversifiable risk**, also known as unsystematic risk, occurs when investors hold individual securities or smallish portfolios and bear the risk that a larger, more well-rounded portfolio could eliminate. In these situations, investors carry additional risk or uncertainty without additional compensation.
- **Non-diversifiable risk**, or systematic risk, is what remains after portfolio diversification has eliminated unnecessary diversifiable risk. We measure non-diversifiable risk with a statistical term called *beta.* Subsequent chapters on risk and return provide a more in-depth discussion of beta.
- **Political risk** is associated with macroeconomic issues beyond the control of a company or its managers. This is the risk of local, state, or national governments "changing the rules" and disrupting firm cash flows. Political risk could come about due to zoning changes, product liability decisions, taxation, or even nationalization of a firm or industry.

1.2 The Role of Finance in an Organization

Learning Outcomes

By the end of this section, you will be able to:

- Describe the finance function.
- Explain the role of finance and its importance within an organization.

The Finance Function

Finance has many functions within an organization, and there are many job titles to reflect the varied job responsibilities. The **comptroller**, or more commonly a *controller*, in a for-profit business relies heavily on a knowledge of accounting. Controllers are in charge of financial reporting and the oversight of the accounting activities necessary to develop those reports. Controllers are concerned with payroll functions, accounts receivable, and accounts payable including taxes, inventory control, and any number of short-term asset and liability tracking and monitoring activities. They aid internal and external auditors and are responsible for monitoring and implementing the day-to-day financial operations of the firm.

In most organizations, the **treasurer** might assume many of the duties of the controller. However, the treasurer is also responsible for monitoring cash flow at a firm and frequently is the contact person for bankers, underwriters, and other outside sources of financing. A treasurer may be responsible for structuring loan and debt obligations and determining when and from whom to borrow funds. Treasurers are also responsible for investing excess funds. Where a controller may face inward toward the organization, the treasurer often faces outward as a representative to the public.

The vice president of finance (VP-F) is an executive-level position and oversees the activities of the controller and treasurer. The chief responsibility of the VP-F is to create and mentor a sufficient and qualified staff that generates reports that are timely, accurate, and thorough.

The **chief financial officer**, or **CFO**, is in a “big picture” position. The CFO sets policy for working capital management, determines optimal capital structure for the firm, and makes the final decision in matters of capital budgeting. The CFO is also forward looking and responsible for strategic financial planning and setting financial goals. Compared to a VP-F, a CFO is less of a “hands-on” manager and engages more in visionary and strategic planning.

Financial Planning

Financial planning is critical to any organization, large or small, private or public, for profit or not-for-profit. Financial planning allows a firm to understand the past, present, and future funding needs and distributions required to satisfy all interested parties. For-profit businesses work to maximize the wealth of the owners. These could be shareholders in a publicly traded corporation, the owner-managers of a “mom and pop” store, partners in a law firm, or the principal owners of any other number of business entities. Financial planning helps managers understand the firm’s current status, plan and create processes and contingencies to pursue objectives, and adjust to unexpected events. The more thoughtful and thorough the financial planning process, the more likely a firm will be able to achieve its goals and/or weather hard times. Financial plans typically consider the firm’s strategic objectives, ethical practices, and sources and costs of funds, as well as the development of budgets, scenarios, and contingencies. The financial plan Bacon Signs developed was thorough enough to anticipate when and how growth might occur. The plan that was presented to commercial banks allowed the firm to be guaranteed new financing at critical moments in the firm’s expansion.

Good financial planning has a number of common features.

- It uses past, current, and pro forma (forward-looking) income statements. Pro forma income statements are created using assumptions from past events to make projections for future events. These income statements should develop likely scenarios and provide a sensitivity analysis of key assumptions.

- Cash flow statements are a critical part of any financial planning. Cash flow statements estimate the timing and magnitude of actual cash flows available to meet financial obligations.
- Balance sheets are critical for demonstrating the sources and uses of funds for a firm. One of the most important aspects of business is accounting (see Figure 1.5).
- Forecasting in the form of expected sales, cost of funds, and microeconomic and macroeconomic conditions are essential elements of financial planning.
- Financial analysis including ratio analysis, common-size financial statements, and trend statements are important aspects of financial planning. Such analysis aids in the understanding of where a firm has been, how it stacks up against the competition, and the assessment of target objectives.

Figure 1.5 The Accounting System The accounting system relies on accurate data used to prepare all the financial reports that help to evaluate a firm.

LINK TO LEARNING

Elements of a Financial Plan

You can view key elements in a financial plan (https://openstax.org/r/write-your-business-plan) at the US Small Business Administration’s website.

Forecasting and Budgeting

Forecasting and budgeting are common practices for businesses, governmental agencies, not-for-profit firms, and individual households. As with many of the financial topics introduced in this chapter, these activities are valuable for individuals and businesses alike. Budgeting, or planning for the amount, sources, and uses of cash, occurs early in the planning process. It is common for businesses to have developed an annual budget well before the start of the year. With budgeting, a firm establishes objectives for the upcoming period by developing financial statements based on historical data and expectations, as well as aspirations for the future. The budgeting process helps the firm identify what actions need to be undertaken to achieve its objectives. However, no matter how strong the budgeting process, actual events can change the timing and magnitude of expected cash flows.

Financial forecasting addresses the changes necessary to the budgeting process. Budgeting can help identify the differences or variance from expectations, and forecasting becomes the process for adapting to those changes. We attribute to President Eisenhower the saying that “plans are worthless, but planning is everything.” That statement applies to business today as well as it did during his service in the military and government. The budgeting or planning process is a road map for organizations, and forecasting helps navigate the inevitable detours toward the firm’s objectives.

The budgeting process develops pro forma financial statements such as income and cash flow statements and balance sheets. These provide benchmarks to determine if firms are on course to meet or exceed objectives and serve as a warning if firms are falling short. Budgeting should involve all departments within a firm to determine sources and uses of funds and required funding to meet department and firm objectives. The process should look to emulate successful processes and change or eliminate ineffective ones. Budgeting is a periodic renewal and reminder of the firm's goals.

Financial forecasting often starts with the firm's budget and recommends changes based on differences between the budgeted financial statements and actual results. Forecasting adjusts management behavior in the immediate term and serves as a foundation for subsequent budgets.

1.3 Importance of Data and Technology

Learning Outcomes

By the end of this section, you will be able to:

- Describe the role of data in finance.
- List and describe the various types of corporate data available.
- Explain how the various types of corporate data can be accessed and analyzed.
- Describe the impact of data digitization.
- Explain how stakeholders use data when making decisions.

Importance of Data

Financial data is important for internal and external analysis of business firms. More accurate and timely data leads to better business and financial decision-making. Financial budgeting and forecasting rely on the creation of several types of financial statements including income statements, the statements of cash flow, and balance sheets, as well as the notes and assumptions used to create the financial statements. Insiders such as executive and middle managers use financial data to evaluate and reevaluate decision-making. Having current and accurate data is key to making consistent value-adding decisions for a firm. Data helps inform managers about how and when to finance projects, which projects to undertake, and necessary changes to make regarding physical, financial, and human resource assets. "Gut feelings" and "seat-of-the-pants" decision-making tend to be inconsistent with value maximization.

Outsiders also use publicly available data about firms to make purchasing, investment, credit, and regulatory decisions. Customers, investors, lenders, suppliers, and regulators must be able to access a firm's financial information. Investors need to determine how much they are willing to pay for a share of stock, banks need data to determine if a loan should be made, suppliers need financial information to determine if they should supply trade credit, and customers need to know that a firm has priced its products appropriately.

Basic Data Types

Financial statements provide some of the data needed for decision-making. Firms summarize data and develop at least three essential financial statements or reports.

1. The income statement summarizes the flow of revenues and expenses over a specified period. Income statements for publicly traded companies are available quarterly.
2. Statements of cash flow identify actual receipt and use of cash over a period.
3. Balance sheets show the existing assets, liabilities, and equity as of a particular date.

These statements represent book values and reflect historical costs and accounting adjustments such as accumulated depreciation. Book values often differ significantly from market values. Market values look forward and reflect expectations, whereas book values represent what has occurred.

In addition to the internal data summarized on financial statements, firms and outside stakeholders also seek external sources of information. External data gathering includes surveys of customers and suppliers, market research, new product development, statistical analysis, agreements with creditors, and discussions with government officials. Broader macroeconomic data is also valuable as it applies to expected market demand, unemployment, inflation, interest rates, and economic growth.

The Impact of Digitization

Data digitization makes the storage and transmission of data easier and more cost effective. Some data starts out as digital data, such as that from a Microsoft Suite product. The Excel files and Word documents we create are ubiquitous and easily stored and transmitted. Cloud storage and video conferencing are now the norm. Emails and Zoom meetings are quick, easy, and inexpensive ways to share and store information. Businesses now create an e-trail, or virtual paper trail, to document, verify, and share processes. Because data is now much easier to access, firms bear the added responsibility of ensuring that it is stored and secured properly so that individuals cannot inappropriately alter or delete information.

Data storage has changed significantly in the last decade as companies have moved the storage of digital data to the cloud. The advantages include only paying for the storage actually used, reduced energy consumption, access to specialized data protection services, and software and hardware maintenance. However, the risk of data hacks and the safety of data are key concerns in the storage of digitized information.

Uses of Data

Taken together and separately, the internally generated financial statements can provide managers with a wealth of information to enable superior decision-making. Harvard Business School identifies six ways managers can use financial statements.[3]

1. Measuring the impact of business decisions such as new software, marketing plan, or product line
2. Aiding in the development of budgets by creating a starting point for future expectations
3. Aiding in cost cutting or the reduction of duplicate activities
4. Providing data-supported strategic planning and visioning
5. Ensuring consistent data and content across departments
6. Motivating teams to set, meet, and exceed goals and objectives

CONCEPTS IN PRACTICE

How and Why Managers Use Financial Statements: The Case of Peloton

Should you lease a new car or buy one? Do you opt for the more expensive high-tech production equipment or reduce your upfront investment and pay higher labor costs over time? Is it better to finance a new product by borrowing money or selling new shares of stock? Should you manufacture overseas where the production costs are lower or in your own country where political and transportation costs are lower? Once you make your choice, how do you know if you've made the right decision? Understanding and applying financial principles can help.

For example, consider Peloton, the leader in social exercising with its bike, treadmill, and yoga platforms. In 2012, the principal founder, John Foley, was inspired to start the company because he lacked the time to attend bicycle exercise classes due to his demanding career and growing family. He enjoyed cycling classes, but they could be expensive and often did not fit into his schedule. He recognized that the most popular instructors had developed a bit of a cult following and that the music playlist was a critical component for many followers. His choice of the company name, Peloton, comes from the French word for a "pack of bike riders," familiar to anyone who has even loosely followed the annual Tour de France bike race. The company name evokes a measure of mystique and prestige.

Peloton started small and underwent five funding rounds in seven years before the company went public with an initial public offering in September 2019. Foley and his friends had the idea that they were a "purposeful music company" and needed to touch on all aspects of the workout experience including the

3 Catherine Cote. "How and Why Managers Use Financial Statements." *Business Insights*. June 16, 2020. https://online.hbs.edu/blog/post/how-managers-use-financial-statements

bike; video, audio, and music content; clothing design; competition among the riders; data gathering; and instructors for livestream and on-demand classes. They were selling an experience, not a bicycle. The equipment is expensive—a Peloton bike typically costs over $2,000. Peloton equips its studios with state-of-the-art camera and music systems and pays its instructors top dollar. Along the way, the founders made several critical financial decisions. They kept control of the firm by using private funding at the start.

How can we tell if Peloton has managed its resources well? The company started with $400,000 of funding to develop a prototype in 2012. By 2018, firm value increased to $4 billion with yet another round of private investor funding. As of April 2021, Peloton is a publicly traded company with a stock value of $34 billion. The executives are sacrificing profits in the short term to generate growth and long-term profitability. The firm uses its financial statements to identify sources and uses of funds, to test the effectiveness of advertising, and to forecast future profitability. Analysts like the firm, the stock price is up, and by many financial measures, Peloton has been a great success. Time will tell if the decisions made over the last several years will lead to long-term profitability or if the company has overinvested in marketing only to miss current and long-term profits.

(Sources: Viktor. "The Peloton Business Model—How Does Peloton Work & Make Money?" *Productmint*. Updated May 9, 2021. https://productmint.com/the-peloton-business-model-how-does-peloton-make-money/. Accessed May 18, 2021; John Ballard. "If You Invested $5,000 in Peloton's IPO, This Is How Much Money You'd Have Now." *The Motley Fool*. June 6, 2020. https://www.fool.com/investing/2020/06/06/if-you-invested-5000-in-pelotons-ipo-this-is-how-m.aspx. Accessed May 18, 2021; Erin Griffith. "Peloton's New Infusion Made It a $4 Billion Company in Six Years." *New York Times*. August 3, 2018. https://www.nytimes.com/2018/08/03/technology/pelotons-new-infusion-made-it-a-4-billion-company-in-6-years.html)

1.4 Careers in Finance

Learning Outcomes

By the end of this section, you will be able to:

- Describe current job opportunities in finance.
- Describe the financial analyst role.
- Describe the business analyst role.

Job Opportunities in Finance: Market Trends

There are many career opportunities in the field of finance. The Bureau of Labor Statistics (BLS) finds that as of May 2020, the median income for finance-related positions was $72,250 versus the overall median income of only $41,950. Further, the BLS predicts that close to an additional 500,000 new finance- and accounting-related jobs will be created by 2029.[4] These new employment opportunities are in addition to the many openings that will become available as baby boomers continue to retire and leave the workforce.

Several of the BLS-listed finance careers do not even have finance or associated wording in the career titles. The BLS identifies finance skills as necessary for careers such as management analysts and market research analysts and work in logistics. Of course, many careers traditionally encourage the study of finance. These include job titles and descriptions such as these:

- Financial manager: Oversees aspects of and produces reports about an organization's financial needs, uses, and related activities
- Investment relations associate: Prepares and presents company financial data to investors and other company stakeholders

4 U.S. Bureau of Labor Statistics. *Occupational Outlook Handbook*. https://www.bls.gov/ooh/business-and-financial/home.htm

- Budget analyst: Reviews, plans, and evaluates an organization’s financial activities
- Credit analyst: Reviews financial and related information to determine the creditworthiness of potential clients and customers; typically works at commercial and investment banks, credit unions, and rating firms such as Moody’s or Standard and Poor’s
- Financial analyst: Collects and examines data to plan future activities and evaluate past decisions
- Personal financial advisor: Provides advice to clients for short-, intermediate-, and long-term financial planning
- Loan officer: Helps individuals and organizations apply for loans and typically works for depository financial institutions such as commercial banks
- Insurance underwriter: Evaluates risk and establishes prices for insurance products such as life, property, and casualty insurance
- Financial examiner: Evaluates and monitors the activities of depository institutions in an effort to assure proper practice and behavior
- Finance professor: Teaches college classes, engages in economic and financial research, and provides community service by serving on boards and providing financial expertise

LINK TO LEARNING

Best Jobs in Finance

You can read more about possible careers in finance (https://openstax.org/r/thebalancecareers) at the Balance Careers website.

Financial Analyst Roles

Many executive-level finance officers worked their way up via the role of financial analyst. Job descriptions vary across firms, industries, and government organizations. However, the role of financial analyst usually includes market research, financial forecasting, modeling, cost analysis, and comparative valuations. Financial analysts gather data and produce financial reports in conjunction with multiple departments within a business or organization. They rely on marketing and production personnel to provide accurate sales forecasts, and they work with accountants to create accurate financial reports.

As a financial analyst, you need strong spreadsheet skills, the ability to develop financial models and pro forma financial statements, outstanding analytical skills, and an overall understanding of business processes. Financial analysts possess a well-diversified collection of business and communication skills, both quantitative and qualitative. Figure 1.6 lists some tasks that financial analysts must perform on a daily basis. Some firms require an MBA or several years of business experience for their financial analysts.

Figure 1.6 Financial Analyst Tasks

Internal financial analysts are important for a successful firm or organization because their work can lead to more efficient and cost-effective use of financial and nonfinancial resources. Responsibilities include keeping current with market conditions, developing financial models, reconciling variance between forecasts and outcomes, and serving as a resource for management. Financial analysts fulfill their responsibilities through the development and analysis of financial data including ratio analysis, trend analysis, in-depth discussions with division managers, and the presentation and interpretation of information at meetings and on electronic platforms.

External financial analysts use similar resources and tools to evaluate financial instruments as an aid to investment companies, investment and commercial bankers, and individual investors who rely on their published reports. Various government agencies also use financial analysts to aid in regulatory oversight and enforcement.

A report from a 2019 BLS survey determines that financial analysts earn an average salary of $81,590, and jobs are predicted to grow at a faster-than-average rate of 5% through 2029.[5]

Business (or Management) Analyst Roles

The job description for a business analyst looks much like that for a financial analyst. However, the strong quantitative skills required for a financial analyst are less emphasized in favor of overall strategic thinking. A successful business analyst is able to evaluate business opportunities by using analytical thinking, industry best practices, process development, team building and organization, and information technology. They then communicate optimal courses of action to executive decision makers to maximize value in alignment with the vision and goals of the firm.

Business analysts can help develop strategy and tactics to move a firm forward. They aid in identifying challenges and solutions. Data-driven solutions help get products to market more quickly, evaluate performance, and optimize production and product mix. The Bureau of Labor Statistics identifies the following as typical business analyst duties:

- Gathering information about problems to be solved or procedures to be improved
- Interviewing personnel and conducting onsite observations to determine the methods, equipment, and

5 Ibid.

personnel that will be needed
- Analyzing financial data, revenues and expenditures, and employment reports, among other data
- Finding root causes for problems and proposing solutions that may include new systems, procedures, or personnel changes
- Presenting findings to decision makers
- Conferring with managers to ensure changes work

The average salary for management analysts was $85,260 in May 2019, and the BLS projects 11% growth, or about 94,000 new jobs, over the next decade.[6]

1.5 Markets and Participants

Learning Outcomes

By the end of this section, you will be able to:
- Identify primary and secondary markets.
- Identify key market players.

Primary and Secondary Markets

Simply put, the **primary market** is the market for "new" securities, and the **secondary market** is the market for "used" securities. Think of the primary market as equivalent to the sale of new cars and the secondary market as equivalent to the sale of used cars. In practice, many market locales trade both new and used securities. For example, the stock markets trade equity securities daily, and most of the trading takes place among individual and institutional investors who own shares in publicly traded companies. Trading a share of Amazon, Facebook, or Nike stock has little impact and no direct cash flow to the underlying firm. However, the information provided by such transactions is valuable, as it is a costly and public real-time statement by investors of their perceptions of firm's value and a reflection of satisfaction and expectations.

Some, though many fewer, transactions in the equity market are for the purchase and sale of new securities. Firms issue new shares of stock called seasoned equity offerings (SEOs) or initial public offerings (IPOs) into the market. These are issues of new shares of stock, previously untraded, and their issuance sends cash flows directly to the underlying firms. SEOs are new shares issued by established firms, and IPOs are new shares issued by firms going public for the very first time. Once the initial transaction takes place, purchasers of these new securities may trade them. However, the second and subsequent trades are secondary, not primary, market transactions.

Extensive primary market transactions take place weekly, when the Treasury Department auctions billions of dollars of new Treasury securities. These new securities repay maturing Treasury securities and provide for the ongoing liquidity and long-term borrowing needs of the federal government. Again, subsequent trading of this government debt occurs as secondary market transactions.

Key Market Players

Key market players in finance include dealers, brokers, financial intermediaries, and you and me. Each of these players facilitates the exchange of products, information, and capital in different ways. The presence of these players makes financial transactions, easier, faster, and safer—essentially more efficient. You and your friends might engage in direct financial transactions, such as buying a coffee or borrowing money for a movie. These are typically small transactions. However, for transactions that are larger or more complicated, you need advanced financial entities with capital, expertise, and networks. The two segments of the secondary markets are broker markets and dealer markets, as Figure 1.7 shows. The primary difference between broker and dealer markets is the way each executes securities trades.

6 Ibid.

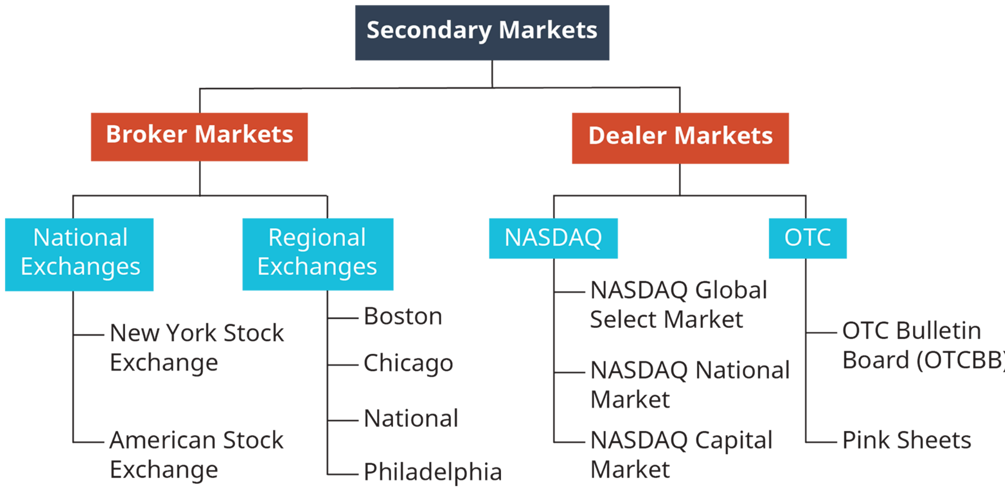

Figure 1.7 Broker and Dealer Markets

Dealers

Financial **dealers** own the securities that they buy or sell. When a dealer engages in a financial transaction, they are trading from their own portfolio. Dealers do not participate in the market in the same manner as an individual or institutional investor, who is simply trying to make their investments worth as much as possible. Instead, dealers attempt to "make markets," meaning they are willing and able to buy and sell at the current bid and ask prices for a security. Rather than relying on the performance of the underlying securities to generate wealth, dealers make money from the volume of trading and the spread between their bid price (what they are willing to pay for a security) and their ask price (the price at which they are willing to sell a security). By standing ready to always buy or sell, dealers increase the liquidity and efficiency of the market. Dealers in the United States fall under the regulatory jurisdiction of the Securities and Exchange Commission (SEC). Such regulatory oversight ensures that dealers execute orders promptly, charge reasonable prices, and disclose any potential conflicts of interest with investors.

Brokers

Brokers act as facilitators in a market, and they bring together buyers and sellers for a transaction. Brokers differ from dealers who buy and sell from their own portfolio of holdings. These firms and individuals traditionally receive a commission on sales.

In the world of stockbrokers, you may work with a discount broker or a full-service broker, and the fees and expenses are significantly different. A discount broker executes trades for clients. Brokers are required for clients because security exchanges require membership in the exchange to accept orders. Discount brokers or platforms such as Robinhood or E-Trade charge no or very low commissions on many of their trade executions, but they may receive fees from the exchanges. They also do not offer investment advice.

Full-service brokers offer more services and charge higher fees and commissions than discount brokers. Full-service brokers may offer investment advice, retirement planning, and portfolio management, as well as execute transactions. Morgan Stanley and Bank of America Merrill Lynch are examples of full-service brokers that serve both institutional and individual investors.

Financial Intermediaries

A **financial intermediary**, such as a commercial bank or a mutual fund investment company, serves as an intermediary to enable easier and more efficient exchanges among transacting parties. For instance, a commercial bank accepts deposits from savers and investors and creates loans for borrowers. An investment company pools funds from investors to inexpensively purchase and manage portfolios of stocks and bonds. These transactions differ from those of a dealer or broker. Brokers facilitate trades, and dealers stand ready to buy or sell from their own portfolios. Financial intermediaries, however, accept money from investors and may create a completely different security all together. For example, if the borrower defaults on a mortgage loan created by the commercial bank where you have your certificate of deposit, your investment is still safely earning interest, and you are not directly affected.

Financial institutions usually facilitate financial intermediation. However, occasionally lenders and borrowers are able to initiate transactions without the help of a financial intermediary. When this occurs on a large scale, the process, known as disintermediation, can cause much turmoil in the financial markets. In the 1970s, inflation rose above 10% on an annual basis, and yet commercial banks were limited to offering maximum rates of 5% on their savings deposits.[7] Savers bypassed banks and savings and loan associations to invest directly into Treasury securities and other short-term marketable securities. This lack of deposit funds and the subsequent behavior of the industry essentially eliminated the savings and loan industry and led to significant deregulation of commercial and investment banking in the United States.

The advantages of a robust network of financial intermediaries are many. They add efficiency to the financial system through lower transaction costs. They gather and disperse information to minimize financial abuse and fraud. They provide economies of scale and specialized knowledge. Finally, financial intermediaries are critical for the functioning of a capitalist economy.

1.6 Microeconomic and Macroeconomic Matters

Learning Outcomes

By the end of this section, you will be able to:

- Define microeconomics and macroeconomics.
- Discuss the relationship between microeconomics and macroeconomics.
- Explain the importance of macroeconomic variables in finance markets.

Microeconomics

In the business setting, finance is the intersection of economics and accounting. Financial decision makers rely on economic theory and empirical evidence combined with accounting data to make informed decisions for their organization. Economics is the study of the allocation of scarce resources. Economists attempt to understand the how and why of human and financial capital allocation to governments, businesses, and consumers.

We typically separate economics into two major areas, microeconomics and macroeconomics. Microeconomics is devoted to the study of these decisions of allocation by individual businesses, persons, or organizations. Microeconomics helps us understand incentives and behavior, consumer choices and consumption, and supply and demand.

Our understanding of microeconomics aids in financial forecasting, planning, and budgeting by understanding how individuals are likely to respond to changes in product or service functionality, price, supply, quality, marketing, or other firm-induced stimulus. Empirical research by individuals, businesses, academics, and government provide evidence of what is going on and suggest what may change or stay the same.

Macroeconomics

Whereas microeconomics studies the decisions of individuals, macroeconomics examines the decisions of groups. Macroeconomic areas of study and concern include inflation, income, economic growth, and unemployment. When Bacon Signs developed a financial and operating plan to expand the business, the firm had to consider unemployment and inflation when estimating its price of labor and materials. Bacon Signs also had to consider interest rates when estimating the cost of borrowing money to expand the business.

Macroeconomic modeling is limited because models cannot capture every variable in testing and application.

7 United States President and Council of Economic Advisers. “The 1970s: Inflation, High Interest Rates, and New Competition.” *Economic Report of the President*. 1991. https://fraser.stlouisfed.org/files/docs/publications/ERP/pages/6688_1990-1994.pdf

However, financial forecasting must incorporate macroeconomic assumptions and expectations into individual firm and industry forecasts. Economic Foundations expands on our discussion of micro- and macroeconomics.

Importance of Macroeconomic Variables in Financial Markets

To make financial forecasts, managers need good information to understand the relationship among several economic variables. Working from small to large, sales forecasts estimate the likely price and quantity of goods sold. In doing so, the forecaster will consider local, regional, state, national, and international economic conditions. Inflation is an important macroeconomic variable that influences prices. Every quarter, financial information hubs, such as the Wall Street Journal (WSJ), and government agencies and regulatory bodies, such as the Treasury Department and the Federal Reserve, release estimates about expected and current inflation. This information informs policy makers how to adjust the money supply to meet target objectives. Financial forecasters pay close attention to current and expected interest rates, as they have a fundamental impact on the cost of raising money and determining the required rate of return for investment.

The unemployment rate helps inform financial forecasters about the expected cost of labor and the ability of employers to hire people if a firm plans to increase the production of goods or services. The stock market is a forward-looking macroeconomic variable and measures investor expectations about future cash flows and economic growth. Political economic variables such as changes in regulation or tax policy can also affect forecasting models.

LINK TO LEARNING

Politics and Stock Markets

Politics and stock market returns make for heated conversations. Who can run the country's economic system better, Republicans or Democrats? Presidents often take the credit or blame for overall economic performance even though their actual influence is less than you might think. See this fun comparison chart (https://openstax.org/r/macrotrends-net) of political economic performance that measures stock market returns by each administration going back to President Warren Harding in 1920. Who had the highest overall increase in the market? What president in the 21st century oversaw an overall decline in the market? Just to get things going, who had better overall market returns after four years in office, Donald Trump or Barack Obama?

Each of the variables we have identified—inflation, interest rates, unemployment, economic growth, the stock market, and government fiscal policy—are macroeconomic factors. They are beyond the scope and influence of individual firms, but combined, they play a critical role in establishing the market in which firms compete. A better understanding of the interaction of these macro variables with each other and with individual micro or firm-specific variables can only strengthen financial forecasting and management decision-making.

CONCEPTS IN PRACTICE

Here, There, and Everywhere: Where Did Your iPhone Come From?

How do international macroeconomic factors affect investment decisions for businesses and individuals? Foreign investment adds risk and potential return to the decision-making process. Macroeconomic factors such as different inflation rates, unexpected changes in currency exchange rates, and mismatched economic growth all add to the uncertainty of making investments abroad. Just as important are government regulations limiting pollution, exploitation of precious minerals, labor laws, and tariffs. Toss in a pandemic, and a bottleneck or two, and suddenly international macroeconomic factors can affect almost every aspect of commerce and international trade.

For example, how far did your new iPhone travel before it got into your hands? Apple is an American company headquartered in Cupertino, California, and worth over $2 trillion.[8] However, your phone may have visited as many as six continents before it reached you. Each location touched by the Apple corporate hand requires an understanding of the financial impact on the product cost and a comparison with alternative designs, resources, suppliers, manufacturers, and shippers. This is where finance can get really fun!

(Sources: Magdalena Petrova. “We Traced What It Takes to Make an iPhone, from Its Initial Design to the Components and Raw Materials Needed to Make It a Reality.” *CNBC*. December 14, 2018. https://www.cnbc.com/2018/12/13/inside-apple-iphone-where-parts-and-materials-come-from.html; Natasha Lomas. “Apple’s Increasingly Tricky International Trade-offs.” *TechCrunch*. January 6, 2019. https://techcrunch.com/2019/01/06/apples-increasingly-tricky-international-trade-offs/; Kif Leswing. “Here’s Why Apple Is So Vulnerable to a Trade War with China.” *CNBC*. May 13, 2019. https://www.cnbc.com/2019/05/13/why-is-apple-so-vulnerable-to-a-trade-war-with-china.html)

Relationship between Microeconomics and Macroeconomics

In the parable, a group of blind people happen upon an elephant for the first time, and they each touch one part—but one part only—of the elephant. Subsequently, when they each describe what they have discovered, the descriptions are vastly different. The group's members become upset, accusing one another of inaccurate descriptions or worse. The parable demonstrates how individuals can make absolute truths from their own limited and subjective information. Financial decision makers run a similar risk, if they choose to recognize only their own findings and ignore other microeconomic or macroeconomic information and the interaction of these factors.

A common view to understanding economics states that macroeconomics is a top-down approach and microeconomics is a bottom-up approach. Financial decision makers need to see both the forest and the individual trees to chart a course and move toward a strategic objective. They need both the macro data, so important for strategic thinking, and the micro data, required for tactical movement. For example, the national rate of unemployment may not have been much help when Bacon Signs was searching for skilled laborers who could form neon signs. However, the unemployment rate helped inform the company about the probability of demand for new businesses and the signs they would need.

1.7 Financial Instruments

Learning Outcomes

By the end of this section, you will be able to:

- Differentiate between money and capital markets.
- List money market instruments.
- List capital market instruments.

Money Markets and Instruments

The **money market** is the market for short-term, low-risk, highly liquid securities. “Short-term” refers to **money market securities** having maturities of less than one year–sometimes as short as overnight. “Low risk” specifically means that the probability of default by the issuer in very unlikely. Defaulting on money market instruments is not unheard of, but it is very rare. “High liquidity” means that money market instruments can generally be sold in a secondary market very quickly and at or near their current market value. Finally, money market securities are homogeneous, meaning that within an issue of securities, a single

8 Sergei Klebnikov. “Apple Becomes First U.S. Company Worth More Than $2 Trillion.” *Forbes.* August 19, 2020. https://www.forbes.com/sites/sergeiklebnikov/2020/08/19/apple-becomes-first-us-company-worth-more-than-2-trillion/

instrument is not unique. For example, if you purchase 13-week T-bills issued in the first week of January, each bill is identical to any other in the issue. Compare that to the purchase of physical assets such as a car or house, where each of the assets sold has some unique feature or measure of quality.

Financial institutions, corporations, and governments that have short-term borrowing and/or lending needs issue securities in the money market. Most of the transactions are quite large, with typical amounts in excess of $100,000. These large transactions are the norm when trading federal funds, repurchase agreements, commercial paper, or negotiable certificates of deposit. Our sample company, Bacon Signs, was much too small to participate directly in the money market. However, Bacon Signs' borrowing rates were affected by changes in the money market. Treasury bills are also a very important component of the money market, and they trade in smaller amounts starting at $10,000 per T-bill.

Treasury bills (T-bills), are short-term debt instruments issued by the federal government. T-bills are auctioned weekly by the Treasury Department through the trading window of the Federal Reserve Bank of New York. The federal government uses T-bills to meet short-term liquidity needs. T-bills have very short maturities and a broad secondary market and are default-risk free. T-bills are also exempt from state and local income taxes. As a result, they carry some of the lowest effective interest rates on publicly traded debt securities. In addition to the regular auction of new T-bills, there is also an active secondary market where investors can trade used or previously issued T-bills. Since 2001, the average daily trading volume for T-bills has exceeded $75 billion.[9]

Commercial paper (CP) is a short-term, unsecured debt security issued by corporations and financial institutions to meet short-term financing needs such as for inventory and receivables. For example, credit card companies use commercial paper to finance credit card payments. Commercial paper has a maturity of one to 270 days. The short maturity reduces SEC oversight. The lesser oversight and the unsecured nature of CP means that only highly rated firms are able to issue the uninsured paper. The default rate on commercial paper is typically low, but default rates did increase into the double-digit range during the financial crisis of 2008.

Commercial paper typically carries a minimum face value of $100,000 and sells at a discount with the face value as the repayment amount. Corporations and financial institutions, not the government, issue commercial paper; thus, returns are taxable. Further, unlike T-bills, there is not a robust secondary market for CP. Most purchasers are large, such as mutual fund investment companies, and they tend to hold commercial paper until maturity.

Negotiable certificates of deposit (NCDs) are very large CDs issued by financial institutions. They are redeemable only at maturity, but they can and often do trade prior to maturity in a broad secondary market. NCDs, or *jumbo CDs*, are so called because they sell in increments of $100,000 or more. However, typical minimums amounts are $1,000,000 with a maturity of two weeks to six months.

NCDs differ in some important ways from the typical CD you may be familiar with from your local bank or credit union. The typical CD has a maturity date, interest rate, and face amount and is protected by deposit insurance. However, if an investor wishes to cash out prior to maturity, they will incur a substantial penalty from the issuer (bank or credit union). An NCD also has a maturity date and amount but is much larger than a regular CD and appeals to institutional investors. The principal is not insured. When the investor wishes to cash out early, there is a robust secondary market for trading the NCD. The issuing institution can offer higher rates on NCDs compared to CDs because they know they will have use of the purchase amount for the entire maturity of the NCD. The reserve requirements on NCDs by the Federal Reserve are also lower than for other types of deposits.

The market for **federal funds** is notable because the Federal Reserve targets the equilibrium interest rate on

9 Henrik Bessembinder, Chester Spatt, and Kumar Venkataraman. "A Survey of the Microstructure of Fixed-Income Markets." *Journal of Financial and Quantitative Analysis*. February 2020. https://www.sec.gov/spotlight/fixed-income-advisory-committee/survey-of-microstructure-of-fixed-income-market.pdf

federal funds as one of its most important monetary policy tools. The federal funds market traditionally consists of the overnight borrowing and lending of immediately available funds among depository financial institutions, notably domestic commercial banks. The participants in the market negotiate the federal funds interest rate. However, the Federal Reserve effectively sets the target interest rate range in the federal funds market by controlling the supply of funds available for use in the market. Many of the borrowing and lending rates in our economy are a direct function of the federal funds rate.

Capital Markets and Instruments

The **capital market** is the market for longer-term financial instruments. The capital market is similar to the money market. However, maturities are longer, default risk varies to a greater degree from low to high, and liquidity is less certain, as is the homogeneity of the financial instruments. Broadly, we separate capital market instruments into debt instruments traded in the bond markets and equity securities traded on the stock markets.

The federal government issues Treasury notes and bonds to raise money for current spending and to repay past borrowing. The size of the Treasury market is quite large, as the US federal government over the years has accumulated a total indebtedness of over $28 trillion.[10]

Treasury notes are US government debt instruments with maturities of 2 to 10 years. The Treasury auctions notes on a regular basis, and investors may purchase new notes from TreasuryDirect.gov in the same way they would a T-bill. T-notes differ from T-bills in that they are longer term, pay semiannual coupon interest payments, and pay the par or face value of the note at maturity. Upon issue of a note, the size, number, and timing of note payments is fixed. However, prices do change in the secondary market as interest rates change. Like T-bills, T-notes are generally exempt from state and local taxes. There is an active secondary market for Treasury notes.

Longer-term Treasury issues, **Treasury bonds**, have maturities of 20 or 30 years. T-bonds are like T-notes in that they pay semiannual coupon interest payments for the life of the security and pay the face value at maturity. They are longer term than notes and typically have higher coupon rates.

State and local governments and taxing districts can issue debt in the form of **municipal bonds ("munis")**. Local borrowing carries more risk than Treasury securities, and default or bankruptcy is unlikely but possible. Thus, munis have ratings that run a spectrum similar to that of corporate bonds in that they receive a bond rating based on the perceived default risk. The defining feature of municipal bonds is that some interest payments are tax-free. Interest on munis is always exempt from federal taxes and sometimes exempt from state and local taxes. This makes them very attractive to investors in high income brackets.

Just as governments borrow money in the long-term from investors, so do corporations. A corporation often issues bonds for longer-term financing. Bond contracts identify very specific terms of agreement and outline the rules for the order, timing, and amount of contractual payments, as well as processes for when one or more of the required activities lapse. A bond contract, known as an indenture, includes both standard "boilerplate" contract language and specific conditions unique to a particular issue. Because of these non-standardized features of a bond contract, the secondary market for trading used bonds typically requires a broker, dealer, or investment company to facilitate a trade.

An important goal of business executives is to maximize the owners' wealth. For corporations, shares of stock represent ownership. Stocks are difficult to price compared to bonds. Bonds have contracts that specify the number and amount of all payments made by the firm to the purchasers of bonds. Stock cash flows are far more uncertain than bond cash flows. Stocks might or might not have periodic dividend payments, and an investor can plan to sell the stock at some point in the future. However, no contract guarantees the size of the dividends or the time or resale price of the stock. Thus, the cash flows from stock ownership are more

10 Trading Economics. "United States Government Debt." *Trading Economics*. https://tradingeconomics.com/united-states/government-debt

uncertain and risky than cash flows from bonds.

Ownership of corporations is easily transferable if a company's stock trades in one of the organized stock exchanges or in the over-the-counter (OTC) market. Most of the trading consists of used or previously issued stocks in the over-the-counter market and organized exchanges. The two largest stock exchanges in the world are the New York Stock Exchange (NYSE) and the NASDAQ. Both exchanges are located in the United States.

1.8 Concepts of Time and Value

Learning Outcomes

By the end of this section, you will be able to:

- Explain the impact of time on saving and spending.
- Describe economic value.

Many students don't have a choice between saving and spending. College is expensive, and it is easy to spend every dollar you earn and to borrow to meet the rest of your obligations. Businesses, however, continually make decisions about when and how much money to borrow or invest. Bacon Signs established banking relationships to borrow money when needed to expand the business or a product line. Sometimes the best decision is to invest as soon as possible to grab opportunities, and other times it is better to delay new investment in order to pay dividends to the owners of the company.

LINK TO LEARNING

The Dow Jones Industrial Average Marches On!

Once you begin to save and invest, here is a "fun fact" about the Dow Jones Industrial Average (DJIA) (https://openstax.org/r/investopedia-djia), also known as the Dow 30. It first appeared on May 26, 1896, as a quick way for stock traders to assess if the stock market had gone "up or down" each day and by how much. Here we are over 100 years later, and the Dow 30 index is alive and well. Of course, the 30 companies have changed, but the index does represent a continuous yardstick to measure stock performance over time. As Table 1.1 shows, it took from 1906 to 1972, or a little over 66 years, for the Dow 30 to increase tenfold, from a value of 100 to a value of 1,000. The next tenfold increase from 1,000 to 10,000 took only a little under 27 years from 1972 to 1999. Time will tell if or when the Dow 30 will top 100,000 at the closing bell.

Closing Milestones	Date
41	5/26/1896
100	1/12/1906
1,000	11/14/1972
10,000	3/29/1999
20,000	1/25/2017
30,000	11/24/2020

Table 1.1 The Dow 30 Closing Milestones and Dates

Impact of Time on Saving and Spending

The choice to spend or save and invest is really a choice between consumption today versus consumption in the future. Economists, investment advisers, your friends, and mine love to discuss the trade-off of consumption now or later—even if not in those words. We have all heard conversations that go something like this: “Let’s go grab a beer—you can study for tomorrow’s exam in the morning.” Or “My father’s investment adviser told me that if I invest $500 per month for the next 30 years and earn an annual rate of 10% on my investments, I will have invested $180,000 over time but accumulated an investment portfolio worth over $1.13 million!”

An important aspect of the trade-off between saving and spending involves your short-, intermediate-, and long-term goals. Delaying consumption until later comes with risks. Will your consumption choices still be available? Will the prices be attainable? Will you still be able to consume and enjoy your future purchases?

When saving for short-term objectives, the safety of the principal invested is important, and the value of compounding returns is minimal compared to longer-term investments. Most short-term investors have a low tolerance for risk and hope to beat the rate of inflation with a little extra besides. An example could be to start a holiday savings account at your local bank as a way to save, earn a small rate of return, and assure that you have funds set aside for consumption at the end of the year.

An intermediate investment may be to save for a new car or for the down payment on a house or vacation home. Again, maintaining the principal is important, but you have some time to recover from poor investment returns. Intermediate-term investments tend to earn higher average annual rates of return than short-term investments, but they also have greater uncertainty and risk.

Long-term investments have the advantage of enough time to recover from temporary poor performance and the luxury of compounded returns over a long period. Further, long-term investments tend to have greater risk and higher expected average annual rates of return. Even though this is a business finance text, sometimes a personal finance example is easier to relate to. To illustrate, Table 1.2 demonstrates four different investment scenarios. In scenario 1, you invest $5,000 annually from ages 26 through 60 into an account earning an average annual rate of return of 10% per year. Over your lifetime, you invest a total of $175,000, and at age 60, you have an estimated portfolio value of $1,490,634. This is a healthy amount that has almost certainly beaten the average annual rate of inflation. In scenario 1, by investing regularly, you accumulate roughly 8.5 times the value of what you invested. Congratulations, you can expect to become a millionaire!

Compare your results in scenario 1 with your college roommate in scenario 2, who is able to invest $5,000 per year from ages 19 through 25 and leave her investments until age 60 in an account that continues to earn an annual rate of 10%. She makes her investments earlier than yours, but they total only $35,000. However, despite a much smaller investment, her head start advantage and the high average annual compounded rate of return leave her with an expected portfolio value of $1,466,369. Her total is almost as great as the amount you would accumulate, but with a much smaller total investment.

Scenarios 3 and 4 are even more dramatic, as can be seen from a review of Table 1.2. In both scenarios, only five $5,000 investments are made, but they are made earlier in the investor’s life. Parents or grandparents could make these investments on behalf of the recipients. In both scenarios, the portfolios grow to amounts greater than those of you or your roommate with smaller total investments. The common factor is that greater time leads to additional compounding of the investments and thus greater future values.

	Average Annual Rate of Return = 10%			
Assumptions	**Scenario 1**	**Scenario 2**	**Scenario 3**	**Scenario 4**
Starting investment age	26	19	14	9
Ending investment age	60	25	18	13
Total investments	35	7	5	5

Table 1.2 Four Investment Scenarios: Assumptions and Expected Outcomes

	Average Annual Rate of Return = 10%			
Assumptions	**Scenario 1**	**Scenario 2**	**Scenario 3**	**Scenario 4**
Annual investment	$5,000	$5,000	$5,000	$5,000
Total investment amount	$175,000	$35,000	$25,000	$25,000
Value at age 60	$1,490,634	$1,466,369	$1,838,858	$2,961,500

Table 1.2 Four Investment Scenarios: Assumptions and Expected Outcomes

Definition of Economic Value

Value is a term used frequently in business and especially in economics, accounting, and finance. Accountants track, record, and display value in the form of financial statements and footnotes. The numbers they present are "book values" and represent what has occurred. Financial people like to speak in terms of "market values." Market values are calculated using expected future cash flows discounted to today. Market values are the prices that consumers pay for a product. **Economic value** is what we believe consumers are actually willing to pay for a product, service, or experience. For example, the price of a movie ticket may be $10, but there are individuals who are willing to pay far more for the experience of watching a movie on the big screen.

Generally, the economic value is at least as great as the market value or current price of an asset. When Bacon Signs planned for the future, the firm attempted to determine the economic value of its products when creating an optimal mix of price and quantity sold. Firms that produce unique products for clients may have multiple prices based on the estimated economic value of their good or service to the client. One way to think about the difference between market value and economic value is that market value is what you have to pay, while economic value is what you are willing to pay.

Summary

1.1 What Is Finance?

Finance is the study of the trade-off between risk and expected return. There are three broad areas of finance: business finance, investments, and financial markets and institutions.

1.2 The Role of Finance in an Organization

The accounting department creates financial statements, and the finance department implements the firm's policy objectives, monitors results, and responds to necessary strategic and tactical changes. Finance is responsible for budgeting and forecasting. Finance aids in establishing firm objectives and is responsible for meeting with creditors, lenders, owners, regulators, and other stakeholders that provide capital to the firm or have a claim against firm assets.

1.3 Importance of Data and Technology

Much of the data used in business today has been available for many years. However, data today is more attainable than ever due to technological advancements facilitating a user's ability to gather, evaluate, and store information faster and more cost effectively than ever. Information is continually available, so the quicker and less expensively firms can adjust to the arrival of new information, the more valuable they become for their stakeholders.

1.4 Careers in Finance

Careers in finance are plentiful, fulfilling, and well compensated. Introductory positions are available in areas such as data collection and data entry. More skill and experience is required for roles such as data analysis and forecasting. Eventually, executive-level positions such as CFO present themselves to the most qualified. Finance careers are not limited to financial firms, as understanding finance is an important skill in government regulatory positions, nonprofit management, and all types of commercial business—from real estate, to retail, to manufacturing, to education.

1.5 Markets and Participants

Financial markets are where buyers and sellers of financial securities come together to trade. The trading of securities allows markets to value assets and signal value as new information arrives. Brokers operate to bring buyers and sellers together and receive commissions. Dealers trade from their own portfolios and are often willing to make markets for specific securities by agreeing to buy or sell at the current bid and ask prices. Financial intermediaries actually change or create new financial products.

1.6 Microeconomic and Macroeconomic Matters

Economics is the study of the allocation of scarce resources. Economists attempt to understand the how and why of human, physical, and financial capital allocation. Microeconomics is the study of factors affecting an individual's consumption, and macroeconomics is the study of all the aggregate factors affecting an economy. Economics is important in finance due to the number of economic variables critical to good financial forecasting.

1.7 Financial Instruments

Maturity is one method to differentiate among financial instruments. Using this methodology, we have money markets and capital markets. Money markets consist of short-term marketable securities, and capital markets focus on longer-term securities such as bonds and stocks.

1.8 Concepts of Time and Value

The concepts of time and value involve the resolution of conflict between consumption now versus consumption later. Time and value represent the trade-off between risk and expected return. Many financial exercises examine the relationships among time, interest rates, risk, cash flows now, and cash flows in the future. You can expect to solve several “time value of money” problems before you complete this book.

Key Terms

brokers individuals or a firm that brings together potential buyers and sellers of a product and receives a commission at transaction
business finance the study and application of how managers can apply financial principles to maximize the value of a firm in a risky environment
capital budgeting the process of determining which long-term or fixed assets to acquire in an effort to maximize shareholder value
capital market market for longer-term financial instruments, such as stocks and bonds, used to finance long-term projects for organizations
capital structure the mix of financing, usually debt and equity, used by a firm
chief financial officer (CFO) an executive-level officer who sets policy for working capital management, determines optimal capital structure for the firm, and makes the final decision in matters of capital budgeting
commercial paper (CP) short-term, unsecured financial obligations issued by firms as a means of short-term financing for items such as inventory or payables
comptroller also referred to as *controller,* individual in charge of financial reporting and the oversight of the accounting activities necessary to develop financial reports
dealers facilitate a market and the trading of securities by holding a portfolio of the underlying asset for easy purchase and sale; earn money on the spread between ask and bid prices for the asset
default risk the risk that the issuer of a financial security will be unable to make payments as specified in the terms of a financial contract
diversifiable risk also called *unsystematic risk*, a risk that can be eliminated without the loss of expected return by holding a portfolio of securities
economic value the amount a consumer is willing to pay for a particular asset or service, usually greater than or equal to the current market price or present value of the asset
federal funds rate the rate targeted by the Federal Reserve in the implementation of monetary policy
financial industry regulatory authority (FINRA) an independent, nongovernmental organization that writes and enforces the rules governing registered brokers and broker-dealer firms in the United States
financial intermediary a commercial bank or a mutual fund investment company that serves as an intermediary to enable easier and more efficient exchanges among transacting parties, often accepting one form of financial asset from which they create another, such as taking demand deposits to create mortgage loans
financial markets and institutions one of the three main areas of the field of finance; firms and regulatory agencies that oversee our financial system
inflation risk the risk of reduced purchasing power of goods and services due to rising prices
investments one of the three main areas of finance; products and processes used to create individual and institutional portfolios with the intent of growing wealth
money market the market for short-term, low-risk, highly liquid, homogeneous financial securities; common money market securities include T-bills, NCDs, and commercial paper
money market mutual funds created by investment companies to pool the money of many investors to purchase and then manage short-term, low-risk, liquid financial portfolios of securities
municipal bonds (munis) long-term debt obligations issued by state or local governments that often have important tax advantages relative to corporate bonds
negotiable certificate of deposit very large CDs issued by financial institutions, redeemable only at maturity but can and often do trade prior to maturity in a broad secondary market; also called *jumbo CDs* because they sell in increments of $100,000 or more

2 Corporate Structure and Governance

Figure 2.1 The legal structure of any business will have a substantial impact on its operations. (credit: modification of work “New Board Room at 2 Broadway” by Metropolitan Transportation Authority/Patrick Cashin/flickr, CC BY 2.0)

Chapter Outline

Why It Matters

When someone opens a business, it is because they want to fulfill important personal financial goals. In publicly traded companies, managers and employees work on behalf of the shareholders, who own the business through their ownership of company stock. These managers and employees have an ongoing obligation to pursue projects, policies, and corporate investments that will increase or promote stockholder value over the long term. Although many companies focus on financially related goals, such as growth, earnings per share, and market share, the main financial goal is to create value for investors.

Keep in mind that a company’s stockholders are not just an abstract group. Like the sole business owner, they are individuals who have chosen to invest their hard-earned cash in a company. They are looking for a return on their investment in order to meet their own personal long-term financial goals, which might be saving for retirement, a new home, or college education for their children.

In addition to increasing value, it is also important to realize that a firm has important nonfinancial goals. Some examples of these might include the following:

- Expanding sales to existing customers
- Increasing customer loyalty to the weaker brands
- Developing new products for current and potential customers
- Becoming international by setting up an online ordering service

- Improving customer satisfaction with customer services

If managers are to help stockholders maximize their wealth, they must know how that wealth is determined in the first place. One of the main concepts in finance is that the value of any asset is determined by the present value of the stream of cash flows that the asset will provide to its owners over the course of time. In subsequent chapters, we will also be covering stock valuation in depth, and we will see that stock prices are based on cash flows expected in future years, not only on those coming in at the present time.

For these reasons, stock price maximization, which leads directly to maximizing shareholder wealth, requires us to take a long-term view of company operations. It is also important to realize that managerial actions that affect a company's value may not immediately be reflected in the price of a company's stock but rather will become evident in the long-term prospects of the organization.

In the case of privately held companies, smaller firms, and sole proprietorships, there are no shareholders. However, attention to long-term growth and maximizing the value of a firm is just as important a goal to the owners, who are also usually senior management with the company.

2.1 Business Structures

Learning Outcomes

By the end of this section, you will be able to:

- Identify the business form created by most organizations.
- Contrast the advantages and disadvantages that the corporate form has over sole proprietorships.
- Contrast the advantages and disadvantages that the corporate form has over partnerships.
- List and describe characteristics associated with a hybrid business structure.

The Most Common Types of Business Organization

The functions of most executive management teams are very similar for most businesses, and they will not differ in any significant manner based on how they may be structured or organized. However, the legal structure of any company will have a substantial impact on its operations, and it therefore deserves a significant amount of analysis and discussion. The four most common forms of business organizations are the following:

1. Sole proprietorships
2. Partnerships
3. Corporations
4. Hybrids, such as limited liability companies (LLCs) and limited liability partnerships (LLPs)

The vast majority of businesses take the form of a proprietorship. However, based on the total dollar value of combined sales, more than 80 percent of all business in the United States is conducted by a **corporation**.[1] Because corporations engage in the most business, and because most successful businesses eventually convert into corporations, we will focus on corporations in this chapter. However, it is still important to understand the legal differences between different types of firms and their advantages and disadvantages.

Sole Proprietorships

A proprietorship is typically defined as an unincorporated business owned by a single person. The process of forming a business as a **sole proprietor** is usually a simple matter. A business owner merely decides to begin conducting business operations, and that person is immediately off and running. Compared to other forms of business organizations, proprietorships have the following four important advantages:

1. They have a basic structure and are simple and inexpensive to form.

1 Aaron Krupkin and Adam Looney. "9 Facts about Pass-Through Businesses." Brookings. The Brookings Institution, May 15, 2017. https://www.brookings.edu/research/9-facts-about-pass-through-businesses

2. They are subject to relatively few government rules and regulations.
3. Taxation on sole proprietorships is far simpler than on other organizational forms. There are no separate taxes associated with a sole proprietorship, as there are with corporations. Sole proprietors simply report all their business income and losses on their personal income tax returns.
4. Controlling responsibilities of the firm are not divided in any way. This results in less complicated managerial decisions and improved timeliness of necessary corrective actions.

However, despite the ease of their formation and these stated advantages, proprietorships have four notable shortcomings:

1. A sole proprietor has unlimited personal liability for any financial obligations or business debts, so in the end, they risk incurring greater financial losses than the total amount of money they originally invested in the company’s formation. As an example, a sole proprietor might begin with an initial investment of $5,000 to start their business. Now, let’s say a customer slips on some snow-covered stairs while entering this business establishment and sues the company for $500,000. If the organization loses the lawsuit, the sole proprietor would be responsible for the entire $500,000 settlement (less any liability insurance coverage the business might have).
2. Unlike with a corporation, the life of the business is limited to the life of the individual who created it. Also, if the sole proprietor brings in any new equity or financing, the additional **investor**(s) might demand a change in the organizational structure of the business.
3. Because of these first two points, sole proprietors will typically find it difficult to obtain large amounts of financing. For these reasons, the vast majority of sole proprietorships in the United States are small businesses.
4. A sole proprietor may lack specific expertise or experience in important business disciplines, such as finance, accounting, taxation, or organizational management. This could result in additional costs associated with periodic consulting with experts to assist in these various business areas.

It is often the case that businesses that were originally formed as proprietorships are later converted into corporations when growth of the business causes the disadvantages of the sole proprietorship structure to outweigh the advantages.

Partnerships

A **partnership** is a business structure that involves a legal arrangement between two or more people who decide to do business as an organization together. In some ways, partnerships are similar to sole proprietorships in that they can be established fairly easily and without a large initial investment or cost.

Partnerships offer some important advantages over sole proprietorships. Among them, two or more partners may have different or higher levels of business expertise than a single sole proprietor, which can lead to superior management of a business. Further, additional partners can bring greater levels of investment capital to a firm, making the process of initial business formation smoother and less risky.

A partnership also has certain tax advantages in that the firm’s income is allocated on a pro rata basis to the partners. This income is then taxed on an individual basis, allowing the company to avoid corporate income tax. However, similar to the sole proprietorship, all of the partners are subject to unlimited personal liability, which means that if a partnership becomes bankrupt and any partner is unable to meet their pro rata share of the firm’s liabilities, the remaining partners will be responsible for paying the unsatisfied claims.

For this reason, the actions of a single partner that might cause a company to fail could end up bringing potential ruin to other partners who had nothing at all to do with the actions that led to the downfall of the company. Also, as with most sole proprietorships, unlimited liability makes it difficult for most partnerships to raise large amounts of capital.

Corporations

The most common type of organizational structure for larger businesses is the corporation. A corporation is a legal business entity that is created under the laws of a state. This entity operates separately and distinctly from its owners and managers. It is the separation of the corporate entity from its owners and managers that limits stockholders' losses to the amount they originally invest in the firm. In other words, a corporation can lose all of its money and go bankrupt, but its owners will only lose the funds that they originally invested in the company.

Unlike other forms of organization, corporations have unlimited lives as business entities. It is far easier to transfer shares of stock in a corporation than it is to transfer one's interest in an unincorporated business. These factors make it much easier for corporations to raise the capital necessary to operate large businesses. Many companies, such as Microsoft and Hewlett-Packard, originally began as proprietorships or partnerships, but at some point, they found it more advantageous to adopt a corporate form of organization as they grew in size and complexity.

An important disadvantage to corporations is income taxes. The earnings of most corporations in the United States are subject to something referred to as double taxation. First, the corporation's earnings are taxed; then, when its after-tax earnings are paid out as dividend income to **shareholders (stockholders)**, those earnings are taxed again as personal income.

It is important to note that after recognizing this problem of double taxation, Congress created the **S corporation**, designed to aid small businesses in this area. S corporations are taxed as if they were proprietorships or partnerships and are exempt from corporate income tax. In order to qualify for S corporation status, a company can have no more than 100 stockholders. Thus, this corporate form is useful for relatively small, privately owned firms but precludes larger, more diverse organizations. A larger corporation is often referred to as a **C corporation**. The vast majority of small corporations prefer to elect S status. This structure will usually suit them very well until the business reaches a point where their financing needs grow and they make the decision to raise funds by offering their stock to the public. At such time, they will usually become C corporations. Generally speaking, an S corporation structure is more popular with smaller businesses because of the likely tax savings, and a C corporation structure is more prevalent among larger companies due to the greater flexibility in raising capital.

Hybrids: Limited Liability Corporations and Partnerships

Another form of business organization is the **limited liability corporation (LLC)**. This type of business structure has become a very popular type of organization. The LLC is essentially a **hybrid form of business** that has elements of both a corporation and a partnership. Another form of organizational structure is something called a **limited liability partnership (LLP)**, which is quite similar to the LLC in structure and in use. It is very common to see LLPs used as the organizational form for professional services firms, often in such fields as accounting, architecture, and law. Conversely, LLCs are typically used by other forms of businesses.

Similar to corporation structures, LLCs and LLPs will provide their principals with a certain amount of liability protection, but they are taxed as partnerships. Also, unlike in limited partnerships, where a senior general partner will have overall control of the business, investors in an LLC or LLP have votes that are in direct proportion to their percentage of ownership interest or the relative amount of their original investment.

A particular advantage of a limited liability partnership is that it allows some of the partners in a firm to limit their liability. Under such a structure, only designated partners have unlimited liability for company debts; other partners can be designated as limited partners, only liable up to the amount of their initial contribution. Limited partners are typically not active decision makers within the firm.

Some important differences between LLCs and LLPs are highlighted in Table 2.1.

Limited Liability Corporation		Limited Liability Partnership	
Advantages	**Disadvantages**	**Advantages**	**Disadvantages**
Fewer restrictions on eligibility (only one member allowed; can be professional, although some states disallow professionals)			Only certain professions eligible
Usually more personal liability protection	Limited protection from partners' actions	Personal protection as well as protection from negligence of other partners	
Flexibility in taxation	Earnings included in members' personal taxes	Earnings taxed just once	Must file taxes as pass-through entity

Table 2.1 Advantages and Disadvantages of LLCs and LLPs

LLCs and LLPs have gained great popularity in recent years, but larger companies still find substantial advantages in being structured as C corporations. This is primarily due to the benefits of raising capital to support long-term growth. It is interesting to note that LLC and LLP organizational structures were essentially devised by attorneys. They generally are rather complicated, and the legal protection offered to their ownership principals may vary from state to state. For these reasons, it is usually necessary to retain a knowledgeable lawyer when establishing an organization of this type.

Obviously, when a company is choosing an organizational structure, it must carefully evaluate the advantages and disadvantages that come with any form of doing business. For example, if an organization is considering a corporation structure, it would have to evaluate the trade-off of having the ability to raise greater amounts of funding to support growth and future expansion versus the effects of double taxation. Yet despite such organizational concerns with corporations, time has proven that the value of most businesses, other than relatively small ones, is very likely to be maximized if they are organized as corporations. This follows from the idea that limited ownership liability reduces the overall risks borne by investors. All other things being equal, the lower a firm's risk, the higher its value.

Growth opportunities will also have a tremendous impact on the overall value of a business. Because corporations can raise financing more easily than most other types of organizations, they are better able to engage in profitable projects, make investments, and otherwise take superior advantage of their many favorable growth opportunities.

The value of any asset will, to a large degree, depend on its liquidity. *Liquidity* refers to asset characteristics that enable the asset to be sold or otherwise converted into cash in a relatively short period of time and with minimal effort to attain fair market value for the owner. Because ownership of corporate stock is far easier to transfer to a potential buyer than is any interest in a business proprietorship or partnership, and because most investors are more willing to invest their funds in stocks than they are in partnerships that may carry unlimited liability, an investment in corporate stock will remain relatively liquid. This, too, is an advantage of a corporation and is another factor that enhances its value.

LINK TO LEARNING

Amazon

Most people are surprised to learn than Amazon, the largest online retailer, is set up as an LLC.

Amazon.com Services LLC is set up as a subsidiary of the larger Amazon.com Inc. Take a look at the Amazon LLC company profile provided by Dun & Bradstreet (https://openstax.org/r/company-profiles-amazon). Why do you think such a large corporation is set up as an LLC?

Incorporating a Business

Many business owners decide to structure their business as a corporation. In order to begin the process of incorporation, an organization must file a business registration form with the US state in which it will be based and carry on its primary business activities. The document that must be used for this application is generally referred to as the **articles of incorporation** or a corporate charter. Articles of incorporation are the single most important governing documents of a corporation. The registration allows the state to collect taxes and ensure that the business is complying with all applicable state laws.

The exact form of the articles of incorporation differs depending on the type of corporation. Some types of articles of incorporation include the following:

- **Domestic corporation** (in state)
- **Foreign corporation** (out of state or out of country)
- **Close (closely held) corporation**
- **Professional corporation**
- **Nonprofit corporation** (several different types of nonprofits)
- **Stock corporation**
- **Non-stock corporation**
- **Public benefit corporation**

It is important to note that articles of incorporation are only required to establish a regular corporation. Limited liability corporations require what are referred to as *articles of organization* (or similar documents) to register their business with a state. Some types of limited partnerships must also register with their state. However, sole proprietorships do not have to register; for this reason, they are often the preferred organizational structure for a person who is just starting out in business, at least initially.

Articles of incorporation provide the basic information needed to legally form the company and register the business in its state. The state will need to know the name of the business, its purpose, and the people who will be in charge of running it (the **board of directors**). The state also needs to know about any stock that the business will be selling to the public. The websites of various **secretaries of state** will have information on the different types of articles of incorporation, the requirements, and the filing process.

2.2 Relationship between Shareholders and Company Management

Learning Outcomes

By the end of this section, you will be able to:

- Explain the difference between principals and agents.
- List and discuss various stakeholders associated with a company and its operations.
- Explain how management impacts the operations and future of a company.

Stakeholders

A **stakeholder** is any person or group that has an interest in the outcomes of an organization’s actions. Stakeholders include employees, customers, shareholders, suppliers, communities, and governments. Different stakeholders have different priorities, and companies often have to make compromises to please as many stakeholders as possible.

Shareholders' Roles and Composition

A shareholder or stockholder can be a person, company, or organization that holds stock in a given company. Shareholders typically receive dividends if the company does well and succeeds. They are entitled to vote on certain company matters and to be elected to a seat on the board of directors. One advantage of being a shareholder is that creditors cannot compel shareholders to pay for any of the company's financial obligations or debts. However, being a shareholder includes responsibilities such as appointing the company's directors, deciding on director compensation, setting limits on directors' power, and monitoring and approving the company's financial statements.

Types of Shareholders

There are two types of shareholders: common shareholders and preferred shareholders. Common shareholders are any persons who own a company's common stock. They have the right to control how the company is managed, and they have the right to bring charges if management is involved in activities that could potentially harm the organization. Preferred shareholders own a share of the company's preferred stock and have no voting rights or involvement in managing the company. Instead, they receive a fixed amount of annual dividends, apportioned before the common shareholders are paid. Though both common shareholders and preferred shareholders see their stock value increase with the positive performance of the company, common shareholders experience higher capital gains and losses.

Shareholders and directors are two different entities, although a director can also be shareholder. The shareholder, as already mentioned, is a part owner of the company. A director, on the other hand, is the person hired by the shareholders to perform oversight and provide strategic policy direction to company management.

The Differences between a Shareholder and a Stakeholder

The terms *shareholder* and *stakeholder* mean different things. A shareholder is an owner of a company because of the shares of stock they own. Stakeholders may not own part of the company, but they are in many ways equally dependent on the performance of the company. However, their concerns may not be financial. For example, a chain of hotels in the United States that employs thousands of people has several classes of stakeholders, including employees who rely on the company for their jobs and local and national governments that depend on the taxes the company pays.

Before a company becomes public, it is a private company that is run, formed, and organized by a group of people called *subscribers*. A **subscriber** is a member of the company whose name is listed in the memorandum of association. Even when the company goes public or they depart from the company, subscribers' names continue to be written in the public register.

Role of Management

Corporations are run at the highest level by a group of senior managers referred to as the board of directors (BOD). The BOD is ultimately responsible for providing oversight and strategic direction as well as overall supervision of the organization at its highest managerial level. From an operational standpoint, the practical day-to-day management of a company comprises of a team of several mid-level managers, who are responsible for providing leadership to various departments in the company. Such managers may often have different functional roles in a business organization. The primary roles of any management group involve setting the objectives of the company; organizing operations; hiring, leading, and motivating employees; and overseeing operations to ensure that company goals are continually being met.

It is also important that managers have a long-term focus on meeting growth targets and corporate objectives. Unfortunately, there have been many examples of companies where the managerial focus was shifted to short-term goals—quarterly or fiscal year earnings estimates or the current price of the company stock—for personal reasons, such as increased bonuses and financial benefits. Such short-term thinking is often not in the best interest of the long-term health and objectives of companies or their shareholders.

2.3 Role of the Board of Directors

Learning Outcomes

By the end of this section, you will be able to:

- Describe the oversight functions performed by boards.
- Define an independent board member.
- Compare arguments for and against having independent board members.
- Describe ways boards can become diverse.

Functions of a Board of Directors

A board of directors is a group of people who are elected to represent shareholders, and these directors are then ultimately responsible for running the company. Every public company is legally required to install a board of directors. Nonprofit organizations and many private companies often establish a board of directors as well, even if they are not legally required to do so.

The board is responsible for protecting shareholders' interests, establishing management policies, overseeing the corporation or organization, and making decisions about important issues. The board of directors acts as a fiduciary for shareholders. The board is also tasked with a number of other responsibilities, including setting company goals, creating dividend and stock option policies, hiring and firing chief executive officers (CEOs), and ensuring that the company has the resources it needs to perform well.

Basic Structure of a Board of Directors

The bylaws of a company or organization determine the structure, responsibilities, and powers given to a board of directors. The bylaws also determine how many board members there are, how the members are elected, and how frequently the board members meet.

The board must represent shareholder and management interests, so it is best for the board to include both internal and external members. Usually, there is an internal director and an external director. The internal director is a member of the board who is involved with the daily workings of the company and manages the interests of shareholders, officers, and employees. The external director represents the interests of those who function outside of the company. The CEO often serves as the chairman of the company's board of directors.

Figure 2.2 Corporate Boardroom (credit: "495 Express Lanes Board Room" by Fairfax County Chamber of Commerce/flickr, CC BY 2.0)

International Structure of a Board of Directors

The structure of a board of directors varies more outside of the United States. In Asia and the European Union, there are commonly executive and supervisory boards. The executive board is made up of company insiders who are elected by employees and shareholders. In most cases, the executive board is headed by the company CEO or a managing officer. The supervisory board oversees daily business operations and acts much like a typical US board of directors. The chair of the board varies, but the board is always led by someone other than the prominent executive officer.

Oversight: Corporate Governance

Corporate governance is a discipline that focuses on how a company conducts its business and the various controls that are implemented to ensure proper procedures and ethical behavior.

Although many companies and managers do operate with a fair and honest philosophy, others will try to exploit the temporary benefits of actions that fall outside ethical behavior. Companies do not always adhere to laws. You may have seen or read news stories about false reporting of earnings, failure to reveal financial information, or payments of large bonuses to top executives shortly after a company files for bankruptcy.

In one infamous example, the insurance giant AIG paid for a lavish trip to California for top employees of the company immediately after declaring that the company was insolvent. It asked for and received financial support from the US government in the bailout of 2008.[2]

At other times, a company may cross the line between legal and illegal and violate the law in order to increase profits. Because of the potential for human self-interest and greed, governments have enacted laws and regulations that require specific actions of a company or restrict its activities in an effort to ensure fair competition and ethical behavior.

Often, Congress enacts laws and regulations in response to major economic or other highly visible events. Following the great market crash of 1929, the US government created a new set of rules and regulations governing the issuing and trading of securities, the Securities Act of 1933 and the Securities Exchange Act of 1934. The government also created the **Securities and Exchange Commission (SEC)** to oversee these laws and regulations.

The new laws required that firms make available specific financial information to current owners and prospective owners and that the SEC approve the initial sale of securities to the public. More recently, following a series of major ethical lapses at some firms, the US government enacted new legislation in 2002. One of the most sweeping acts is the Sarbanes-Oxley Act (SOX), which requires, among other things, the following:

- That the CEO and chief financial officer (CFO) must attest to the fairness and accuracy of the company's financial reporting
- That the company implements and maintains an effective structure of internal controls responsible for the reporting of financial results
- That the company and an external public accounting firm confirm the effectiveness of the controls over the most recent fiscal year

In addition, SOX created the Public Company Accounting Oversight Board, outlining the prohibited activities of auditors. It also set a requirement that the SEC issue new rulings that establish compliance with the act.

Board of Directors Oversight and Corporate Governance

Because of the widely publicized control breakdowns at Wells Fargo Bank and recent regulatory actions, boards of directors of public companies and financial institutions have been directed to improve oversight and

2 Scott Vogel. "You Paid for It: AIG's Retreat Destination, Up Close." *Washington Post*. October 9, 2008. http://voices.washingtonpost.com/travellog/2008/10/disaster_tourism_comes_to_cali.html

corporate governance. Boards are evolving from focusing primarily on the needs of top key individuals to considering broader aspects of ethics, values, and corporate culture. Boards now oversee the monitoring systems being put in place and may take on direct responsibilities related to senior management.

The Role of the Audit Committee

A strong independent audit committee (AC) is an important part of the corporate governance efforts of any firm. The AC is formed by the board of directors as a separately chartered subcommittee of the board of directors. It reports regularly to the BOD and assists the board by assuming responsibilities for critical corporate financial matters, such as reviewing audit plans and findings, approving external public accountants, and coordinating the efforts of both internal and external financial reviews and audits. The audit committee provides expertise in all financial and accounting matters for a company, and it is therefore a critical part of a company's corporate governance efforts.

Some important functions of the audit committee include

- confirming the accuracy of the firm's financial reporting;
- verifying that systems of internal control and risk management are operating effectively;
- ensuring compliance with legal and regulatory requirements;
- verifying the qualifications, independence, and performance of the external public auditing firm; and
- coordinating the activities and performance of the internal audit function.

The role of the audit committee has significantly expanded over the years, and it has become exceedingly important with the enactment of the Sarbanes-Oxley Act. Due to this increase in importance and recognition, several boards have shifted some of the audit committee's responsibilities to separately chartered committees in order to create a balance of duties and ensure that those duties are effectively focused on and efficiently executed. Some of these additional committees have been known to include a compensation committee, a disclosure committee, and a governance committee, and they all have related objectives that need to be documented within the charter of each of the individual committees. It is important for the different committees to have close working relationships so that the audit committee can help each one fulfill its responsibilities to senior management, the greater board of directors, shareholders, and other stakeholders.

The audit committee performs an internal audit to review the organization's corporate governance process and to communicate any recommendations for changes. The audit committee will usually follow up and monitor the process put in place to implement any changes or necessary improvements. As with any other corporate function, the audit committee's role is greatly affected by the legal, institutional, financial, cultural, and political circumstances that impact the company.

Importance of Improving Oversight and Governance

It is crucial to today's corporate environment that firms do not lose sight of achieving and maintaining strong and efficient oversight and governance. This is true despite the litany of other important items on the busy agendas of most boards.

Keeping a focus on the critical ethics of management, as well as the traditional focus on the importance of ethics to the overall organization, is not only timely in this day and age but also sound business practice. The importance of establishing a comprehensive system of checks and balances cannot be overemphasized. Beginning with the chief executive officer, these checks and balances need to progress through senior management, and they ultimately include the board of directors itself. Similar checks and balances need to then filter down though the rest of the entire firm. By taking the appropriate steps to improve corporate oversight and governance, overall business risk can be mitigated and future operational problems reduced. Additionally, such steps can lead to the positive effects of achieving sustainable operational and financial benefits for a company and its shareholders.

LINK TO LEARNING

PepsiCo

PepsiCo is a global leader in the food and beverage industry. It has also been noted for its excellence in corporate governance. Take a look at the PepsiCo website (https://openstax.org/r/pepsico). Why do you think the company has won numerous awards and was featured in Fortune's annual Blue Ribbon Companies list for 2021?

The Importance of Independence in Boards of Directors

An independent board of directors is composed of individuals who have no material interest in the company other than their directorship. They maintain their independence by only accepting compensation from the company for their BOD services. They also have their own information sources, instead of relying on information provided by senior management of the company. It is considered a corporate governance best practice to have independent members serve on boards of directors for both publicly and privately held companies.

In most cases, board members have no affiliation with activities or organizations that could result in conflicts of interest. An example of this might be a scenario in which a board is considering the formation of a partnership or alliance with an organization that is directly associated with one of its board members. In such an instance, a director might be excused from participating in that decision process, particularly if it is clear that it would lead to potential conflict.

A board with a majority of independent directors can bring expertise and objectivity, which

- helps assure ownership that the company is being run legally, ethically, and in the best interest of shareholders;
- allows for both independence and objectivity regarding senior managerial representatives and limits situations in which a key decision maker might have a vested interest or an "ax to grind"; and
- enables board members to advance discussions with no hidden agendas for self-advancement or other self-profiting motives.

The Importance of Diversity in Boards of Directors

As mentioned earlier, diversity can be an important quality for any board of directors. Increasingly over recent years, corporate management has begun to appreciate the value of diversity in boards of directors. This has resulted in a significant increase in the total number of women and people of color in boardrooms in the United States. However, many business observers believe that corporate governance practices have a long way to go in this respect. Increasing representation has now grown to become a high priority for most businesses and organizations around the world.

Board members face many challenges in making decisions effectively and efficiently as possible. Because of such challenges, the potential objective of diversifying the boardroom competes with other worthy topics and objectives such as improving cybersecurity, advancing customer service, identifying and reducing risk, improving community relations, and positioning strategically within an industry. This has left corporate governance experts and researchers in a situation where they find themselves "playing catch-up" to adequately diversify.

2.4 Agency Issues: Shareholders and Corporate Boards

Learning Outcomes

By the end of this section, you will be able to:

- Define the concept of agency costs.
- Discuss conflicts of interest between board members, company management, and employees.
- Define each component of ESG.
- Discuss the findings indicating how ESG policies impact stock returns.

Agency Problems and Issues

Agency problems refers to conflicts that occur when an **agent** (manager) who is entrusted with following the interests of the **principal** (shareholder or owner) of an organization abuses their position to further their own personal goals. In the field of corporate finance, agency problems are often related to a conflict of interest between the management of a company and its shareholders.

For many years, this has been a very common problem that has been seen in nearly every kind of organization, irrespective of it being a church, a club, a not-for-profit organization, a multinational corporation, or any other government agency or institution. As with most problematic issues in business, agency problems can be resolved, but only if organizations are willing to take the appropriate steps to resolve them.

Every company has its own set of goals and objectives, but it is important to note that the employee and personal goals of managers may differ and may not align with the goals and objectives of stockholders (ownership). Because these differences exist, and because all parties have a desire to maximize their own wealth, agency problems can often arise, having a negative impact on company profits, stock price, and the goodwill of the shareholder base.

There are three primary types of agency problems, discussed below.

CONCEPTS IN PRACTICE

Example of an Agency Problem

ABC Co. used to sell organic shampoo for $15, but the stockholders of ABC lobbied for an increase in the selling price of the shampoo from $15 to $18. This was to increase earnings and, ultimately, their own personal wealth through an uptick in stock price. However, as a result of this unnecessary rise in the price of the shampoo, customers were disappointed, and a majority of them wound up boycotting the product. Additionally, some of the consumers who continued to purchase the product noticed a decline in the overall quality of the shampoo and were also very disappointed. In this scenario, agency problems surfaced between stockholders and loyal customers of the company.

Stockholders versus Management

Large corporations typically have a substantial number of stockholders forming their ownership. It is essential for an organization to separate the management of a company from this ownership in order to avoid this type of agency problem.

Segregating ownership from management can be advantageous for an organization. Doing so will usually not have any effects on normal business operations. At the same time, the company can employ different experts and professionals to manage key operations of the business.

However, a drawback to this is that hiring outsiders may eventually become troublesome for shareholders. External managers who are brought into a company may end up making self-serving decisions or even misusing company funds. This could eventually result in declining bottom line results and company share prices, which would then lead to conflicts of interests between stockholders and company management.

An example of an agency problem between management and shareholders occurred at WorldCom in 2001, when their CEO used company assets to underwrite several personal loans.[3] As a result of these inappropriate actions, the company took on additional debt that negatively impacted WorldCom's capital structure, liquidity, and ultimately its stock price. From this example, we can see how individual greed on the part of agents, executives, or corporate management can lead to significant agency problems.

Investors versus Creditors

If a company decides to engage in risky investments and projects in order to drive organizational profitability, these increased risk levels could threaten the company's ability to service (repay) their debts, leading to possible default.

This additional risk could also result in creditors taking steps to devalue such debts, which in most cases refers to company bond issues. In the end, if these riskier projects end up failing and the company loses money, investors (bondholders) may also experience financial risk as bonds go into default or otherwise lose market value. This then becomes a potential agency problem between bondholders (investors) and creditors.

Stockholders versus Other Stakeholders

Situations may arise in which stockholders of a firm find themselves in conflicts of interest with other stakeholders of the company. For example, employees of a firm might be asking for a general wage increase. If such a wage increase were voted down by stockholders, this could result in key employees departing the organization, eventually leading to poorer business results and the dissatisfaction of other stakeholders in the company as company profits decline. In such an example, we see the agency problem of stockholders versus other stakeholders.

A more specific example of such an agency problem occurred in 2011, when Oregon-based food and gift basket company Harry & David was forced to file for bankruptcy.[4] This was a direct result of the company being purchased through a leveraged buyout that left the company saddled with a tremendous amount of debt. However, the most important factor leading to the company's failure was the actions of Steven Heyer, who was a friend of the new owners and had been hired as CEO. Heyer, who was awarded an exorbitant executive salary, was also allowed to sink the company into further debt. Harry & David has since emerged from bankruptcy under new leadership. But this example should serve as a cautionary tale of what can happen when stockholders are able to put their interests ahead of those of other stakeholders in a corporate environment.

CONCEPTS IN PRACTICE

Infamous Agency Problems

Enron

Enron is one particularly infamous example of an agency problem. Enron's directors were responsible for protecting and promoting investor interests, but they failed to carry out their regulatory and oversight responsibilities, enabling the company to venture into illegal activity. The company's resulting accounting scandal resulted in billions of dollars in losses to its investors.

At one time, Enron had been one of the largest companies in the United States. Despite being a multibillion-

3 Anshita Kohli. "Worldcom Scam: The Fall of the Biggest US Telecommunication Company." The Company Ninja. JD Learning Ventures, May 26, 2020. https://thecompany.ninja/worldcom-scam/
4 Beth Kowitt. "Harry & David's Failed Mr. Fix-It." *Fortune*. April 1, 2011. https://fortune.com/2011/04/01/harry-davids-failed-mr-fix-it/

dollar company, Enron began losing money in 1997. It had also started incurring a tremendous amount of debt. Fearing a drop in stock prices, Enron's management team tried to disguise the problems by misrepresenting them through inappropriate accounting methods, which resulted in confusing and misleading financial statements.

Disaster started to unfold in 2001, when common stock prices fell from $90 to under $1 per share. The company filed for bankruptcy in December 2001, and criminal charges were brought against several key Enron employees, including former CEO Kenneth Lay and former CFO Andrew Fastow. Jeffrey Skilling was subsequently named CEO in February 2001, but he ended up resigning six months later.

Bernard L. Madoff Investment Securities LLC

Ponzi schemes are common examples of the agency problem. **Agency theory** claims that a lack of oversight and incentive alignment greatly contributes to these problems. Many investors fall into Ponzi schemes thinking that taking fund management outside a traditional banking institution reduces fees and saves money.

Even though established financial institutions reduce risk by providing oversight and enforcing legal practices, some Ponzi schemes simply involve taking advantage of consumer suspicions about the banking industry and financial markets. In this type of environment, the consumer cannot ensure that an agent is acting in their best interest. Investments are made under limited or, in many cases, completely nonexistent oversight.

Bernie Madoff's scam is probably one of the most infamous examples of a Ponzi scheme. Madoff's fraud started with friends, relatives, and acquaintances in New York, but it ultimately grew to encompass major charities such as Hadassah, universities such as Tufts and Yeshiva, institutional investors, and wealthy families in Europe, Latin America, and Asia. The cash losses of Madoff's scheme were recently estimated to be between $17 billion and $20 billion. The returns he promised were higher than what most investment firms and banks were offering—so promising that almost all of his investors ignored any concerns they may have had and basically looked the other way. Madoff paid for any redemption requests with money that had been newly invested.

Madoff's Ponzi scheme fell apart when he could no longer pay his investors. He was criminally charged, convicted, and given a 150-year prison sentence. Madoff died in April 2021 while serving his prison term.

(Sources: Diana B. Henriques. "Bernard Madoff, Architect of Largest Ponzi Scheme in History, Is Dead at 82." *New York Times*. April 14, 2021. https://www.nytimes.com/2021/04/14/business/bernie-madoff-dead.html; Chase Peterson-Withorn. "The Investors Who Had to Pay Back Billions in Ill-Gotten Gains from Bernie Madoff's Ponzi Scheme." *Forbes*. April 14, 2021. https://www.forbes.com/sites/chasewithorn/2021/04/14/the-investors-who-had-to-pay-back-billions-in-ill-gotten-gains-from-bernie-madoffs-ponzi-scheme/; Adam Hayes. "The Agency Problem: Two Infamous Examples." Investopedia. Dotdash, updated April 15, 2021. https://www.investopedia.com/ask/answers/041315/what-are-some-famous-scandals-demonstrate-agency-problem.asp)

How to Resolve Agency Problems

Ultimately, agency problems result from the differences among the interests of a company's management, other stakeholders of the firm, and its ownership or stockholders. When perpetuated, these differences may eventually result in lasting conflicts of interest. In order for companies to avoid such problems, it is imperative that they address the underlying problems of these differences. This will help ensure that normal business operations are not being adversely impacted by the agency problem.

While there is no surefire way to resolve all conflicts of interest and agency problems, some measures that can help mitigate such issues include the following:

- Offering incentives to management for strong performance and ethical behavior
- Awarding decision makers with stock packages, commissions, and other long-term compensation packages to encourage long-term thinking and matching of company objectives with shareholders' priorities
- Penalizing poor performance, shortsightedness, and unethical behavior

The prevailing belief in agency theory is that when a business creates organizational incentives that encourage hard work on projects that will benefit the company in both the short and long term, more employees will be encouraged to act in the business's best interest.

Another means of resolving agency problems is through a hostile takeover of the organization. Even the threat of such a takeover may be effective in reducing or eliminating these conflicts of interest. A hostile corporate takeover tends to unify and discipline a management or agent group, thus fostering a union of agent and shareholder interests. When such a potential threat or outright ownership change is introduced to a company, its managers are more likely to act in the best long-term interests of the shareholders in order to maintain their leadership positions within the company.

By better aligning *agent* (management) and *principal* (ownership) goals, agency theory attempts to bridge any gulfs among employees, employers, and stakeholders that are created by the principal-agent problem. While it is recognized as being nearly impossible for companies to eliminate the ongoing agency problem, it is also recognized that it is possible to minimize its negative effects.

Impact of ESG Ratings

In recent years, many publicly traded companies, as well as many that are privately owned, are being evaluated and rated according to environmental, social, and governance **(ESG)** factors. These ratings and evaluations are primarily conducted by third-party organizations. As a result, the investment community is using these reports and ratings to an ever-increasing degree in order to measure and assess corporate ESG factors and performance.

Environmental, social, and governance issues have become an important part of the investment community's evaluation of publicly traded companies. Each component of what is now referred to as ESG has equal importance in ongoing corporate evaluations, as per Figure 2.3 below. It is critical for the senior management of any corporation to stay abreast of any and all ESG issues as they arise and take immediate corrective action when necessary.

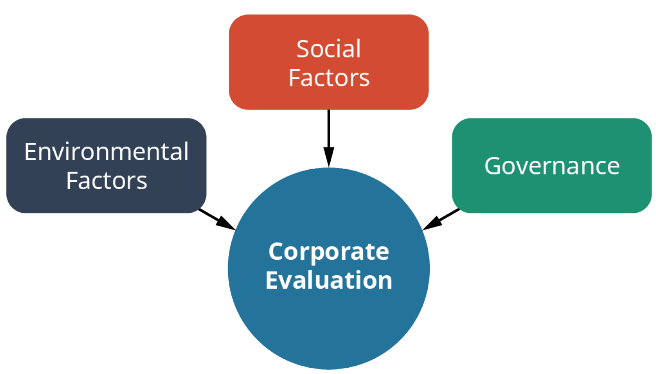

Figure 2.3 Importance of ESG Factors to a Business Concern

ESG measurements and assessments have become very important to firms, as they often become the basis of formal and informal buy recommendations by investment professionals. ESG ratings were originally developed to assist in determining the general risk of ESG factors for any public company, but they have since grown to become unique scores used by investors to gauge the potential attractiveness of investment in the subject company. Because of the nature of these factors, firms that are rated with high ESG metrics are believed to represent superior investments and to have proactive management teams focused on creating long-term value of company stock.

Thus, with investors increasingly using ESG scores to form their investment strategies, the consequences of a poor rating can have a negative impact on a firm's share price and result in substantial problems. In any case, it is important to note that ESG is only a starting point from which it is possible to gather indicators on a business and its direction. In the end, it does not present the entire story of a firm. Any investment decisions about the company in question should include a significant amount of additional data.

2.5 Interacting with Investors, Intermediaries, and Other Market Participants

Learning Outcomes

By the end of this section, you will be able to:

- Define the investor relations function.
- Discuss how the investor relations office interacts with investors, regulators, and other corporate stakeholders.
- Describe the topics most often discussed during a quarterly conference call.
- Explain how press release information impacts company stock prices.

Investor Relations

Within the general field of corporate public relations is a specific subdivision referred to as **investor relations (IR)**. IR involves elements of communication, marketing, and finance and is designed to control the flow of information from the management of a public corporation to its investors and stakeholders.

Because the investment community plays such a critical role in the overall growth and success of any corporation, it is imperative that firms maintain strong and open relationships with their shareholder or potential investor audience. IR was developed to take responsibility for achieving and maintaining these crucial relationships.

Investor relations are quite different from typical public relations practices. A firm's IR group must work very closely with the accounting and legal departments, as well as with members of the senior management team, such as the CEO and CFO.

As might be expected, IR has far more regulatory obligations than standard public relations functions, largely due to corporate reporting requirements enforced by the SEC and the **International Financial Reporting Standards (IFRS)**. IR became significantly more important in 2002, when the United States Congress passed the Sarbanes-Oxley Act (SOX), also known as the Public Company Accounting Reform and Investor Protection Act. This legislation resulted in requirements that dramatically increased the extent of financial reporting for any publicly traded company. SOX was enacted in an attempt to prevent the occurrence of corporate financial scandals such as the one notoriously committed by the Enron Corporation that we discussed earlier.

In summary, investor relations functions have responsibilities including, but not limited to,

- coordinating live shareholder meetings and press conferences;
- disseminating financial information to the investment community;
- conducting briefings to the financial analyst community;
- publishing the **quarterly report** and **annual report**; and
- addressing any issues that arise as a result of financial disclosure.

The best time to form an internal IR function or to engage an IR firm is when a company begins the process of becoming publicly traded through an initial public offering, or IPO.

Quarterly Earnings Conference Calls

As a result of the Securities Exchange Act of 1934, all publicly traded companies are required to file certain financial reports with the SEC. The underlying purpose of these requirements is to provide shareholders and the investment community with important operational and financial information on a regular basis and in a transparent manner. Reports filed with the SEC include the annual Form 10-K, quarterly Form 10-Qs, and current periodic Form 8-Ks, in addition to proxy reports and certain shareholder and affiliate reporting documents. Quarterly 10-Qs are an ongoing and regular reporting requirement of publicly traded companies and are to be filed within 45 days following the end of each fiscal quarter.

Depending on a company's size and the complexity of its operation, a firm is likely to issue an earnings **press release** and conduct a **conference call** with the investment community within this same 45-day period. There is no legal requirement for companies to do either of these things, but experts in IR view these communications tools as best practice. They can add context and commentary to the reported financial results.

It is important for companies to do their planning and not enter a quarterly earnings conference call unprepared. There is a multitude of available resources for companies to analyze and review in preparation. Among such resources are industry reports prepared by government agencies; the financial reports and earnings calls of competing organizations, both within and outside of a company's primary industry; and financial research reports prepared by various covering analysts, who follow the specific company and are employed by financial brokerage firms.

Investment Meetings and Conferences

Organizing the **annual meeting** of shareholders, investor roadshows, and investment conferences is no easy task for any corporation, though all of these audience-facing events are critical to maintaining strong relations with shareholders and the investment community. It is important to reach shareholders and investors on an almost personal basis by crafting a successful and interesting investment story. For effective investor relations, key messages supporting any ownership or potential investment case should be clear and consistent. These key messages should be embedded within the company's materials and should form the basis of presentations, the corporate website, and annual reports. They should also be reinforced via concrete examples during annual meetings, roadshows, and investor presentations.

Figure 2.4 Quarterly Investor Relations Presentation (credit: "MAPFRE" by Castilla y León Económica/flickr, CC BY 2.0)

Corporations have found that using senior management's time efficiently is also important to investor relations. By targeting the ownership and potential investing audience, senior executives can make the best use of their time and improve their interactions with the investing public during these events. If smaller companies outsource the investor meeting planning process, the third-party firm should be thoroughly grounded in the client's corporate culture.

The most productive investor and shareholder meetings begin with a strong, understandable corporate introduction and continue by delivering an engaging story that demonstrates the company's successes, a track record of growth, and the high probability of favorable future prospects. Additionally, it is important for a company's senior management to end any meeting with feedback from the investor audience and set timelines for follow-up. There will always be times when something unexpected may happen and the addition of information or impromptu changes to scheduled agendas may occur. It is at times like these when understanding the body language and facial expressions of an audience can be critical in producing a favorable outcome of the meeting.

It is unlikely that the decision to invest or to remain an investor will be made based on a single corporate event, but impressions, good or bad, will certainly factor into such decisions over a period of time. Thus, it is important for IR officers to understand the importance of follow-up communication with their audience.

Purposes of Corporate Press Releases

Press releases have always been a vital tool in the communications toolkit of an IR professional. Various social media channels are also becoming increasingly popular for delivering company information and news. However, the press release remains a standard medium for most companies to communicate corporate news, results, and ideas.

Press releases can be written with various intentions. Whether to release financial information, unveil new products or services, announce changes in management, or a host of other reasons, all communications have a different objective. Not all press releases are created equally, and they have varying degrees of effectiveness. Any press release should contain information in easy-to-understand language that is free of corporate jargon and as concise as possible. Press releases may be viewed by multiple audiences, such as customers, stakeholders, investors, potential investors, and the general public, which is vital to consider when drafting a press release.

According to PR Newswire statistics, press releases that contain multimedia content have been known to substantially increase press release views.[5] Using infographics and charts where possible and relaying the key messages in short, easy-to-digest points make a press release easier for the reader to take in. Quotes from senior management can provide valuable insight, but they should not provide any new information; they should simply extend or expand on a subject already mentioned and further back up a claim.

LINK TO LEARNING

Press Releases Approved by PR Newswire

Take a look at this press release on mobile drive-in movies during the COVID-19 pandemic (https://openstax.org/r/mobile-drive-in-movies).

How would you judge this press release? Is it effective? Why or why not?

2.6 Companies in Domestic and Global Markets

Learning Outcomes

By the end of this section, you will be able to:

- Explain why corporations expand beyond domestic borders.
- Determine how different strategic decisions may influence corporate performance.

5 "Multimedia Content Distribution." PR Newswire. Cision, accessed August 27, 2021. https://www.prnewswire.com/products/multimedia-distribution-options.html

Important Differences among Domestic, International, and Global Organizations

If a company becomes global or multinational in scope, fundamental analysis of the organization by the investment community can become more complex. In order to better understand a company, it is important to determine what laws affect the company's governance process and which set of accounting rules is used to fashion its financial reports.

Domestic companies operate completely or for the most part within the borders of the United States. While such organizations may import raw materials and supplies from other nations or end up exporting their finished products to other countries around the world, in the end, these international activities represent only a very small portion of their overall business activities.

Domestic companies are typically governed by US accounting and securities laws that have been established by the SEC. Further, financial reporting for these domestic organizations is to be completed using **Generally Accepted Accounting Principles (GAAP)**.

International firms, while based in the United States, will typically maintain significant levels of international investment and conduct operations that may be quite diverse, both geographically and culturally. For such international firms, parent company accounting will usually adhere to GAAP standards. Conversely, non-US subsidiaries of such international firms may be regulated by laws dictated by their host countries. These will often differ significantly from those in the United States.

In recent years, accounting regulations in countries outside the United States have come under the jurisdiction of International Financial Reporting Standards (IFRS). It should be noted that guidelines and regulations under IFRS and those under GAAP can differ significantly. As a result of these regulatory differences, any specific divergences in accounting or governance practices between foreign subsidiaries and a US parent company should be clearly stated and disclosed in the parent company's financial reports.

Global firms have substantial operations and investments in different countries (**global markets**), and they may have no single center or basis of operational activity. In such cases, regulations for corporate governance are usually determined by the laws of the country in which the parent company has been established. While there are some global firms that report their financial statements according to GAAP standards, usually to satisfy the informational needs of US investors, most global parent companies' financials will adhere to IFRS reporting standards.

Difference in Financial Reporting: GAAP versus IFRS

Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS) were designed with similar objectives in mind: to provide a common and structured set of guidelines to assist in the preparation of accurate and unbiased financial reporting for public corporations.

Yet despite these commonalities in purpose, there are important differences between them. Among these are differences in inventory accounting and reporting, guidelines for consolidation of subsidiaries, and the accounting and reporting of minority interests.

LINK TO LEARNING

GAAP and IFRS

Learn more about US GAAP reporting from the SEC website (https://openstax.org/r/corpfin-manual), and learn about international standards from the IFRS website (https://openstax.org/r/ifrs-org).

SEC Reporting and EDGAR

EDGAR (Electronic Data Gathering, Analysis, and Retrieval system) is the primary system for collecting and indexing documents submitted by companies to the SEC under the Securities Act of 1933, the Securities Exchange Act of 1934, the Trust Indenture Act of 1939, and the Investment Company Act of 1940.

LINK TO LEARNING

EDGAR System

The SEC's EDGAR system (https://openstax.org/r/edgar-html) contains millions of corporate and individual filings. It benefits investors, corporations, and the US economy overall by increasing the efficiency, transparency, and fairness of the securities markets. The system processes about 3,000 filings per day, serves up 3,000 terabytes of data to the public annually, and accommodates 40,000 new filers per year on average.[6]

6 "About EDGAR." US Securities and Exchange Commission. Modified March 23, 2021. https://www.sec.gov/edgar/about

Summary

2.1 Business Structures

The most common forms of business organizations are sole proprietorships, partnerships, corporations, and hybrids. There are advantages and disadvantages to each type of organization involving ease of formation, tax requirements, and personal liabilities. The most common type of organization for larger businesses is the corporation, the establishment of which involves filing articles of incorporation.

2.2 Relationship between Shareholders and Company Management

A stakeholder is any individual or group that has an interest in the outcomes of an organization's actions. Shareholders are relevant to a corporation form of business because they own stock in the corporation. The board of directors of a company is ultimately responsible to shareholders for effectively running the business.

2.3 Role of the Board of Directors

The board of directors acts as a fiduciary for shareholders. The board is also tasked with a number of other responsibilities, including setting company goals, creating dividend and stock option policies, hiring and firing CEOs, and ensuring that the company has the resources it needs to perform well. Diversity and experience play important roles in corporate governance and in the strength and effectiveness of a board of directors.

2.4 Agency Issues: Shareholders and Corporate Boards

Issues and conflicts of interest might arise between shareholders (public ownership) and senior management, including C-level executives and the board of directors. Although there is no definite way to resolve all conflicts of interest, some measures that can help mitigate problems include offering incentives for strong performance and ethical behavior and awarding decision makers with stock packages to encourage long-term thinking.

2.5 Interacting with Investors, Intermediaries, and Other Market Participants

Investor relations are important to a company's overall corporate governance strategy. Effective communication that is straightforward, open, and free of potentially confusing corporate jargon has become a critical component of a company's image, overall message, and long-term success.

2.6 Companies in Domestic and Global Markets

Companies sometimes expand internationally, and there are advantages and disadvantages of such growth. International or global expansion efforts require careful and efficient communication, planning, and financing.

Key Terms

agency theory a principle that is used to explain and resolve issues in the relationship between business principals and their agents, most commonly between shareholders (principals) and company executives (agents)

agent a person who acts on behalf of another person or group

annual meeting a meeting of the general membership and shareholders of a corporation; also known as an annual general meeting (AGM)

annual report a document describing a public corporation's operations and financial condition that must be provided to shareholders once per year; also known as Securities and Exchange Commission (SEC) Form 10-K

articles of incorporation a set of formal documents filed with a government body to legally document the creation of a corporation

board of directors (BOD) a group of people who jointly supervise the activities of an organization

C corporation a legal structure for a corporation in which the owners, or shareholders, are taxed separately from the entity

close (closely held) corporation a company that has only a limited number of shareholders

conference call a meeting or presentation conducted via telephone or internet to relay company information to all interested parties, including institutional and individual investors, as well as buy-and-sell side analysts; also known as an earnings conference call

corporate governance the system of rules, practices, and processes by which a firm is directed and controlled

corporation a legal entity that is separate and distinct from its owners

domestic corporation (in state) a corporation incorporated under the laws of the country or state in which it does business

Electronic Data Gathering, Analysis, and Retrieval system (EDGAR) the primary system for collecting and indexing documents submitted by companies and others under the Securities Act of 1933, the Securities Exchange Act of 1934, the Trust Indenture Act of 1939, and the Investment Company Act of 1940

ESG environmental, social, and governance (ESG) standards for a company's operations that socially conscious investors use to screen potential investments

foreign corporation (out of state or out of country) an existing corporation that conducts business in a state or jurisdiction other than where it was originally incorporated

Generally Accepted Accounting Principles (GAAP) a common set of accounting principles, standards, and procedures issued by the Financial Accounting Standards Board (FASB)

global markets economies or markets that are multinational in nature, spanning several different countries or jurisdictions

hybrid form of business a limited liability company (LLC) or limited liability partnership (LLP) that combines the characteristics of a corporation with those of a sole proprietorship or partnership

International Financial Reporting Standards (IFRS) accounting standards used by international corporations, issued by the IFRS Foundation and the International Accounting Standards Board

investor a person or an entity, such as a firm or mutual fund, that invests capital with the expectation of receiving financial returns

investor relations (IR) a strategic management responsibility that is capable of integrating finance, communication, marketing, and securities law compliance to enable the most effective two-way communication between a company and the financial community or other constituencies, which ultimately contributes to a company's securities achieving fair valuation

limited liability corporation (LLC) a US-specific form of a private limited company; a business structure that can combine the pass-through taxation of a partnership or sole proprietorship with the limited liability of a corporation

limited liability partnership (LLP) a partnership in which some or all partners have limited liabilities; can exhibit elements of both partnerships and corporations

non-stock corporation a corporation that does not have owners represented by shares of stock but typically has members who are the functional equivalent of stockholders in a stock corporation (having the right to vote, etc.); describes the vast majority of not-for-profit corporations

nonprofit (not-for-profit) corporation a legal entity that has been incorporated under the law of its jurisdiction for purposes other than making profits for its owners or shareholders

partnership a formal arrangement by two or more parties to manage and operate a business and share its profits and liabilities equally

press release an official statement delivered to members of the news media for the purpose of making an announcement or otherwise providing information

principal the person with the highest authority or most important position in a company, organization, institution, or group

professional corporation a form of corporate entity used by licensed professionals such as attorneys, architects, engineers, public accountants, and physicians, which is regulated by special provisions in many corporation statutes