

Chapter 1

INTRODUCTION TO CORPORATE FINANCE

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CHAPTER WEBSITES

Section	Web Address
1.1	CFO.com Website: www.cfo.com
1.2	Incorporate Website: www.incorporate.com Benefit Corporation: www.benefitcorp.net
1.4	Business Ethics Website: www.business-ethics.com
1.5	S&P 500 board composition: www.spencerstuart.com
1.6	SOX costs: www.tinyurl.com/ybm8n5ne
End-of-chapter material	NYSE Website: www.nyse.com
	Nasdaq Website: www.nasdaq.com
	BizFilings Website: www.bizfilings.com

Please visit us at corecorporatefinance.blogspot.com for the latest developments in the world of corporate finance.

CHAPTER ORGANIZATION

- 1.1 What Is Corporate Finance?
 - The Balance Sheet Model of the Firm
 - The Financial Manager
- 1.2 The Corporate Firm
 - The Sole Proprietorship
 - The Partnership
 - The Corporation
 - A Corporation by Another Name
- 1.3 The Importance of Cash Flows

Chapter 01 - Introduction to Corporate Finance

Identification of Cash Flows

Timing of Cash Flows

Risk of Cash Flows

1.4 The Goal of Financial Management

Possible Goals

The Goal of Financial Management

A More General Goal

1.5 The Agency Problem and Control of the Corporation

Agency Relationships

Management Goals

Do Managers Act in the Stockholders' Interests?

Stakeholders

1.6 Regulation

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

ANNOTATED CHAPTER OUTLINE

Slide 1.1 ***Chapter 1 Introduction to Corporate Finance***

Slide 1.2 ***Key Concepts and Skills***

Slide 1.3 ***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.

Slide 1.4 **What is Corporate Finance?**

Corporate finance addresses several important questions:

1. Economic resources are required to establish and maintain a firm

2. Funds enable materials and processes for delivering salable goods and services
3. Funds are essential for assembling a workforce
4. Funds are required to purchase long-lived assets such as equipment and buildings
5. The balance sheet offers insight into the array of decisions, activities and objectives of the financial manager

Slide 1.5 *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 which reveals the three basic questions that corporate finance managers must answer.

Slide 1.6 *The Balance Sheet Reveals*

the top three concerns of corporate finance:

1. What long term investments should the firm choose?
2. How should the firm raise funds for the selected investments?
3. How should current assets be managed and financed?

Slide 1.7 *The Capital Budgeting Decision*

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

Slide 1.8 *The Capital Structure Decision*

Financing policy determines the liabilities and equity side of the balance sheet.

Slide 1.9 *Short-Term Asset Management*

Short-term asset management choices (e.g., conservative versus aggressive) affect the level of net working capital.

Slide 1.10 *The Financial Manager*

The firm's three main financial concerns are usually handled by a top officer and aides:

- V.P. or Chief Financial Officer – ordinarily acts as a financial strategist, coordinator and authority dedicated to making decisions that increase the value of the firm
- Treasurer – concerned with cash flow, capital expenditures and capital structure

- Controller – concerned with accounting, information systems, and taxes

Slide 1.11 *Hypothetical Organization Chart*

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.

Slide 1.12 *The Corporate Firm*

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

Slide 1.13 *Forms of Business Organization*

A. 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.

B. 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, and low liquidity.

Lecture Tip: Recent years have seen resurgence in the importance of private equity funds in the financing of firms. A discussion of this industry may increase student interest and facilitate a practical example of limited partnerships, which is the primary structure employed by these entities.

C. The Corporation

A distinct legal entity composed of one or more owners

Slide 1.14 **A Comparison**

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.

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.

Slide 1.15 **A Global Phenomenon**

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.

Slide 1.16 **The Importance of Cash Flows**

Lecture Tip: It is essential at this early stage to assure that students understand that finance examines both accounting income and cash flow. It is critically

important for students to understand that a firm cannot sustain itself unless it produces a positive cash flow.

If the firm is to prosper, it must purchase assets that produce more cash than they cost and finance itself using the least costly means of doing so. Successful firms produce more cash than they use.

Slide 1.17 *The Conceptual Flow of Cash*

The purpose of this slide is to provide a graphical representation of the interconnectedness of the three goals of financial management. It will be important for students to appreciate that it is the capital structure that enables capital spending. Capital spending in turn enables the production and sales that produce the cash flow necessary to make a return to investors, pay creditors, and add to the treasure of the business.

Slide 1.18 *Cash Flow $\neq$ Accounting Income*

Lecture Tip: *Now is the best time to assure students are comfortable with the distinction between accounting income and cash flow. It may be useful to refer to Example 1.1 in the text to drive the point home.*

Slide 1.19 *The Goal of Financial Management*

A. 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 IPOs 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 additional funds. In fact, many of these companies have gone out of business.

B. The Goal of Financial Management

From a stockholder (owner) perspective, the goal of buying the stock is to gain financially. Thus, **the goal of financial management 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 a 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.

Consider obtaining recent estimates for return on equity and the PE ratio for both companies to see how things have changed. This can be used to discuss how company strategies and performance change over time, including the challenges these companies face as consumers become more health conscious.

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).

Lecture Tip: It may be worth to point out recent events about Shareholder Primacy. In 2019, the Business Roundtable redefined the purpose of a corporation to help promote an “economy that serves all Americans.” The full statement can be found here (accessed on 1/9/2021:

<https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans/>)

Lecture Tip: For those interested in behavioral finance, this may be an opportune time to discuss outside influences that impact share price, many of which are beyond the control of the firm.

C. A More General Goal

The more general goal is to maximize the market value of owners' equity. 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.

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 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?

Slide 1.20 The Agency Problem and Control of the Corporation

The agency relationship arises when a principal hires an agent to represent their interest. Stockholders (principals) hire managers (agents) to run a company.

The agency problem is defined by a situation in which there is a conflict of interest between a principal and agent.

Lecture Tip: This topic also lends itself well to an ethics discussion that could be initiated on a wide variety of potential conflicts.

Slide 1.21 Agency Cost

Agency cost is simply the cost of the conflict of interest.

For example, if owners want to make a large risky investment in order to harvest long-term profits, managers may object because their short-term objectives are put at risk.

If managers prevail, any foregone long-term cash flow is the agency cost.

Slide 1.22 Management Goals

Direct agency costs – compensation and perquisites for management.

Indirect agency costs – cost of monitoring and sub-optimal decisions.

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 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.

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. 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.

Slide 1.23 Managing Managers

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: *Stern Stewart & Company 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 analysis, companies that tie management compensation to EVA® significantly outperform competitors that do not. This example illustrates that carefully crafted compensation packages may reduce the conflict between management and stockholders.

Lecture Tip: *According to The National Center for Employee Ownership, broad based stock option plans increased dramatically, not only for technology firms, but also for non-tech firms such as Starbucks and the Gap. They report that an estimated 7.2 employees held stock options down from its peak in 2001, when the number was about 30% higher. They attribute the decline to changes in accounting rules and shareholder concerns about ownership dilution. The decline may also be related to the fact that several firms have been embroiled in option backdating scandals. As such, the use of options in recent years has fallen, giving way to restricted shares.*

Stockholders technically have control of the firm, and dissatisfied shareholders can oust management via proxy fights, takeovers (e.g., Carl Icahn), 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. Further, the cost of a proxy fight can be prohibitive, with the 2002 HP/Compaq battle costing over \$100 million. Reports indicated that DuPont spent \$15 million on its proxy fight with Nelson Peltz in 2015.

Lecture Tip: *A discussion of the rise of activist investors would also stimulate class discussion. The classic proxy battle between DuPont and activist investor Nelson Peltz would be a good example. Peltz's Trian Fund Management sought four seats on the board but ultimately all 12 of the directors backed by DuPont's management were elected in May 2015. Despite the loss, the Wall Street Journal reported in December 2015 that Dow Chemical Co. and DuPont Co. announced plans to merge in a transaction valued at \$120 billion before splitting up into three separate companies. They noted that the plan originated with management, but management worked with activist investor Nelson Peltz to execute the deal. The merger was seen as a victory for activist investors.*

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 practitioner-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.

A good thing to note is that culture influences the goal of the firm. The US and UK are examples of countries/regions where shareholder wealth maximization is paramount. In countries like Germany and Japan the interests of employees and customers are given emphasis.

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 had 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 the U.S. Department of Justice [website](#).

Slide 1.24 Regulation

Regulation of financial activities arises from two substantial sources:

Antitrust legislation governing issuance of securities and creating the SEC; and, Sarbanes Oxley that requires increased reporting requirements and personal consequences for non-compliance.

Slide 1.25 Quick Quiz