Chapter 1

Goals and Governance of the Corporation

The Instructor’s Manual is divided into two parts. The first is an overview of the chapter, including a description of the material covered and a perspective on how the chapter content relates to the balance of the textbook. The second part reviews the learning objectives of the chapter and includes a list of challenges encountered by students when learning the material. Where appropriate, pedagogical ideas and tips are provided to improve student learning.

# OVERVIEW

Part One of the book covers background information students will need while navigating the rest of the material. This section is divided into 4 chapters, each with content needed to fully comprehend the material in the balance of the book.

The first chapter addresses the goals of the corporation and the various organizational structures a company may adopt. Once established, students learn about the functions a company performs in order to achieve its goals. This includes the role of the financial manager, specifically as it relates to financing and investment decisions.

The latter part of the chapter address qualitative issues related to governance / agency theory and the ethics of maximizing market value. Students learn that maximizing value and ethical behavior are not mutually exclusive.

The content covered in chapter 1 provides a “big picture” look at the scope, concerns, and issues of corporate finance. It sets the stage for later material and shows how it fits into the overall scheme of corporate finance. Several themes are introduced, which will be reemphasized throughout the book.

As future topics are covered, it is important to link the material back to the themes contained in this first chapter. Students often lose perspective and need to be reminded of the purpose of finance, rather than merely learning skills with no context. When the student has a sense of where and how a chapter fits into the whole, they can begin to tie chapters and concepts together, instead of staying mired in terms, computations, and specific topics.

# REVIEW OF LEARNING OBJECTIVES (with teaching tips and notes)

The **first learning objective** is an understanding of the two major decisions made by financial managers. The primary functions of the financial manager or financial decision maker are to raise cash in financial markets (the financing decision) and to invest cash (capital budgeting decision).

**Teaching Note: Investment and Financing Decisions –** Much of the material in later chapters can be tied back to the two fundamental decisions of the financial manager. Figure 1.2 can be used when discussing later material to show the student where the topic fits in the “big picture”. For example, bring up Figure 1.2 again before discussing Net Present Value and how this decision rule is used to make investment decisions in the firm, and bring up the graph again when discussing dividend policy to remind students that this policy is part of the financing decisions.

The **second learning objective** is an understanding of the difference between real and financial assets. Financial managers raise funds in financial markets by selling financial assets, or securities, to investors as part of the financing decision, and invest this cash in real assets. The decision as to the amount and which tangible or intangible assets to acquire is an investment (capital budgeting) decision.

The **third learning objective** is an understanding of the corporate form of business organization. The choice of business organization affects the risk and the potential return in the form of after-tax cash flow and thus, the value of the business. Not all businesses are organized as corporations because of the time and cost of managing and maintaining a corporate entity, and the double-taxation of corporate earnings in the United States.

The **fourth learning objective** is an understanding of the principal financial managers in the corporation. The classic financial manager titles are the treasurer and the controller, with the former being more associated with financing, cash management, and financial market relationships, and the latter being associated with more traditional accounting functions of financial statements, budgeting, and auditing. The chief financial officer, in larger firms, oversees the treasurer and controller and is involved in formulating corporate strategy and financial policy.

**Teaching Note: Career Planning** – This first chapter is a good opportunity to get students thinking about careers in finance. The Finance in Practice (Working in Finance) section describing the work of four finance professionals can help students match their interests with a career in finance.

The **fifth learning objective** is an understanding of the goal of the firm. Shareholders want managers to make decisions based upon which alternative will maximize the market value of the shareholders’ investment. Other decision criteria, such as profit maximization or market share maximization, do not achieve value maximization.

The **sixth learning objective** is an understanding of different mechanisms that can be used to align the interest of managers with those of shareholders. Agency problems exist when managers, as agents of shareholders, have a conflict of interest with shareholders. *Compensation plans* can motivate managers to work for the best interest of the shareholders, the *board of directors*, can monitor managers on behalf of shareholders, managers not performing in the best interest of shareholders are candidates for a *takeover*, and *legal and regulatory requirements* for financial managers require responsible actions in the interests of investors

The **seventh learning objective** is an understanding of why maximizing market value does not justify behaving unethically. Fair and ethical relationships build and maintain long-run value. There is positive relation between maximizing value and doing business ethically.

**Teaching Note: Ethical Issues –** This first chapter provides a good opportunity to discuss ethical issues with the class that can be reinforced when covering material later in the course. The “Finance Through the Ages” section provides not only a good historical perspective on the financial practices and theories that are constantly evolving, but also a reminder that financial scandals arise regularly. The Finance in Practice section “Ethical Disputes in Finance” provides a good conversation starter for students to think about what constitutes good corporate behavior. A discussion of the ethical issues need not be a lecture in morality, but rather a discussion of conflicts which naturally exist within agency theory.

# LECTURE EXERCISE

To help students understand the link between corporate structures and agency theory a simple illustration may help. Ask for a volunteer who has the desire to start a business. Explain how they may begin as a sole proprietor and how they are accountable only to themselves. Next, ask for another volunteer to be a passive investor in the now successful company. Tell the class how the ownership and management has now changed in the partnership structure. Finally, tell the two owners they are so successful, the company will conduct an IPO, whereby the two owners will leave the company and a new CEO will be hired. This final step can lead to a detailed discussion of governance and agency theory.

This exercise can also be used to explain how the new business must finance operations and conduct capital budgeting. Many teaching avenues are available in a discussion format such as this.