Chapter 1

INTRODUCTION TO CORPORATE FINANCE

# SLIDES

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# CHAPTER WEB SITES

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| *Section* | *Web Address* |
| 1.1 | [CFO: www.cfo.com](http://www.cfo.com/) |
| 1.4 | Business Ethics magazine: www.business-ethics.com |
| 1.6 | [Sarbanes-Oxley survey: www.protiviti.com/US-en/insights/sox-compliance-survey](http://www.protiviti.com/US-en/insights/sox-compliance-survey) |

# CHAPTER ORGANIZATION

1. What Is Corporate Finance?
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   2. The Financial Manager
2. The Corporate Firm
   1. The Sole Proprietorship
   2. The Partnership
   3. The Corporation
   4. A Corporation by Another Name…
3. The Importance of Cash Flows

Identification of Cash Flows

Timing of Cash Flows

Risk of Cash Flows

1. The Goal of Financial Management
   1. Possible Goals
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   3. A More General Goal
2. The Agency Problem and Control of the Corporation
   1. Agency Relationships
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   3. Do Managers Act in the Stockholders’ Interests?
   4. Stakeholders
3. Regulation

The Securities Act of 1933 and the Securities Exchange Act of 1934

Sarbanes-Oxley



# ANNOTATED CHAPTER OUTLINE

## Slide 1.0 Chapter 1 Title Slide

## Slide 1.1 Key Concepts and Skills

***Slide 1.2 Chapter Outline***

**PowerPoint Note**: If there is a slide that you do not wish to include in your presentation, choose to hide the slide under the “Slide Show” menu, instead of deleting it. If you decide that you would like to use that slide at a later date, you can just unhide it.

***PowerPoint Note****: Be sure to check out the notes that accompany some of the slides on the “Notes Pages” within PowerPoint.*

* 1. What is Corporate Finance?

Slide 1.3 What Is Corporate Finance?

Corporate finance addresses several important questions:

1. In what long-term assets should the firm invest? (Capital budgeting)

2. How should the firm raise funds for required capital expenditures? (Capital structure)

3. How should short-term operating cash flows be managed? (Net working capital)

A. The Balance Sheet Model of the Firm

***Slide 1.4 Balance Sheet Model of the Firm***

The Balance Sheet presents a picture of the firm at a point in time, and it provides a model by which to address the three basic questions that corporate finance managers must answer.

***Slide 1.5 The Capital Budgeting Decision***

* + - 1. 1. Long-term investment decisions determine the level of fixed assets.

***Slide 1.6 The Capital Structure Decision***

* + - 1. 2. Financing policy determines the liabilities and equity side of the balance sheet.

***Slide 1.7 Short-Term Asset Management***

* + - 1. 3. Short-term asset management choices (e.g., conservative versus aggressive) affect the level of net working capital.
    1. The Financial Manager

Slide 1.8 The Financial Manager

* + - 1. Financial Managers should make decisions that increase firm value, which effectively involves three primary categories of financial decisions.
      2. 1. Capital budgeting – process of planning and managing a firm’s investments in fixed assets. The key concerns are the size, timing, and risk of future cash flows.
      3. 2. Capital structure – mix of debt (borrowing) and equity (ownership interest) used by a firm. What are the least expensive sources of funds? Is there an optimal mix of debt and equity? When and where should the firm raise funds?
      4. 3. Working capital management – managing short-term assets and liabilities. How much inventory should the firm carry? What credit policy is best? Where will we get our short-term loans?

These broad categories, however, can be summarized with two concrete responsibilities:

* + - * 1. Selecting value creating projects
        2. Making smart financing decisions

***Slide 1.9 Hypothetical Organization Chart***

* + - 1. The Chief Financial Officer (CFO) or Vice-President of Finance coordinates the activities of the treasurer and the controller.  
           
         The controller handles cost and financial accounting, taxes, and information systems (i.e., data processing).  
           
         The treasurer handles cash and credit management, financial planning, and capital expenditures.

**Video Note**: The Role of the Chief Financial Officer - This video looks at the changing role of the CFO.

* 1. The Corporate Firm

***Slide 1.10 The Corporate Firm***

Although many forms of business organizations exist, the corporate form is the standard by which we address most large scale problems. This approach, however, does not imply that the methods we develop are inappropriate for other business types.

Slide 1.11 Forms of Business Organization

* + 1. The Sole Proprietorship

– A business owned by one person  
  
Advantages include ease of start-up, lower regulation, single owner keeps all the profits, and taxed once as personal income.  
  
Disadvantages include limited life, limited equity capital, unlimited liability and low liquidity.

* + 1. The Partnership

– A business with multiple owners, but not incorporated

General partnership – all partners share in gains or losses; all have unlimited liability for all partnership debts.  
  
Limited partnership – one or more general partners run the business and have unlimited liability. A limited partner’s liability is limited to his or her contribution to the partnership, and they cannot help in running the business.

Advantages include more equity capital than is available to a sole proprietorship, relatively easy to start (although written agreements are essential), and income taxed once at personal tax rate.  
  
Disadvantages include unlimited liability for general partners, dissolution of partnership when one partner dies or wishes to sell, low liquidity.

* + 1. The Corporation

– A distinct legal entity composed of one or more owners

Slide 1.12 A Comparison

* + - 1. Corporations account for the largest volume of business (in dollar terms) in the U.S. Advantages include limited liability, unlimited life, separation of ownership and management (ability to own shares in several companies without having to work for all of them), liquidity, and ease of raising capital.  
           
         Disadvantages include separation of ownership and management (agency costs) and double taxation. Recent tax laws reduce the level of double taxation, but it has not been eliminated.
    1. A Corporation by Another Name…  
       1. Corporations exist around the world under a variety of names. Table 1.2 lists several well-known companies, along with the type of company in the original language.
       2. ***Lecture Tip:*** *Although the corporate form of organization has the advantage of limited liability, it has the disadvantage of double taxation. A small business of 75 or fewer stockholders is allowed by the IRS to form an S Corporation. The S Corp. organizational form provides limited liability but allows pretax corporate profits to be distributed on a pro rata basis to individual shareholders, who are only obligated to pay personal income taxes on the income. A similar form of organization is the limited liability corporation, or LLC. LLC’s are a hybrid form of organization that falls between partnerships and corporations. Investors in LLC’s have the protection of limited liability, but they are taxed like partnerships. LLC’s first appeared in Wyoming in 1977 and have skyrocketed since. They are especially beneficial for small- and medium-sized businesses such as law firms or medical practices.*
  1. The Importance of Cash Flow

**Slide 1.13** **The Importance of Cash Flow**

* + 1. Identification of Cash Flows

To create value, the firm must generate more cash than it uses. Stated differently, the firm must generate sufficient cash flow, after taxes, to compensate investors for providing the firm with financing.

* + 1. Timing of Cash Flows

Additionally, the value of the cash flows generated by the firm must be analyzed in light of both the timing of the cash flows, as well as …

* + 1. Risk of Cash Flows

…the risk of the cash flows.

**Lecture Tip**: It is an important reminder for students to reiterate that Net Income and Cash Flow can be extremely different values for various reasons, some of which are non-cash expenses (e.g., depreciation, amortization), revenue recognition principles, and credit policies.

* 1. The Goal of Financial Management

Slide 1.14 The Goal of Financial Management

* + 1. Possible Goals  
         
       Profit Maximization – this is an imprecise goal. Do we want to maximize long-run or short-run profits? Do we want to maximize accounting profits or some measure of cash flow? Because of the different possible interpretations, this should not be the main goal of the firm.

Other possible goals that students might suggest include minimizing costs or maximizing market share. Both have potential problems. We can minimize costs by not purchasing new equipment today, but that may damage the long-run viability of the firm. Many dot.com companies got into trouble in the late 1990’s because their goal was to maximize market share. They raised substantial amounts of capital in IPO’s and then used the money on advertising to increase the number of “hits” on their site. However, many firms failed to translate those “hits” into enough revenue to meet expenses, and they quickly ran out of capital. The stockholders of these firms were not happy. Stock prices fell dramatically, and it became difficult for these firms to raise funds. In fact, many of these companies have gone out of business.

* + 1. The Goal of the Financial Manager

From a stockholder (owner) perspective, the goal of buying the stock is to gain financially. Thus, *the goal of the financial manager in a corporation is to maximize the current value per share of the existing stock.*

***Lecture Tip:*** *The late Roberto Goizueta, former chairman and CEO of the Coca-Cola Company, wrote an essay entitled “Why Share-Owner Value?,” that appeared in the firm’s 1996 annual report. It is an excellent introduction to the goal of financial*

*management at any level. It may also be useful to discuss how Mr. Goizueta’s vision transferred to the stock market’s valuation of the company.*

*A subsequent article also illustrates the difference in strategy between Coca-Cola and Pepsi-Co during Mr. Goizueta’s tenure: “How Coke is Kicking Pepsi’s Can,” Fortune, October 28, 1996.*

*Coke focused on soft drinks while Pepsi-Co diversified into other areas. Pepsi-Co’s goal was to double revenues every 5 years, while Mr. Goizueta focused on return on investment and stock price. The article states that Goizueta "has created more wealth for stockholders than any other CEO in history.” In mid-1996, Pepsi-Co sold at 23 times earnings with return on equity of about 23% and Coke sold at 36 times earnings with a return on equity of around 55%. The article goes on to discuss the differing strategies in more detail. It provides a nice validation of Mr. Goizueta’s remarks in his letter to the shareholders.*

* + - 1. ***Lecture Tip:*** *The validity of this goal assumes “investor rationality.” In other words, investors in the aggregate prefer more dollars to fewer and less risk to more. Rational investors will act as risk-averse, return-seekers in making their purchase and sale decisions, and, given different levels of risk aversion and wealth preferences, the only single goal suitable for all shareholders is the maximization of their wealth (which is represented by their holdings of the firm’s common stock). However, the prevalence of “social responsibility” funds may make for an interesting discussion, as would the increasing focus on behavioral finance and the impact of investor emotions on trading behavior.*
    1. A More General Goal
       1. The more general goal is to maximize the market value of owners’ equity.
       2. Many students think this means that firms should do “anything” to maximize stockholder wealth. It is important to point out that unethical behavior does not ultimately benefit owners.
       3. ***Ethics Note:*** *Any number of ethical issues can be introduced for discussion. One particularly good opener to this topic that many students can relate to is the issue of the responsibility of the managers and stockholders of tobacco firms. Is it ethical to sell a*
       4. *product that is known to be addictive and dangerous to the health of the user even when used as intended? Is the fact that the product is legal relevant? Do recent court decisions against the companies matter? What about the way companies choose to market their product? Are these issues relevant to financial managers?*
  1. The Agency Problem and Control of the Corporation

***Slide 1.15 The Agency Problem***

* + 1. Agency Relationships

The relationship between stockholders and management is called the agency relationship. This occurs when one party (principal) hires another (agent) to act on their behalf. The possibility of conflicts of interest between the parties is termed the agency problem.

* + 1. Management Goals

***Slide 1.16 Managerial Goals***

Direct agency costs – compensation and perquisites for management

* + - 1. Indirect agency costs – cost of monitoring and sub-optimal decisions
         1. ***Lecture Tip:*** *In the early 1980s, the Burlington Northern Railroad sought to sell off real estate with a value of approximately $778 million. The firm was enjoined from doing so, however, by restrictions written into covenants of the firm’s bonds in 1896. These were very long-term bonds with an additional fifty years to maturity. They also were not callable and did not include a sinking fund provision. Management found it necessary to negotiate with the bondholders to release some of the value tied up in the real property originally used to secure these bonds. Following a great deal of legal wrangling, the bondholders settled for payments totaling $35.5 million. Lawyers for the bondholders settled for another $3.4 million. In other words, the cost of addressing this stockholder/bondholder conflict was nearly $40 million – and this doesn’t include the opportunity cost of management time spent on*
         2. *this issue instead of running the business. For further discussion of this case, see “Bond Covenants and Foregone Opportunities” by Gene Laber, in the Summer, 1992 issue of Financial Management.*
      2. ***Ethics Note:*** *When shareholders elect a board of directors to oversee the corporation, the election serves as a control mechanism for management. The board of directors bears legal responsibility for corporate actions. However, this responsibility is to the corporation itself and not necessarily to the stockholders (“Sarbox,” discussed below, has somewhat changed this issue).*

*Although it happened several years ago, the following example still makes for an interesting discussion of directors’ and managers’ duties:*

*In 1986, Ronald Perelman engaged in an unsolicited takeover offer for Gillette. Gillette’s management filed litigation against Perelman and subsequently entered into a standstill agreement with Perelman. This action eliminated the premium that Perelman offered shareholders for their stock in Gillette.*

*A group of shareholders filed litigation against the board of directors in response to its actions. It was subsequently discovered that Gillette had entered into standstill agreements with ten additional companies. When questioned regarding the rejection of Perelman’s offer, management responded that there were projects on line that could not be discussed (later revealed to be the “Sensor” razor, which was one of the most profitable new ventures in Gillette’s history up to that time). Thus, despite appearances, management’s actions may have been in the best interests of the firm, and this case indicates that management may consider factors other than the bid when considering a tender offer.*

* + 1. Do Managers Act in the Stockholders’ Interests?

Slide 1.17 Managing Managers

* + - 1. Managerial compensation can be used to encourage managers to act in the best interest of stockholders. One commonly cited tool is stock options. The idea is that if management has an ownership interest in the firm, they will be more likely to try to maximize owner wealth.  
           
         ***Lecture Tip:*** *A 1993 study performed at the Harvard Business School indicates that the total return to shareholders is closely* *related to the nature of CEO compensation. Specifically, higher*
      2. *returns were achieved by CEOs whose pay packages included more option and stock components. (See The Wall Street Journal, November 12, 1993, p. B1). However, this may not even be the best way to encourage managers to act in the stockholders’ best interest.*

*Stern Stewart & Company has developed a tool called EVA®, which measures how much “economic value” is being added to a corporation by management decisions. According to* [*Stern-Stewart’s web site (www.sternstewart.com)*](http://www.sternstewart.com/)*, companies that tie management compensation to EVA® significantly outperform competitors that do not. They are conducting ongoing studies to measure this performance, but the preliminary data indicate that the stock returns for these companies have outperformed their competitors by a significant amount.*

* + - 1. *Both of these examples illustrate that carefully crafted compensation packages can reduce the conflict between management and stockholders. However, the option backdating scandal may provide a point of discussion for possible downfalls of such approaches.*
      2. ***Lecture Tip:*** *According to The National Center for Employee Ownership, broad based stock option plans have increased dramatically, not only for technology firms, but also for non-tech firms such as Starbucks and the Gap. Some firms have found a way to provide stock-based incentive to employees without giving them equity ownership at all. As reported in the October 26, 1998, issue of Fortune, “phantom stock” is used by private companies such as Kinko’s and Mary Kay, Inc., as well as public companies, to provide employees with an incentive to work harder. Generally, an employee is awarded “shares” on a bonus basis, and the share values increase if the value of the business increases. (For a private firm, this means obtaining outside appraisals of value based on earnings multiples, etc.) At some future point, the employee has the right to cash in his “shares.”*
      3. Stockholders technically have control of the firm, and dissatisfied shareholders can oust management via proxy fights, takeovers, etc. However, this is easier said than done. Staggered elections for board members often make it difficult to remove the board that appoints management. Poison pills and other anti-takeover mechanisms make hostile takeovers difficult to accomplish.
    1. Stakeholders

Stakeholders are other groups, besides stockholders, that have a vested interest in the firm and potentially have claims on the firm’s cash flows. Stakeholders can include creditors, employees, customers, and the government.

***Lecture Tip:*** *A good practioner-oriented discussion of the impact of stakeholders on decision-making is found in a 1987 Wall Street Journal article by Charles Exley, Jr., then-chairman and president of NCR Corp. The thrust of Mr. Exley’s comments is that giving more consideration to the interests of non-stockholder stakeholders is good business and results in the decentralization of management. Frequently, a discussion of stakeholder interests (as opposed to a discussion exclusively geared toward stockholder interests) leads to a better understanding of the nature of the corporate form of organization, the role of the corporation in society (and the question of “corporate social responsibility”), as well as the role of contracting in the labor and financial markets.*

***Ethics Note:*** *A discussion of stakeholder interests leads very nicely into a discussion of ethical decision making. Theories of ethical behavior focus on the rights of all parties affected by a decision, not just one or two. The “utilitarian” model defines an action as acceptable if it maximizes the benefit, or minimizes the harm, to stakeholders in the aggregate. The “golden rule” model deems a decision ethical if all stakeholders are treated as the decision maker would wish to be treated. Finally, the Kantian “basic rights” model defines acceptable actions as those that minimize the violation of stakeholders’ rights.*

***Lecture Tip:*** *The antitrust case against Microsoft can generate a healthy discussion of ethical behavior, innovation and the government’s role in monitoring business practices. The basic idea behind the case is that: (1) Microsoft stifled competition by imposing stiff penalties on computer manufacturers that chose to install operating systems other than Windows on some of their machines; (2) Microsoft tried to put Netscape out of business by incorporating Internet Explorer into the operating system; and (3) Microsoft has an unfair advantage in the applications programming area because their programmers have access to the source code for the operating system. There were other issues as well, but these were the major ones. The Judge in the case originally found that Microsoft did violate*

*antitrust laws and that they continued to operate in a monopolistic fashion. He ordered the break-up of Microsoft into an “operating system” company and an “applications” company. The Judge also ordered that Microsoft allow programmers from the Company’s competitors to come to a secured location and view the source code for Microsoft Windows. Microsoft contended that this would allow other companies to determine the direction that Microsoft is moving with their software and eliminate the competitive advantage that their research and development has afforded the company. The case was appealed and Microsoft was still found in violation of antitrust laws, but not to the extent found in the original case.*

*The Final Judgment was issued on November 12, 2002 and has the following components: (1) Microsoft cannot retaliate against an Original Equipment Manufacturer (OEM) if the OEM “is or is contemplating developing, distributing, promoting, using, selling or licensing any software that competes with Microsoft Platform Software” or ships a computer with more than one operating system; (2) Microsoft must publish and use a consistent licensing agreement schedule with all covered OEMs; (3) Microsoft cannot restrict OEMs from selling computers that include competing products, display competing product icons on the desktop, and launch competing products when a Microsoft application would normally be launched; (4) Microsoft must allow Independent Software Vendors (ISVs), Independent Hardware Vendors (ISDs), Internet Access Providers (IAPs), Internet Content Providers (ICPs) and OEMs access to Windows Operating System Product source code as necessary to develop products that will work effectively with the operating system – these companies must demonstrate why they need access and they are limited to access to that code that is required for “interoperating” with the operating system; and (5) Microsoft is not required to disclose any intellectual property rights related to security or that is designed to prevent software piracy.*

*The Final Judgment called for the appointment of a technical committee that will assist in the enforcement and compliance with the judgment and Microsoft was required to appoint an internal compliance officer to make sure that all employees of the firm understand and comply with the judgment. Reports on compliance are routinely filed with the Department of Justice and can be found, along with the Final Judgment, at* [*U.S. Department of Justice site (http://www.usdoj.gov/atr/cases/ms\_index.htm)*](http://www.usdoj.gov/atr/cases/ms_index.htm)*.*

* 1. Regulation

Slide 1.18 Regulation

Historically, most regulation has focused on the disclosure of relevant information, thereby putting all investors on an equal playing field.

* + 1. The Securities Act of 1933 and the Securities Exchange Act of 1934

These Acts provide the basic regulatory framework for the public trading of securities in the United States. The 1933 Act focuses on the issuance of securities, while the 1934 Act established the SEC and addressed other regulatory issues, such as insider trading and corporate reporting.

* + 1. Sarbanes-Oxley

Following the scandals at Enron, WorldCom, and Tyco, among others, “Sarbox” was enacted in 2002. This Act significantly increased the auditing and reporting requirements that public firms face, and it also explicitly placed the responsibility for any fraud on the corporate directors.

As with any law, however, there is a cost. In response to the added burden, many (particularly small) firms have delisted and others have foregone going public. For others, the cost of compliance has significantly increased, thereby reducing profits.

Slide 1.19 Quick Quiz