1 Introduction to Corporate Finance

IN 2009, Adam Neumann and a business partner opened the first WeWork space in New York's Little Italy. WeWork provided shared office space for businesses, who would rent space as needed, sometimes only for a day. By 2019, WeWork operated in more than 111 cities in 29 countries. Revenues had grown to about $3 billion, but the company was still losing money. Early in 2019, the giant tech investor SoftBank made a major bet on WeWork, which valued the company at $47 billion.

Unfortunately, everything was not rosy at WeWork. In the middle of 2019, the company filed to go public in an IPO, but then changed its mind. In late 2019, Softbank agreed to another major investment, but it pulled the deal in 2020. What happened? Among other things, the COVID-19 pandemic hit, calling into question the company's entire business model of shared, face-to-face meeting spaces.

Understanding WeWork's story as it progressed from a start-up to a multi-billion dollar enterprise and its subsequent struggles takes us into issues involving the corporate form of organization, corporate goals, and corporate control, all of which we discuss in this chapter.

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

LO1 Define the basic types of financial management decisions and the role of the financial manager.

LO2 Explain the goal of financial management.

LO3 Articulate the financial implications of the different forms of business organization.

LO4 Explain the conflicts of interest that can arise between managers and owners.

For updates on the latest happenings in finance, visit fundamentalsofcorporatefinance.blogspot.com.

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

1.1 Finance: A Quick Look

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

FINANCE: THE FIVE MAIN AREAS

Financial topics are usually grouped into five main areas:

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

We discuss each of these next.

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

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

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

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

Students who specialize in the investments area have various career opportunities. Being a financial advisor is one of the most common. Advisors often work for large companies such as Merrill Lynch, advising customers on what types of investments to consider and helping them make buy and sell decisions.

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

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

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

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

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

Fintech Finance has always been an early adopter of faster, cheaper technologies. The combination of technology and finance is called *fintech*. Fintech is a broad term for a company that uses the internet, mobile phones, software, and/or cloud services to provide a financial service. We discuss fintech in more detail in the next section.

WHY STUDY FINANCE?

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

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

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

Beyond this, the finance industry employs marketers to help sell financial products such as bank accounts, insurance policies, and mutual funds. Financial services marketing is one of the most rapidly growing types of marketing, and successful financial services marketers are very well compensated. To work in this area, you obviously need to understand financial products.

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

Financial analysts make extensive use of accounting information; they are some of the most important end users. Understanding finance helps accountants recognize what types

of information are particularly valuable and, more generally, how accounting information is actually used (and abused) in practice.

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

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

Technology and Finance STEM (Science, Technology, Engineering, and Math) classes have become more important in recent years. Finance is considered a STEM discipline, especially at the graduate level. As we discussed, fintech is the area in finance that focuses on the STEM side of things. We'll consider a few examples next. As we'll see, fintech companies can often provide cheaper, faster, and more convenient services than brick-and-mortar setups.

Banking Fintech Fintech companies are beginning to compete with traditional bank roles. Mobile payments are a fast-growing form of fintech. Companies such as Venmo and PayPal permit users to transfer money directly from one person to another. These companies have reduced the need for more traditional payment methods, such as checks. In 2019, more than $1 trillion was transferred by mobile payment companies.

Crowdfunding companies like Kickstarter and GoFundMe allow users to raise money directly from other people. Variations exist in these crowdfunding companies: Kickstarter participants are often buying a product before it comes to market, while GoFundMe is used to raise money for a cause.

Fintechs such as Kabbage, Lendio, and Accion have been created to establish marketplaces to provide companies with working capital. These companies have a more streamlined process compared to banks and are willing to fund working capital for start-ups, which are often unable to find funding through more traditional means.

Other fintech companies, such as Upstart and Prosper, have become marketplaces for direct lending to consumers. Customers of these companies apply for loans, which are funded directly by other participants, usually individuals. In a traditional bank loan, much of the decision is determined by a credit score and previous credit history. These marketplaces allow for loans to be funded based off other factors.

Blockchain and Cryptocurrency Blockchain is at the heart of many new fintech services. Blockchain is a list of records, called blocks, that are used to record transactions. Each block contains a cryptographic hash of the previous block, a time stamp, and transaction data. By design, blockchain is resistant to alteration and thus provides an accurate record of transactions.

Cryptocurrency is a digital asset designed to act like currency but is not controlled by any centralized monetary authority. Bitcoin, the first cryptocurrency, was released in 2009. Since then, more than 4,000 variations have been released.

Insurance Insurance technology, or *insurtech,* allows customers to research, compare, and purchase insurance online without physically visiting an insurance agent. Insurtech has streamlined the processes of claims management and evaluating and pricing risks, driving down costs. Insurtech companies are expanding into all areas of insurance, from Lemonade, which offers homeowners and renters insurance, and Oscar Health, which specializes in

health insurance, to Trōv, which allows you to insure a single item for any time period right from your mobile phone.

Robo-advising and Stock Trading Traditionally, if you invested through a broker, the broker would advise you on a good asset allocation. Robo-advisors provide investment advice based on mathematical rules or algorithms. This means there is minimal human interaction between the investor and an advisor.

Stock trading apps, such as Robinhood, allow investors to trade stocks commission free. Other apps, like Acorns, allow investors to invest small amounts, often as low as $1. These apps allow small investors to participate in the stock market much more easily (and cheaply).

Budgeting Apps Perhaps the most common use of fintech is through budgeting apps used by consumers. Budgeting apps allow people to keep track of income, monthly payments, expenditures, and more, right on a mobile phone. These apps allow people more insight into their finances and help with creating financial plans for the future.

You and Finance Perhaps the most important reason to know finance is that you will have to make financial decisions that will be important to you personally. Today, for example, when you go to work for almost any type of company, you will be asked to decide how you want to invest your retirement funds. We'll see in a later chapter that what you choose to do can make an enormous difference in your future financial well-being.

On a different note, is it your dream to start your own business? Good luck if you don't understand basic finance before you start; you'll end up learning it the hard way. Want to know how big your student loan payments are going to be before you take out that next loan? Maybe not, but we'll show you how to calculate them anyway.

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

Concept Questions

1.1a What are the major areas in finance?

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

1.2 Corporate Finance and the Financial Manager

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

WHAT IS CORPORATE FINANCE?

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

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

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

THE FINANCIAL MANAGER

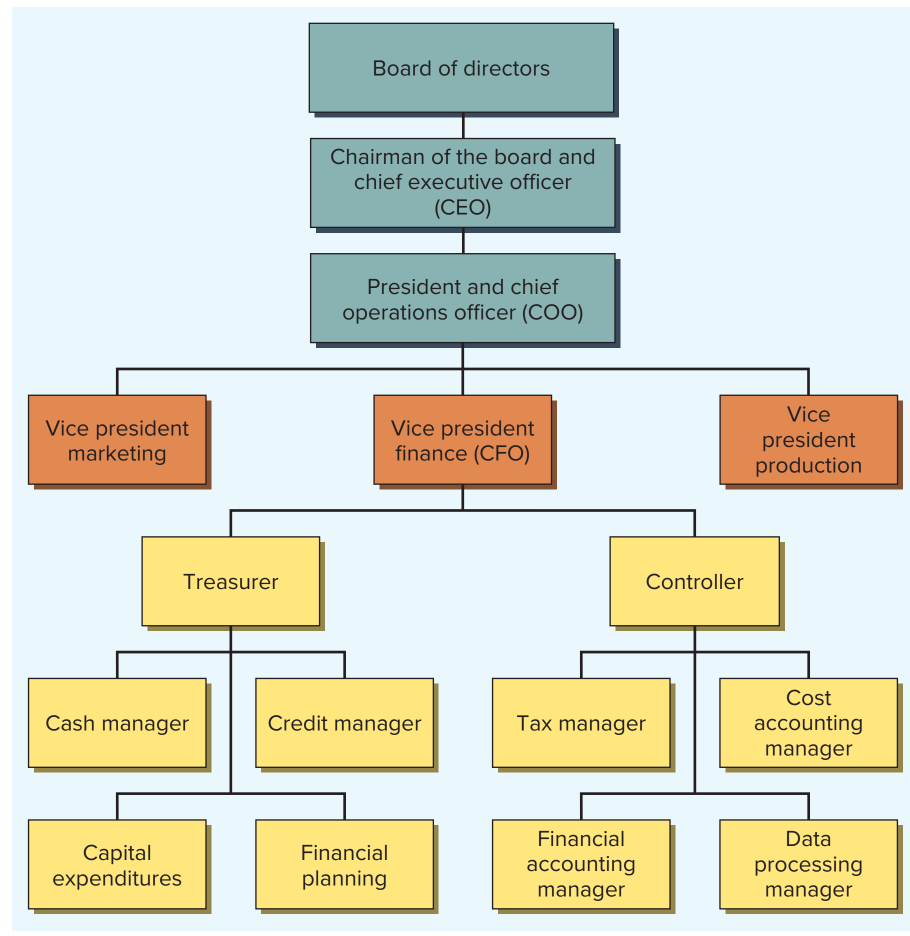
For current issues facing CFOs, see **ww2.cfo.com**.

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

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

FIGURE 1.1

A Sample Simplified Organizational Chart



FINANCIAL MANAGEMENT DECISIONS

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

Capital Budgeting

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

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

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

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

Capital Structure

The second question for the financial manager concerns ways in which the firm obtains and manages the long-term financing it needs to support its long-term investments. A firm's **capital structure** (or financial structure) is the specific mixture of long-term debt and equity the firm uses to finance its operations. The financial manager has two concerns in this area. First, how much should the firm borrow? That is, what mixture of debt and equity is best? The mixture chosen will affect both the risk and the value of the firm. Second, what are the least expensive sources of funds for the firm?

capital structure
The mixture of debt and equity maintained by a firm.

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

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

Working Capital Management

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

working capital
A firm's short-term assets and liabilities.

Some questions about working capital that must be answered are the following: (1) How much cash and inventory should we keep on hand? (2) Should we sell on credit? If so, what terms will we offer, and to whom will we extend them? (3) How will we obtain any needed

short-term financing? Will we purchase on credit, or will we borrow in the short term and pay cash? If we borrow in the short term, how and where should we do it? These are just a small sample of the issues that arise in managing a firm's working capital.

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

Concept Questions

1.2a What is the capital budgeting decision?

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

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

1.3 Forms of Business Organization

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

SOLE PROPRIETORSHIP

sole proprietorship
A business owned by a single individual.

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

The owner of a sole proprietorship keeps all the profits. That's the good news. The bad news is that the owner has *unlimited liability* for business debts. This means that creditors can look beyond business assets to the proprietor's personal assets for payment. Similarly, there is no distinction between personal and business income, so all business income is taxed as personal income. However, with the passage of the Tax Cuts and Jobs Act of 2017, up to 20 percent of business income may be exempt from taxation (the specific rules are too complex to cover here).

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

PARTNERSHIP

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

A **partnership** is similar to a proprietorship except that there are two or more owners (partners). In a *general partnership,* all the partners share in gains or losses, and all have unlimited liability for *all* partnership debts, not just some particular share. The way partnership gains

(and losses) are divided is described in the *partnership agreement.* This agreement can be an informal oral agreement, such as "let's start a lawn mowing business," or a lengthy, formal written document.

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

The advantages and disadvantages of a partnership are basically the same as those of a proprietorship. Partnerships based on a relatively informal agreement are easy and inexpensive to form. General partners have unlimited liability for partnership debts, and the partnership terminates when a general partner wishes to sell out or dies. Ownership of a general partnership is not easily transferred because a transfer requires that a new partnership be formed. A limited partner's interest can be sold without dissolving the partnership, but finding a buyer may be difficult. All income is taxed as personal income to the partners, and the amount of equity that can be raised is limited to the partners' combined wealth. As with sole proprietorships, beginning in 2018, up to 20 percent of a partner's income may be exempt depending on various rules spelled out in the Tax Cuts and Jobs Act of 2017.

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

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

CORPORATION

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

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

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

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

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

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

The relative ease of transferring ownership, the limited liability for business debts, and the unlimited life of the business are why the corporate form is superior for raising cash. If a corporation needs new equity, for example, it can sell new shares of stock and attract new investors. Apple is an example. The company was a pioneer in the personal computer business. As demand for its products exploded, it had to convert to the corporate form of organization to raise the capital needed to fund growth and new product development. The number of owners can be huge; larger corporations have many thousands or even millions of stockholders. For example, in 2020, General Electric Company (better known as GE) had about 440,000 stockholders and about 8.7 billion shares outstanding. In such cases, ownership can change continuously without affecting the continuity of the business.

The ability of large corporations to raise cash can be lifesaving. In 2020, the COVID-19 virus decimated the cruise ship industry. Even so, Norwegian Cruise Line, the world's third-largest such company, was able to raise $2.2 billion at the height of the pandemic, enough to keep the company afloat (no pun intended) for well over a year with no ships sailing.

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

Today, all 50 states have enacted laws allowing for the creation of a relatively new form of business organization, the limited liability company (LLC). The goal of this entity is to operate and be taxed like a partnership but retain limited liability for owners, so an LLC is essentially a hybrid of partnership and corporation. Although states have differing definitions for LLCs, the more important scorekeeper is the Internal Revenue Service (IRS). The IRS will consider an LLC a corporation, thereby subjecting it to double taxation, unless it meets certain specific criteria. In essence, an LLC cannot be too corporation-like, or it will be treated as one by the IRS. LLCs have become common. For example, Goldman Sachs and Co., one of Wall Street's last remaining partnerships, decided to convert from a private partnership to an LLC (it later "went public," becoming a publicly held corporation). Large accounting firms and law firms by the score have converted to LLCs.

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

A CORPORATION BY ANOTHER NAME . . .

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

[1]An S corporation is a special type of small corporation that is essentially taxed like a partnership and thus avoids double taxation. In 2020, the maximum number of shareholders in an S corporation was 100.

TABLE 1.1

International Corporations

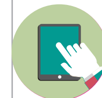
		Type of Company	
Company	**Country of Origin**	**In Original Language**	**Translated**
Bayerische Motoren Werke (BMW) AG	Germany	Aktiengesellschaft	Corporation
Lindauer Dornier GmbH	Germany	Gesellschaft mit Beschränkter Haftung	Limited liability company
Rolls-Royce PLC	United Kingdom	Public limited company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

public limited companies, or *limited liability companies,* depending on the specific nature of the firm and the country of origin.

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

BENEFIT CORPORATION

As of early 2020, 36 states have enacted laws for a new type of company called a benefit corporation. A benefit corporation is for profit, but it has three additional legal attributes: accountability, transparency, and purpose. *Accountability* refers to the fact that a benefit corporation must consider how an action will affect shareholders, employees, customers, the community, and the environment. *Transparency* means that, in addition to standard corporate reports, a benefit corporation must provide an annual report detailing how the company pursued a public benefit during the year, or any factors that inhibited the pursuit of this goal. Finally, *purpose* refers to the idea that a benefit corporation must provide a public benefit, either to society as a whole or the environment.



For more about benefit corporations, check out **benefitcorp.net**.

Concept Questions

1.3a What are the three forms of business organization?

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

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

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

1.4 The Goal of Financial Management

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

POSSIBLE GOALS

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

Survive.

Avoid financial distress and bankruptcy.

Beat the competition.

Maximize sales or market share.

Minimize costs.

Maximize profits.

Maintain steady earnings growth.

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

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

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

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

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

THE GOAL OF FINANCIAL MANAGEMENT

The financial manager in a corporation makes decisions for the stockholders of the firm. Given this, instead of listing possible goals for the financial manager, we really need to answer a more fundamental question: From the stockholders' point of view, what is a good financial management decision?

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

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

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

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

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

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

A MORE GENERAL GOAL

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

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

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

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

SARBANES-OXLEY

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

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

For more about Sarbanes-Oxley, visit **www.soxlaw.com**.

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

Because of its extensive reporting requirements, compliance with SOX can be very costly, which has led to some unintended results. Since its implementation, hundreds of public firms have chosen to "go dark," meaning that their shares are no longer traded on the major stock exchanges, in which case SOX does not apply. Most of these companies stated that their reason was to avoid the cost of compliance. Ironically, in such cases, the law has had the effect of eliminating public disclosure instead of improving it.

Concept Questions

1.4a What is the goal of financial management?

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

1.4c Can you give a definition of *corporate finance*?

1.5 The Agency Problem and Control of the Corporation

We've seen that the financial manager acts in the best interests of the stockholders by taking actions that increase the value of the stock. However, we've also seen that in large corporations ownership can be spread over a huge number of stockholders. This dispersion of ownership arguably means that management effectively controls the firm. In this case, will management necessarily act in the best interests of the stockholders? Put another way, might management choose to pursue its own goals at the stockholders' expense? In the following pages, we briefly consider some of the arguments relating to this question.

AGENCY RELATIONSHIPS

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

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

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

MANAGEMENT GOALS

To see how management and stockholder interests might differ, imagine that the firm is considering a new investment. The new investment is expected to favorably impact the share value, but it is also a relatively risky venture. The owners of the firm will wish to take the investment (because the stock value will rise), but management may not because

there is the possibility that things will turn out badly and management jobs will be lost. If management does not take the investment, then the stockholders may lose a valuable opportunity. This is one example of an agency cost.

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

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

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

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

DO MANAGERS ACT IN THE STOCKHOLDERS' INTERESTS?

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

Managerial Compensation Management will frequently have a significant economic incentive to increase share value for two reasons. First, managerial compensation, particularly at the top, is usually tied to financial performance in general and often to share value in particular. For example, managers are frequently given the option to buy stock at a bargain price, or **restricted stock units (RSUs)**. The more the stock is worth, the more valuable these forms of compensation become. In fact, both are often used to motivate employees of all types, not just top managers. For example, in late 2019, Alphabet's more than 103,000 employees owned enough RSUs to buy 22.6 million shares in the company. Many other corporations, large and small, have adopted similar policies.

restricted stock unit (RSU)
A restricted stock unit, or RSU, is issued to an employee, but is distributed only when it vests. The vesting generally requires a performance milestone or length of service.

For more about RSUs, check out **www.investopedia.com/terms/r/restricted-stock-unit.asp**.

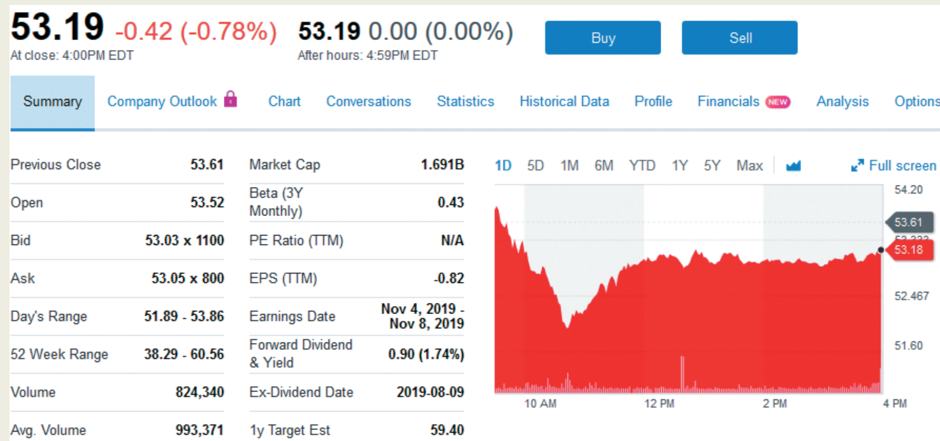
The second incentive managers have relates to job prospects. Better performers within the firm will tend to get promoted. More generally, managers who are successful in pursuing stockholder goals will be in greater demand in the labor market and thus command higher salaries.

In fact, managers who are successful in pursuing stockholder goals can reap enormous rewards. For example, according to *USA Today,* the best-paid executive in 2019 was Sundar Pichai, the CEO of Alphabet, who made about $281 million. The next best-paid CEO was Robert Swan of Intel, who earned about $67 million. By way of comparison, Taylor Swift made about $185 million and LeBron James made about $89 million. Information about executive compensation, along with lots of other information, can be easily found on the web for almost any public company. Our nearby *Work the Web* box shows you how to get started.

WORK THE WEB

The web is a great place to learn more about individual companies, and there are a slew of sites available to help you. Try pointing your web browser to finance.yahoo.com. Once you get there, you should see a box for a "Quote Lookup."

To look up a company, you can use its "ticker symbol" (or just ticker for short), which is a unique one-to five-letter identifier. You can even type the company name into the lookup box and Yahoo Finance will show you the ticker symbol. We typed in "PZZA", which is the ticker for pizza maker Papa John's. Here is a portion of what we found:



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

Questions

1. *Go to finance.yahoo.com and find the current stock prices for Southwest Airlines (LUV), Harley-Davidson (HOG), and Anheuser-Busch InBev (BUD).*
2. *Get a quote for American Express (AXP) and follow the "Statistics" link. What information is available on this link? What do mrq, ttm, yoy, and lfy mean?*

While the appropriate level of executive compensation can be debated, bonuses and other payments made to executives who receive payments due to illegal or unethical behavior are a problem. Recently, "clawbacks" and deferred compensation have been introduced to combat such questionable payments. With a clawback, a bonus can be reclaimed by the company for specific reasons, such as fraud. For example, in 2019, Goldman Sachs said it was investigating the possibility of clawing back $14.2 million from former CEO Lloyd Blankfein and $15.4 million from Chief Executive David Solomon. The clawback was being considered after a Malaysian bribery scandal that caused the bank's value to tumble by half. The use of deferred compensation has also increased. Deferred compensation is money paid to an executive several years after it is earned. With a deferred compensation agreement, if circumstances warrant, the payment can be canceled.

Business ethics are considered at **www.business-ethics.com**.

Control of the Firm Control of the firm ultimately rests with stockholders. They elect the board of directors, who in turn hire and fire managers. The fact that stockholders

control the corporation was made abundantly clear by Steve Jobs's experience at Apple. Even though he was a founder of the corporation and was largely responsible for its most successful products, there came a time when shareholders, through their elected directors, decided that Apple would be better off without him, so out he went. He was later rehired and helped turn Apple around with great new products such as the iPod, iPhone, and iPad. Of course, company founders have used other methods to maintain corporate control. For example, Facebook, specifically Mark Zuckerberg, created new shares of stock with no voting rights. Why would he want to do this? The answer is that Zuckerberg had pledged to give away 99 percent of his shares in Facebook during his lifetime. The new C shares he received with no voting rights were to be given to the Chan Zuckerberg Initiative, a philanthropic entity that he created. Therefore, even in giving away these shares, he still retained control of Facebook. Similarly, Alphabet created Class C shares with no voting rights to fund acquisitions and employee stock options. This allowed founders Sergey Brin and Larry Page to retain voting control.

An important mechanism by which unhappy stockholders can act to replace existing management is called a *proxy fight.* A proxy is the authority to vote someone else's stock. A proxy fight develops when a group solicits proxies in order to replace the existing board and thereby replace existing managers. For example, Land & Buildings Investment Management founder Jonathan Litt has engaged in several proxy battles with mall owner Taubman Properties. With mall traffic declining, Litt disagreed with the company's decisions regarding several key properties. Litt lost a proxy fight in 2017 for a seat on the board of directors, but he won a seat in 2018. Then, in 2019, Litt promised another proxy fight if Taubman did not sell several of its properties.

Another way that managers can be replaced is by takeover. Firms that are poorly managed are more attractive as acquisitions because a greater profit potential exists. Thus, avoiding a takeover gives management another incentive to act in the stockholders' interests. For example, in 2019, toy maker Hasbro completed its takeover of film and TV studio company Entertainment One. The acquisition of Entertainment One gave Hasbro access to a $2 billion library, as well as an established distribution channel for its own franchises, such as Peppa Pig and Transformers.

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

STAKEHOLDERS

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

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

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

Concept Questions

1.5a What is an agency relationship?

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

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

1.6 Financial Markets and the Corporation

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

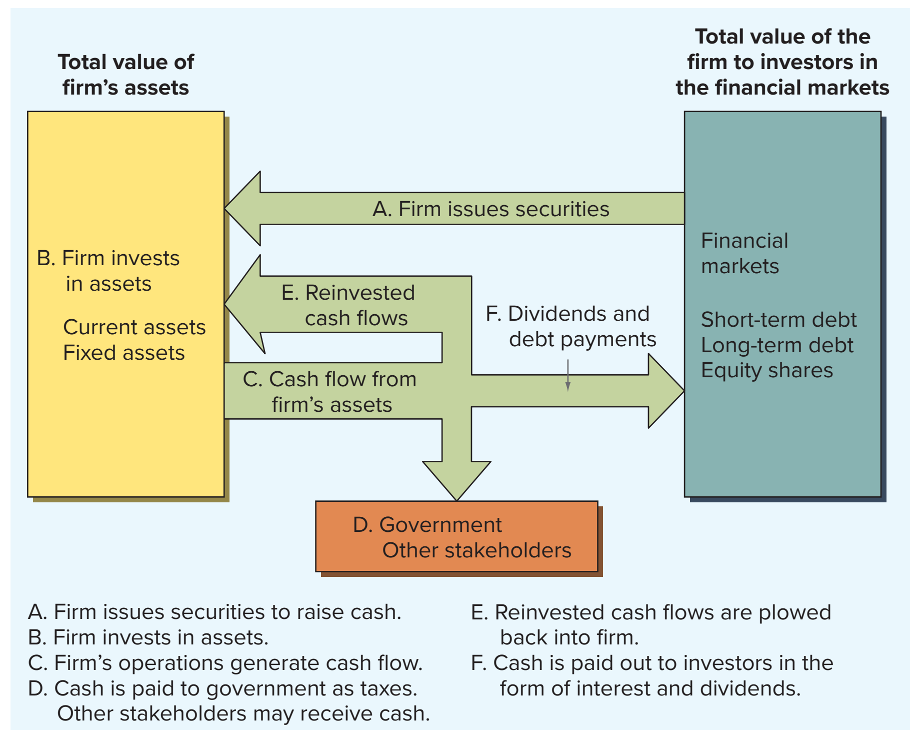
CASH FLOWS TO AND FROM THE FIRM

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

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

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

FIGURE 1.2
Cash Flows between the Firm and the Financial Markets

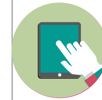


PRIMARY VERSUS SECONDARY MARKETS

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

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

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



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

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

Secondary Markets A secondary market transaction involves one owner or creditor selling to another. Therefore, the secondary markets provide the means for transferring ownership of corporate securities. Although a corporation is directly involved only in a primary market transaction (when it sells securities to raise cash), the secondary markets are still critical to large corporations. The reason is that investors are much more willing to purchase securities in a primary market transaction when they know that those securities can later be resold if desired. To give you an idea of the size of stock markets worldwide, Table 1.2 shows the countries with the largest market capitalization, or total value.

Dealer versus Auction Markets There are two kinds of secondary markets: *auction* markets and *dealer* markets. Generally speaking, dealers buy and sell for themselves, at their own risk. A car dealer, for example, buys and sells automobiles.

TABLE 1.2

The 10 Largest World Stock Markets, 2018 (in billions)

1	United States	$30,436
2	China	6,325
3	Japan	5,297
4	Hong Kong SAR, China	3,819
5	France	2,366
6	India	2,083
7	Canada	1,938
8	Germany	1,755
9	Switzerland	1,441
10	Republic of Korea (South Korea)	1,414
	Total world stock market capitalization	$68,654

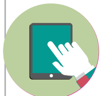
SOURCE: https://data.worldbank.org/indicator/CM.MKT.LCAP.CD, September 12, 2019.

In contrast, brokers and agents match buyers and sellers, but they do not actually own the commodity that is bought or sold. A real estate agent, for example, does not normally own the houses he is buying and selling.

Dealer markets in stocks and long-term debt are called *over-the-counter* (OTC) markets. Most trading in debt securities takes place over the counter. The expression *over the counter* refers to days of old when securities were literally bought and sold at counters in offices around the country. Today, a significant fraction of the market for stocks and almost all of the market for long-term debt do not take place in a central location; the many dealers are connected electronically.

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

Trading in Corporate Securities The equity shares of most of the large firms in the United States trade in organized auction markets. The largest such market is the New York Stock Exchange (NYSE). There is also a large OTC market for stocks. In 1971, the National Association of Securities Dealers (NASD) made available to dealers and brokers an electronic quotation system called Nasdaq (which stands for NASD Automated Quotation system and is pronounced "naz-dak"). Nasdaq-listed companies tend to be smaller and trade less actively. There are exceptions, of course. Both Microsoft and Intel trade OTC, for example. Nonetheless, the total value of Nasdaq stocks is much less than the total value of NYSE stocks.



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

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

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

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

Concept Questions

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

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

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

Summary and Conclusions

1.7

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

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

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

CONCEPTS REVIEW AND CRITICAL THINKING QUESTIONS

1. **The Financial Management Decision Process** [LO1] What are the three types of financial management decisions? For each type of decision, give an example of a business transaction that would be relevant.
2. **Sole Proprietorships and Partnerships** [LO3] What are the four primary disadvantages of the sole proprietorship and partnership forms of business organization? What benefits are there to these types of business organization as opposed to the corporate form?
3. **Corporations** [LO3] What is the primary disadvantage of the corporate form of organization? Name at least two advantages of corporate organization.
4. **Sarbanes-Oxley** [LO3] In response to the Sarbanes-Oxley Act, many small firms in the United States have opted to "go dark" and delist their stock. Why might a company choose this route? What are the costs of "going dark"?
5. **Corporate Finance Organization** [LO1] In a large corporation, what are the two distinct groups that report to the chief financial officer? Which group is the focus of corporate finance?

6. **Goal of Financial Management [LO2]** What goal should always motivate the actions of a firm's financial manager?
7. **Agency Problems [LO4]** Who owns a corporation? Describe the process whereby the owners control the firm's management. What is the main reason that an agency relationship exists in the corporate form of organization? In this context, what kinds of problems can arise?
8. **Primary versus Secondary Markets [LO3]** You've probably noticed coverage in the financial press of an initial public offering (IPO) of a company's securities. Is an IPO a primary market transaction or a secondary market transaction?
9. **Auction versus Dealer Markets [LO3]** What does it mean when we say the New York Stock Exchange is an auction market? How are auction markets different from dealer markets? What kind of market is Nasdaq?
10. **Not-for-Profit Firm Goals [LO2]** Suppose you were the financial manager of a not-for-profit business (a not-for-profit hospital, perhaps). What kinds of goals do you think would be appropriate?
11. **Goal of the Firm [LO2]** Evaluate the following statement: Managers should not focus on the current stock value because doing so will lead to an overemphasis on short-term profits at the expense of long-term profits.
12. **Ethics and Firm Goals [LO2]** Can our goal of maximizing the value of the stock conflict with other goals, such as avoiding unethical or illegal behavior? In particular, do you think subjects like customer and employee safety, the environment, and the general good of society fit in this framework, or are they essentially ignored? Think of some specific scenarios to illustrate your answer.
13. **International Firm Goal [LO2]** Would our goal of maximizing the value of the stock be different if we were thinking about financial management in a foreign country? Why or why not?
14. **Agency Problems [LO4]** Suppose you own stock in a company. The current price per share is $25. Another company has just announced that it wants to buy your company and will pay $35 per share to acquire all the outstanding stock. Your company's management immediately begins fighting off this hostile bid. Is management acting in the shareholders' best interests? Why or why not?
15. **Agency Problems and Corporate Ownership [LO4]** Corporate ownership varies around the world. Historically individuals have owned the majority of shares in public corporations in the United States. In Germany and Japan, however, banks, other large financial institutions, and other companies own most of the stock in public corporations. Do you think agency problems are likely to be more or less severe in Germany and Japan than in the United States? Why? Over the last few decades, large financial institutions such as mutual funds and pension funds have been becoming the dominant owners of stock in the United States, and these institutions are becoming more active in corporate affairs. What are the implications of this trend for agency problems and corporate control?
16. **Executive Compensation [LO4]** Critics have charged that compensation to top managers in the United States is too high and should be cut back. For example, focusing on large corporations, Lisa Su, CEO of Advanced Micro Devices, earned about $59 million in 2019. Are such amounts excessive? In answering, it might be helpful to recognize that superstar athletes such as LeBron James, top entertainers such as Taylor Swift and Dwayne Johnson, and many others at the top of their respective fields earn at least as much, if not a great deal more.

MINICASE

The McGee Cake Company

In early 2016, Doc and Lyn McGee formed the McGee Cake Company. The company produced a full line of cakes, and its specialties included chess cake,* lemon pound cake, and double-iced, double-chocolate cake. The couple formed the company as an outside interest, and both continued to work at their current jobs. Doc did all the baking, and Lyn handled the marketing and distribution. With good product quality and a sound marketing plan, the company grew rapidly. In early 2021, the company was featured in a widely distributed entrepreneurial magazine. Later that year, the company was featured in *Gourmet Desserts,* a leading specialty food magazine. After the article appeared in *Gourmet Desserts,* sales exploded, and the company began receiving orders from all over the world.

Because of the increased sales, Doc left his other job, followed shortly by Lyn. The company hired additional workers to meet demand. Unfortunately, the fast growth experienced by the company led to cash flow and capacity problems. The company is currently producing as many cakes as possible with the assets it owns, but demand for its cakes is still growing. Further, the company has been approached by a national supermarket chain with a proposal to put four of its cakes in all of the chain's stores, and a national restaurant chain has contacted the company about selling McGee cakes in its restaurants. The restaurant would sell the cakes without a brand name.

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

*Chess cake is quite delicious and distinct from cheesecake. The origin of the name is obscure.

QUESTIONS

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