Fundamentals of Corporate Finance, 2/e

ROBERT PARRINO, PH.D.
DAVID S. KIDWELL, PH.D.
THOMAS W. BATES, PH.D.

Chapter 1: The Financial Manager and the Firm

Learning Objectives

1. IDENTIFY THE KEY FINANCIAL DECISIONS FACING THE FINANCIAL MANAGER OF ANY BUSINESS FIRM.
2. IDENTIFY THE BASIC FORMS OF BUSINESS ORGANIZATION IN THE UNITED STATES AND THEIR RESPECTIVE STRENGTHS AND WEAKNESSES.

Learning Objectives

3. DESCRIBE THE TYPICAL ORGANIZATION OF THE FINANCIAL FUNCTION IN A LARGE CORPORATION.
4. EXPLAIN WHY MAXIMIZING THE CURRENT VALUE OF THE FIRM'S STOCK IS THE APPROPRIATE GOAL FOR MANAGEMENT.
5. DISCUSS HOW AGENCY CONFLICTS AFFECT THE GOAL OF MAXIMIZING SHAREHOLDER VALUE.

Learning Objectives

6. EXPLAIN WHY ETHICS IS AN APPROPRIATE TOPIC IN THE STUDY OF CORPORATE FINANCE.

The Role of the Financial Manager

- THREE KEY FINANCIAL DECISIONS
  - **Capital Budgeting: decide which long-term assets to acquire**
  - **Financing: decide how to pay for short-term and long-term assets**
  - **Working Capital: decide how to manage short-term resources and obligations**

The Role of the Financial Manager

- THREE KEY FINANCIAL DECISIONS
  - **Capital Budgeting**

    Choose the long-term assets that will yield the greatest net benefits for the firm.

The Role of the Financial Manager

- THREE KEY FINANCIAL DECISIONS
  - **Financing**

    Finance assets with the optimal combination of short-term debt, long-term debt, and equity.

The Role of the Financial Manager

- THREE KEY FINANCIAL DECISIONS
  - **Working Capital Management**

    Adjust current assets and current liabilities as needed to promote growth in cash flow.

Cash Flows Between the Firm and Its Stakeholders and Owners

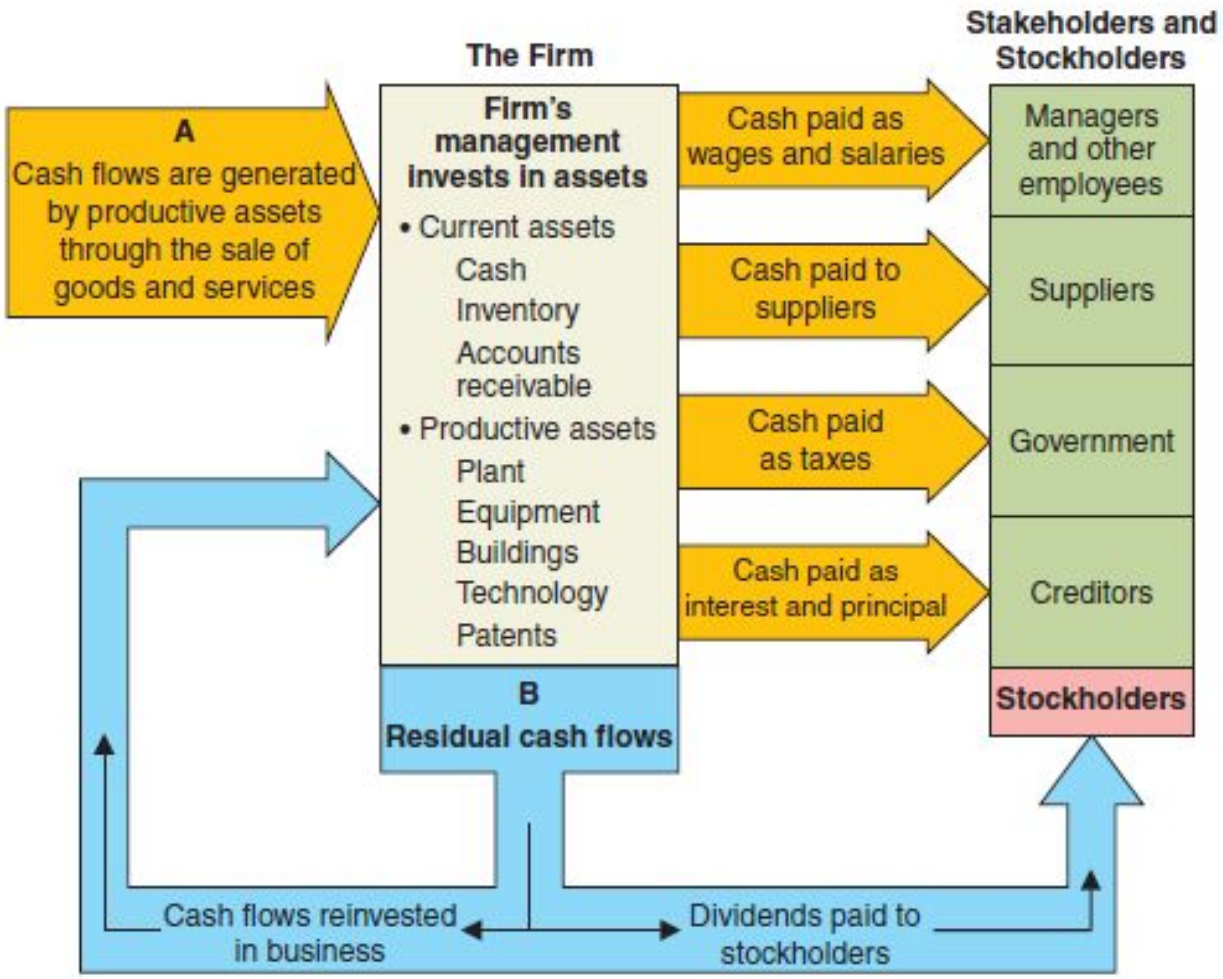


EXHIBIT 1.1
Cash Flows Between the Firm and Its Stakeholders and Owners (Stockholders)

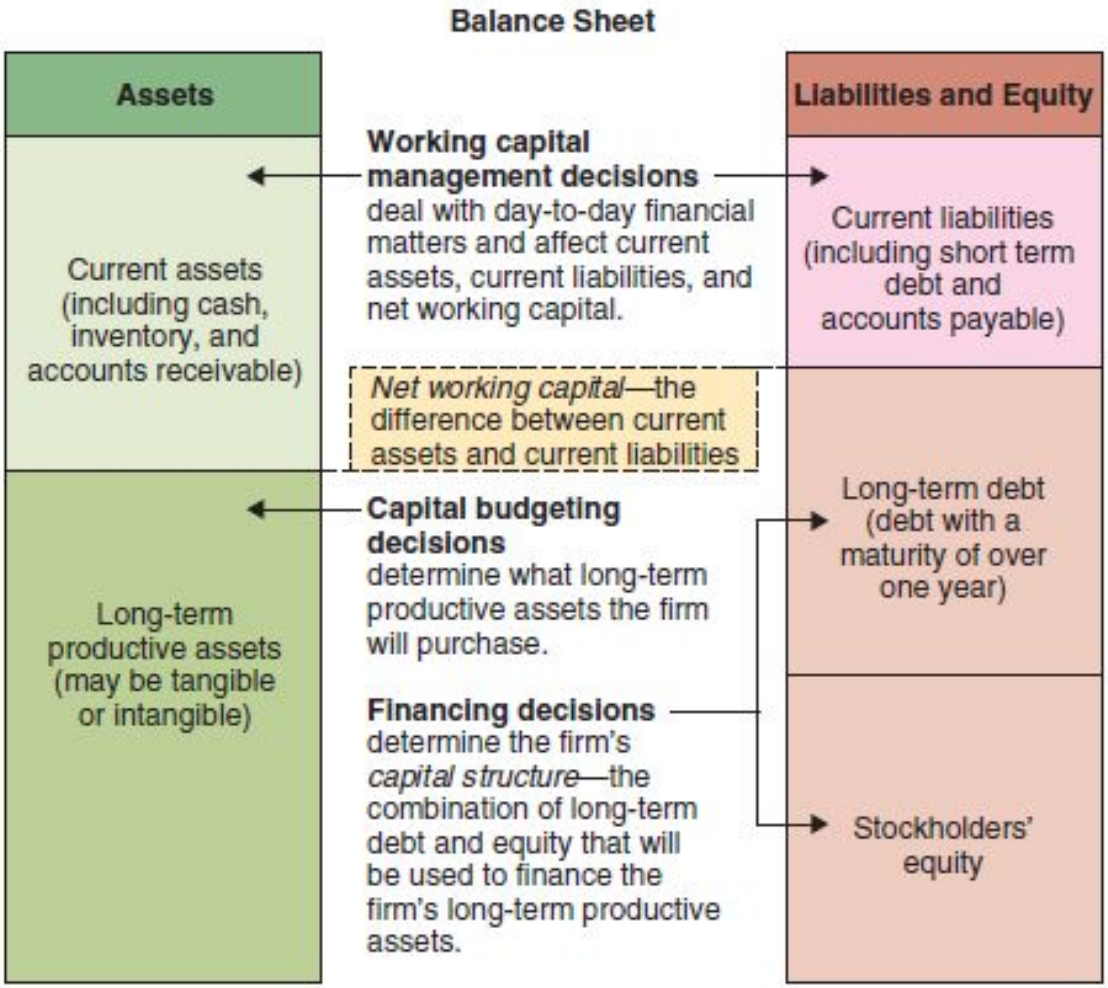
A. Making business decisions is all about cash flows, because only cash can be used to pay bills and buy new assets. Cash initially flows into the firm as a result of the sale of goods or services. The firm uses these cash inflows in a number of ways: to pay wages and salaries, to buy supplies, to pay taxes, and to repay creditors.

B. Any cash that is left over (residual cash flows) can be reinvested in the business or paid as dividends to stockholders.

How the Financial Manager's Decisions Affect the Balance Sheet

EXHIBIT 1.2
How the Financial Manager's Decisions Affect the Balance Sheet

Financial managers are concerned with three fundamental types of decisions: capital budgeting decisions, financing decisions, and working capital management decisions. Each type of decision has a direct and important effect on the firm's balance sheet—in other words, on the firm's profitability.



The Role of the Financial Manager

- THREE KEY FINANCIAL DECISIONS
  - **Poor decisions about capital budgeting, financing, or working capital may lead to bankruptcy or business failure**

Basic Forms of Business Organization

- BUSINESS STRUCTURE
  - **Sole Proprietorship**
  - **Partnership**
  - **Corporation**

Basic Forms of Business Organization

- SOLE PROPRIETORSHIP
  - **Owned by a single person who is financially responsible for the actions and obligations of the business**

Basic Forms of Business Organization

- SOLE PROPRIETORSHIP
  - **Advantages**

    easiest to create

    easiest to control

    easiest to dissolve

    right to all profit

Basic Forms of Business Organization

- SOLE PROPRIETORSHIP
  - **Disadvantages**

    owner's personal assets at risk

    owner's unlimited liability for firm obligations

    equity only from owner or business profit

    business income taxed as personal income

    difficult to transfer ownership

Basic Forms of Business Organization

- PARTNERSHIP
  - **A business owned by more than one person; one or more of them financially responsible for the actions and obligations of the business**

Basic Forms of Business Organization

- PARTNERSHIP
  - **Advantages vs. sole proprietorship**

    limited protection of owners' personal assets

    owners' limited liability for firm obligations

    more sources of equity

    more sources of expertise

Basic Forms of Business Organization

- PARTNERSHIP
  - **Disadvantages vs. proprietorship**

    shared control

    shared profit

    harder to dissolve

Basic Forms of Business Organization

- CORPORATION
  - **A business owned by more than one person; none of them financially responsible for the actions and obligations of the business. The corporation is responsible for its obligations and actions.**

Basic Forms of Business Organization

- CORPORATION
  - **Advantages**

    protects personal assets

    no shareholder liability for business

    easiest to change ownership

    greatest access to sources of funds

Basic Forms of Business Organization

- CORPORATION
  - **Disadvantages**

    most difficult and expensive to establish

    dilutes individual control over the firm

    overall higher taxes on income for shareholders

Basic Forms of Business Organization

- HYBRID FORMS OF BUSINESS ORGANIZATION
  - **Limited Liability Partnerships (LLPs)**
  - **Limited Liability Companies (LLCs)**
  - **Professional Companies (PCs)**

    All have the limited liability of a corporation and tax advantage of a partnership.

Organization of the Financial Function

- CHIEF EXECUTIVE OFFICER (CEO)
  - **Chief manager in the firm**
  - **Ultimate power to make decisions and ultimate responsibility for decisions**
  - **Reports directly to the board-of-directors who protect shareholder's interests**

Simplified Corporate Organization Chart

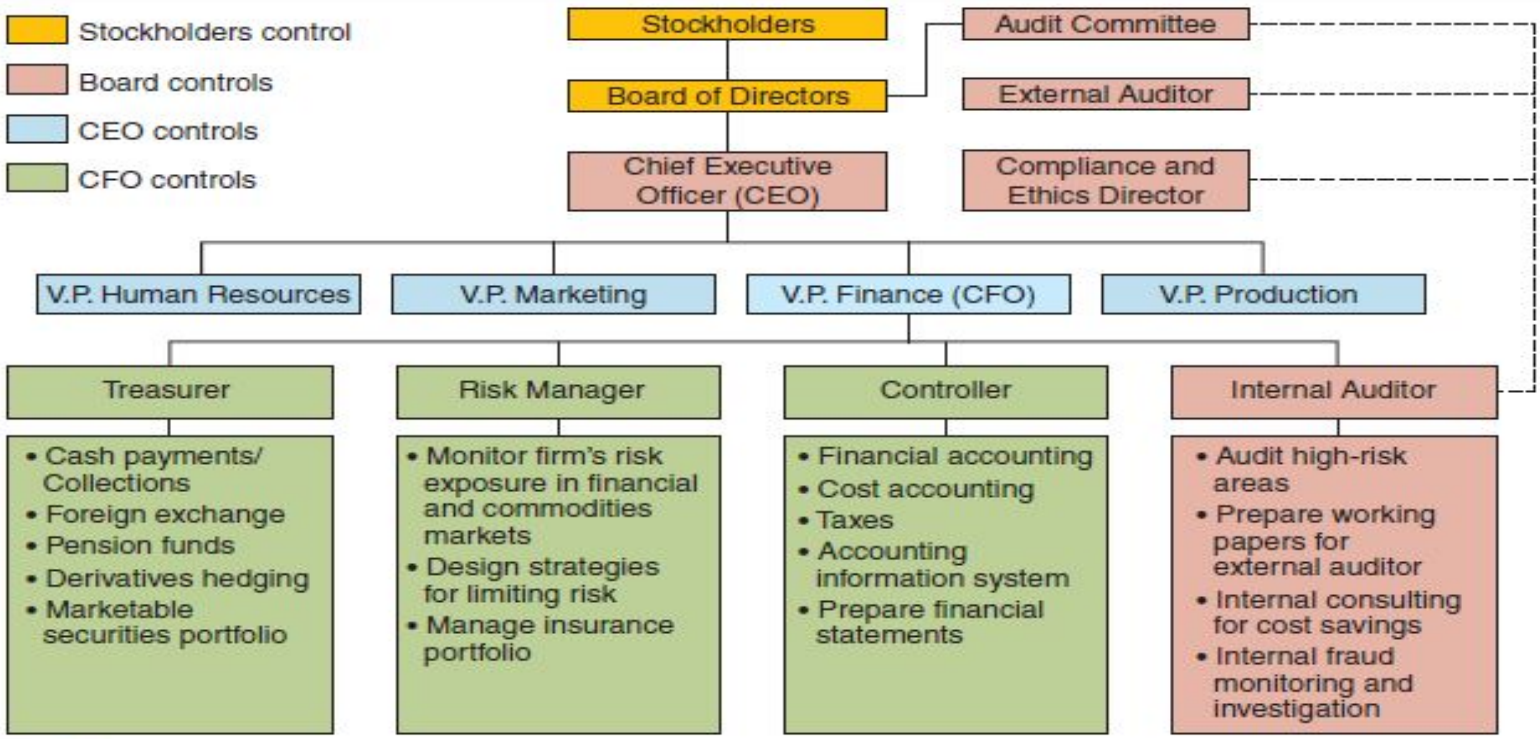


EXHIBIT 1.3
Simplified Corporate Organization Chart

The firm's top finance and accounting executive is the CFO, who reports directly to the CEO. Positions that report directly to the CFO include the treasurer, risk manager, and controller. The internal auditor reports both to the CFO and to the audit committee of the board of directors. The external auditor and the ethics director also are ultimately responsible to the audit committee.

Organization of the Financial Function

- CHIEF FINANCIAL OFFICER (CFO)
  - **The V.P. of Finance/CFO is responsible for the quality of the financial reports received by the CEO**

Organization of the Financial Function

- KEY FINANCIAL REPORTS
  - **The Treasurer manages and reports on the collection and disbursement of cash**
  - **The Risk Manager manages and reports on activities to limit the firm's risks in financial and commodity markets**

Organization of the Financial Function

- KEY FINANCIAL REPORTS
  - **The Controller is the firm's accountant and prepares its financial reports**
  - **The Internal Auditor controls and reports on activities to limit the firm's exposure to internal threats such as fraud and inefficient use of resources**

Organization of the Financial Function

- EXTERNAL AUDITOR
  - **Conducts an independent audit of a firm's financial activities**
  - **Provides an opinion about whether the financial reports the firm prepared are reasonably accurate and conform to generally accepted accounting principles**

The Goal of the Firm

- DO NOT MAXIMIZE MARKET SHARE
  - **Giving away goods or services for free will maximize a firm's market share for a while, but the firm will not be able to pay its bills and stay in business**

The Goal of the Firm

- DO NOT MAXIMIZE PROFIT
  - **Accounting profit differs from economic profit**
  - **Profit earned may not equal cash received**
    - Cash not received can't be used to pay bills
  - **The strategy ignores the timing of future cash flows**
  - **The strategy ignores the risks associated with having to wait for cash flows**

The Goal of the Firm

- MAXIMIZE SHAREHOLDERS' WEALTH!
  - **Future cash flows are considered**
  - **The timing of future cash flows is considered**
  - **The risks associated with having to wait to for cash flows are considered**

The Goal of the Firm

- MAXIMIZE SHAREHOLDERS' WEALTH!
  - **Maximizing the price of a firm's stock will maximize the value of a firm and the wealth of its shareholders (owners)**

The Goal of the Firm

- ITS ALL ABOUT CASH FLOW!
  - **Positive residual cash flow may be paid to firm owners as dividends or invested in the firm**
  - **The larger the positive residual cash flow, the greater the value of a firm**
  - **Negative residual cash flow – over the long run - leads to bankruptcy or closing a business**

Agency Conflicts

- AGENCY RELATIONSHIP
  - **An agency relationship is created when the owner (a principal) of a business hires an employee (an agent)**
  - **The owner surrenders some control over the enterprise and its resources to the employee**
  - **Separating ownership from control creates the potential for agency conflicts**

Agency Conflicts

- AGENCY RELATIONSHIP
  - **An agency relationship exists between stockholders (principals) and the firm's hired management (agents)**
  - **In large corporations, shared ownership among many shareholders may result in relatively little control over management**

Agency Conflicts

- OWNERSHIP AND CONTROL
  - **Shareholders own the corporation, but managers control the firm's assets and may use them for their own benefit**

Major Factors Affecting Stock Prices

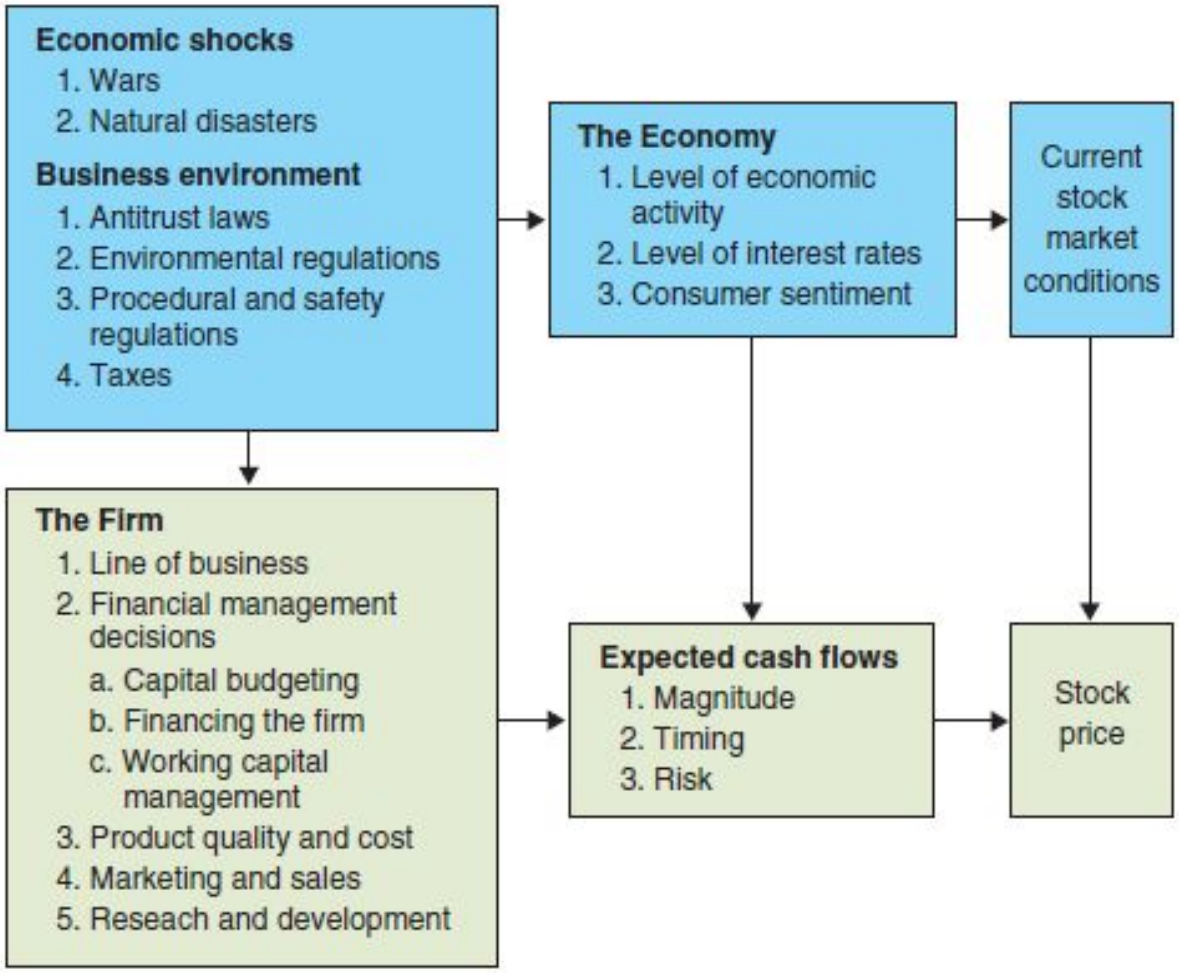


EXHIBIT 1.4
Major Factors Affecting Stock Prices

The firm's stock price is affected by a number of factors, and management can control only some of them. Managers exercise little control over external conditions (blue boxes), such as the general economy, although they can closely observe these conditions and make appropriate changes in strategy. Also, managers make many other decisions that directly affect the firm's expected cash flows (green boxes)—and hence the price of the firm's stock.

Agency Conflicts

- AGENCY COSTS
  - **Arise from (incurring and preventing) conflicts-of-interests between a firm's owners and its managers**
  - **May reduce positive residual cash flow, stock price, and shareholder wealth**

Agency Conflicts

- GIVING AGENTS THE RIGHT INCENTIVE
  - **Managers tend to focus on wealth maximization when their compensation depends on stock price**

Agency Conflicts

- GIVING AGENTS THE RIGHT INCENTIVE
  - **Today, the firm's stock trades at $0.95 per share. The CEO has an option to buy 2.5 million shares from the firm for $1.15 per share at any time, beginning one year from today. If the stock price rises to $3.15, the option will be worth $5 million.**

Agency Conflicts

- GIVING AGENTS THE RIGHT INCENTIVE
  - **Want to keep their jobs**
  - **Oversight by the board of directors**
  - **Oversight by large blockholders**
  - **Potential takeover of the firm**
  - **The legal and regulatory environment.**

Agency Conflicts

- SARBANES-OXLEY AND REGULATORY REFORM
  - **Better corporate governance reduces agency costs by requiring**
    - more effective monitoring of managers' activities
    - programs that promote appropriate behavior by managers
    - penalties for executives who do not fulfill their fiduciary responsibilities

Corporate Governance Regulations Designed to Reduce Agency Costs

EXHIBIT 1.5 **Corporate Governance Regulations Designed To Reduce Agency Costs**

Recent regulatory changes that are designed to reduce agency costs. The most important changes resulted from the Sarbanes-Oxley Act, passed by Congress in 2002. The act was aimed at reducing agency costs, promoting ethical conduct, and improving the integrity of accounting reporting systems.

Board of Directors

- Board has a fiduciary responsibility to represent the best interest of the firm's owners.
- Majority of the board must be outside independent directors.
- Firm is required to have a code of ethics, which has to be approved by the board.
- Firm must establish an ethics program that has a complaint hotline and a whistleblower protection provision which is approved by the board.
- Separation of chairman and CEO positions is recommended.
- Board memebers can be fined or receive jail sentences if they fail to fulfill their fiduciary responsibilities.

Audit Committee

- External auditor, internal auditor, and compliance officer's fiduciary (legal) responsibilities are to the audit committee.
- Audit committee approves the hiring, firing, and fees paid to external auditors.
- CEO and CFO must certify financial statements.
- All audit committee members must be outside independent directors.
- One member must be a financial expert.

External Auditor

- Lead partner must change every five years.
- There are limits on consulting (nonaudit) services that external auditors can provide.

Sources: Sarbanes-Oxley Act, Public Accounting Reform and Investor Protection Act, and NYSE and NASDAQ new listing requirements.

Ethics in Corporate Finance

- WHAT ARE ETHICS?
  - **Ethics**

    society's standards for judging whether an action is right or wrong
  - **Business Ethics**

    society's standards for acceptable behavior applied to business and financial markets

Ethics in Corporate Finance

- EXAMPLES OF ETHICAL CONFLICT IN BUSINESS
  - **Agency Cost**

    employee's unacceptable use of employer's computer
  - **Conflict of Interest**

    mortgage contract which a home-buyer is unlikely to fulfill but earns a mortgage broker more money
  - **Information Asymmetry**

    seller knows about prior damage to the vehicle but the potential buyer does not

Ethics in Corporate Finance

- BUSINESS BEHAVIOR
  - **Regulation and market forces are not enough to maintain integrity in the marketplace**
  - **Business norms must be based on ethical beliefs, customs, and practices**

Ethics in Corporate Finance

- CONSEQUENCES OF UNETHICAL BEHAVIOR
  - **Inefficiency in the economy and costs to society**
  - **High legal and social costs**
  - **Problems such as the recent financial crisis in the U.S.**

Ethics in Corporate Finance

- ETHICAL BEHAVIOR
  - **Sometimes, it is difficult to judge whether behavior is ethical or not**
    - Was the manager too careful?
    - Did the manager take too much risk?
    - Was it an honest mistake?
    - Was it against policy, but well-intentioned?

A Framework for the Analysis of Ethical Conflicts

EXHIBIT 1.6 **A Framework for the Analysis of Ethical Conflicts**

Dealing with ethical conflicts is an inescapable part of professional life for most people. An analytical framework can be helpful in understanding and resolving such conflicts.

The first step toward ethical behavior is to recognize that you face a moral issue. In general, if your actions or decisions will cause harm to others, you are facing a moral issue. When you find yourself in this position, you might ask yourself the following questions:

1. What does the law require? When in doubt, consult the legal department.
2. What do your role-related obligations require? What is your station, and what are its duties? If you are a member of a profession, what does the code of conduct of your profession say you should do in these circumstances?
3. Are you an agent employed on behalf of another in these circumstances? If so, what are the interests and desires of the employing party?
4. Are the interests of the stockholders materially affected? Your obligation is to represent the best interests of the firm's owners.
5. Do you have a confilict of interest? Will full diclosure of the conflict be sufficient? If not, you must determine what interest has priority.
6. Are you abusing information asymmetry? Is your use of the information asymmetry fair? It probably is fair if you would make the same decision if the roles of the parties were reversed or if you would publicly advocated the principle behind your decision.
7. Would you be willing to have your action and all the reasons that motivated it reported in the *Wall Street Journal*?