

Chapter 1

Corporate Finance and the Financial Manager

■ Chapter Overview

The focus of this book is on how to make optimal corporate financial decisions. Organizations, regardless of their form or goals, have one thing in common—they will need to make financial decisions, and each organization will have a financial manager contributing to those decisions. These decisions are tied to one very powerful concept, the Valuation Principle, an ongoing theme throughout this text. In this chapter, students are introduced to the different types of firms, noting global differences in the choice of the organizational format. Chapter 1 examines the functions of the financial manager and his or her role on the management team. The importance of a skillful and ethical financial manager cannot be overemphasized, so much so that the chapter details the major decisions faced by a financial manager. Poorly managed companies are targets for takeovers, and stockholders are no longer uninformed or passive. Because stock prices are impacted by decisions made by financial managers, an introduction to the traditional and non-traditional trading venues of the 21st century, as well as the mechanics of trading is provided. The chapter concludes with a discussion of the importance of financial institutions and their role in very complex, tech savvy world.

■ Chapter Outline

Introduction

- 1.1 Why Study Finance?
- 1.2 The Four Types of Firms
 - Sole Proprietorships
 - Partnerships
 - Limited Liability Companies
 - Corporations
 - Formation of a Corporation
 - Ownership of a Corporation
 - Tax Implications for Corporate Entities
 - *Example 1.1:* Taxation of Corporate Earnings
 - S Corporations
 - *Example 1.2:* Taxation of S Corporation Earnings
 - C Corporations

1.3 The Financial Manager

Making Investment Decisions

Making Financing Decisions

Managing Short-Term Cash Needs

The Goal of the Financial Manager

1.4 The Financial Manager's Place in the Corporation

The Corporate Management Team

Ethics and Incentives in Corporations

—Agency Problems

—The CEO's Performance

1.5 The Stock Market

The Largest Stock Markets

Primary Versus Secondary Markets

Traditional Trading Venues

- Interview with Frank Hatheway, Chief Economist and Senior Vice President for NASDAQ

New Competition and Market Changes

Dark Pools

Listing Standards

Other Financial Markets

1.6 Financial Institutions

The Financial Cycle

Types of Financial Institutions

Role of Financial Institutions

■ Learning Objectives

- Grasp the importance of financial information in both your personal and business lives
- Understand the important features of the four main types of firms and see why the advantages of the corporate form have led it to dominate economic activity
- Explain the goal of the financial manager and the reasoning behind that goal, as well as understand the three main types of decisions a financial manager makes
- Know how a corporation is managed and controlled, the financial manager's place in it, and some of the ethical issues financial managers face
- Understand the importance of financial markets, such as stock markets, to a corporation and the financial manager's role as liaison to those markets
- Recognize the role of that financial institutions play in the financial cycle of the economy

■ CFA Topic Areas

The following table shows which CFA learning outcomes are covered in the chapter and points to the specific topic covered by the material.

CFA Topic Area	Chapter Section
Ethical Practices	1.4 The Financial Manager's Place in the Corporation
Firm and Industry Organization	1.2 The Four Types of Firms
	1.3 The Financial Manager
	1.4 The Financial Manager's Place in the Corporation
	1.6 Financial Institutions
Corporate Governance	1.4 The Financial Manager's Place in the Corporation
Equity Markets: Characteristics, Institutions	1.5 The Stock Market
Business Cycles	1.6 Financial Institutions
Analysis of Taxes	1.2 The Four Types of Firms

■ Lecture Launchers

1. A student recently graduated from a prestigious university with a marketing degree. She spent her last year as an intern in her major. To her dismay, she discovered that it would take at least 10 years before she would be allowed to do the work in advertising that she truly wanted to do. Her decision: graduate and take a job as a bartender until she figures out what she wants to do. Ask the students what they think about her decision. Is she being realistic? Did she decide that her career goal was not worth 10 years of her life, that the benefits did not justify the costs? Is there a way to quantify her decision? What are ways for her to determine the financial impact of her decision?
2. Read aloud the following sentence from Section 1.1 of the chapter: "Our career paths have become less predictable and more dynamic." Ask the students what this sentence implies and what its implication is for their lives and goals. How does this affect their financial futures and how might they plan and prepare for such uncertainty?
3. Was "financial ignorance" a driving force behind the collapse of the housing markets? During the last two years, many students found themselves in a role reversal: taking extra jobs to help out their unemployed parents or to help make mortgage payments that were no longer affordable by their parents.
4. It is important for students to realize that finance is so much more than the study of financial markets. To those outside the industry, finance and investment seem synonymous, while in reality investment is one small subset of the field of finance. To appreciate the variety of careers available in finance and the myriad of ways it is used across industries, have students research and then present in class nontraditional and nonpedestrian examples of careers in finance. For example, most opera companies have a financial officer.

5. By the time students take an introductory finance course, they have taken accounting and a basic introduction to business class, so they should have some idea, right or wrong, of finance. Ask them to explain what they think finance is as if they were explaining it to their grandparents or younger siblings or people who have no idea of what the field is—literally breaking it down to its basics so that a “child” could understand it. The answers can be very surprising, particularly from some of the international students.
6. Ask how many students own, or intend to own, stock. (You usually get a few hands.) Do they (or will they) feel any responsibility toward the company in which they have invested? Do they (or will they) follow it in the financial news? Do they plan on keeping abreast of how well the company is run or even who the managers/board members are? Why not? Bring to the class’s attention any imbalances between male/female stockholders and, perhaps, note cultural imbalances as well.
7. Do you think of the field of finance as ethical compared to other fields, like marketing, accounting, engineering, or even architecture?

■ Questions for Further Class Discussion

1. Very knowledgeable and experienced people in finance know the Valuation Principle, and yet mistakes are made, both on a personal and corporate level, as people still make the wrong decisions. Why?
2. Is it easy to distinguish between a benefit and a cost? What benefit today could be a cost tomorrow?
3. Ask students what the state of Delaware (if different from your own) offers that your state does not in terms of the legal environment for incorporation. Either in class or as homework, have students use the Internet to find the chartering requirements for Delaware and the state in which the class is located to help answer this question .
4. Given the liability of sole proprietorships and the protection of corporations, why is the number of sole proprietorships so high?
5. Limited partnerships are very popular in the entertainment industry. Why?
6. We all have rights and responsibilities as individuals. The Supreme Court ruling in the nineteenth century gave similar rights to corporations. What rights do you and corporations have in common, and how do your rights and responsibilities differ?
7. How important is the stockholder to the economic success of the United States?
8. Discuss compensation for managers. Many students will be managers one day, regardless of their major. Can they think of an example where their interest and the interest of the corporation will not coincide? What are their options in this situation?
9. Merrill Lynch executives gave themselves a very large bonus despite the bankruptcy declaration that amounted to millions. Do you really believe that the Dodd Frank Act can keep this from happening again?

10. Few hierarchal management systems are in place these days. Most corporations have teams. Making a decision that is best for the company is one thing when only you are affected, but what happens when you realize that doing what is ethical may cost your team in compensation?
11. Thinking back over what you have read in the newspapers or seen on television, what are some very bad investment decisions made by managers? Why were these mistakes made?
12. Working capital will be discussed later, but what is it exactly and why is it so important to the financial manager?
13. Who would you rather be: chairman of the board, the CEO, or CFO? Why?
14. Why do you think the New York Stock Exchange is still the largest in the world? How long do you think it will continue to be the largest? Will all exchanges eventually go the way of NASDAQ—no physical location, just technology?

■ AACSB Learning Standards

This section details how the end-of-chapter problems correlate to the general knowledge and skill guidelines in the accreditation standards, as set by the Association to Advance Collegiate Schools of Business (AACSB).

AACSB Learning Standards	End-of-Chapter Problem
Reflective Thinking	Problems 1, 9, 10, 15, 20, 22
Ethical Understanding and Reasoning	Problems 10–15
Information Technology	Problem 18, 21

■ End-of-Chapter Problem Complexity Rating

The end-of-chapter problems are sorted below, according to their level of complexity.

Simple	Average	Complex
2–4, 8, 16, 17, 21	1, 5–7, 9, 10, 18, 19, 21–24	11–15, 20, 25

■ Spreadsheet Solutions in Excel

The following end-of-chapter problem solutions are available with Excel spreadsheets. These spreadsheets can be downloaded from the Instructor's Resource Center at www.pearsonhighered.com/irc. If you do not have a login and password for this Web site, contact your Pearson sales representative.

Problems: None