

# An Overview of Financial Management



SOURCE: Courtesy BEN & JERRY'S HOMEMADE, INC. [www.benjerry.com](http://www.benjerry.com)

## STRIKING THE RIGHT BALANCE



### BEN & JERRY'S

For many companies, the decision would have been an easy “yes.” However, Ben & Jerry’s Homemade Inc. has always taken pride in doing things differently. Its profits had been declining, but in 1995 the company was offered an opportunity to sell its premium ice cream in the lucrative Japanese market. However, Ben & Jerry’s turned down the business because the Japanese firm that would have distributed their product had failed to develop a reputation for promoting social causes! Robert Holland Jr., Ben & Jerry’s CEO at the time, commented that, “The only reason to take the opportunity was to make money.” Clearly, Holland, who resigned from the company in late 1996, thought there was more to running a business than just making money.

The company’s cofounders, Ben Cohen and Jerry Greenfield, opened the first Ben & Jerry’s ice cream shop in 1978 in a vacant Vermont gas station with just \$12,000 of capital plus a commitment to run the business in a manner consistent with their underlying values. Even though it is more expensive, the company only buys milk and cream from small local farms in Vermont. In addition, 7.5 percent of the company’s before-tax income is donated to charity, and each of the company’s 750 employees receives three free pints of ice cream each day.

Many argue that Ben & Jerry’s philosophy and commitment to social causes compromises its ability to

make money. For example, in a recent article in *Fortune* magazine, Alex Taylor III commented that, “Operating a business is tough enough. Once you add social goals to the demands of serving customers, making a profit, and returning value to shareholders, you tie yourself up in knots.”

Ben & Jerry’s financial performance has had its ups and downs. While the company’s stock grew by leaps and bounds through the early 1990s, problems began to arise in 1993. These problems included increased competition in the premium ice cream market, along with a leveling off of sales in that market, plus their own inefficiencies and sloppy, haphazard product development strategy.

The company lost money for the first time in 1994, and as a result, Ben Cohen stepped down as CEO. Bob Holland, a former consultant for McKinsey & Co. with a reputation as a turnaround specialist, was tapped as Cohen’s replacement. The company’s stock price rebounded in 1995, as the market responded positively to the steps made by Holland to right the company. The stock price, however, floundered toward the end of 1996, following Holland’s resignation.

Over the last few years, Ben & Jerry’s has had a new resurgence. Holland’s replacement, Perry Odak, has done a number of things to improve the company’s financial performance, and its reputation among Wall Street’s

analysts and institutional investors has benefited. Odak quickly brought in a new management team to rework the company's production and sales operations, and he aggressively opened new stores and franchises both in the United States and abroad.

In April 2000, Ben & Jerry's took a more dramatic step to benefit its shareholders. It agreed to be acquired by Unilever, a large Anglo-Dutch conglomerate that owns a host of major brands including Dove Soap, Lipton Tea, and Breyers Ice Cream. Unilever agreed to pay \$43.60 for each share of Ben & Jerry's stock—a 66 percent increase over the price the stock traded at just before takeover rumors first surfaced in December 1999. The total price tag for Ben & Jerry's was \$326 million.

While the deal clearly benefited Ben & Jerry's shareholders, some observers believe that the company "sold out" and abandoned its original mission. In

response to these concerns, Ben & Jerry's will retain its Vermont headquarters and its separate board, and its social missions will remain intact. Others have suggested that Ben & Jerry's philosophy may even induce Unilever to increase its own corporate philanthropy. Despite these assurances, it still remains to be seen whether Ben & Jerry's vision can be maintained within the confines of a large conglomerate.

As you will see throughout the book, many of today's companies face challenges similar to those of Ben & Jerry's. Every day, corporations struggle with decisions such as these: Is it fair to our labor force to shift production overseas? What is the appropriate level of compensation for senior management? Should we increase, or decrease, our charitable contributions? In general, how do we balance social concerns against the need to create shareholder value? ■

## PUTTING THINGS IN PERSPECTIVE



See <http://www.benjerry.com/mission.html> for Ben & Jerry's interesting mission statement. It might be a

good idea to print it out and take it to class for discussion.

The purpose of this chapter is to give you an idea of what financial management is all about. After you finish the chapter, you should have a reasonably good idea of what finance majors might do after graduation. You should also have a better understanding of (1) some of the forces that will affect financial management in the future; (2) the place of finance in a firm's organization; (3) the relationships between financial managers and their counterparts in the accounting, marketing, production, and personnel departments; (4) the goals of a firm; and (5) the way financial managers can contribute to the attainment of these goals. ■



Information on finance careers, additional chapter links, and practice quizzes are available on the web site to accompany this

text: <http://www.harcourtcollege.com/finance/concise3e>.

## CAREER OPPORTUNITIES IN FINANCE

Finance consists of three interrelated areas: (1) *money and capital markets*, which deals with securities markets and financial institutions; (2) *investments*, which focuses on the decisions made by both individual and institutional investors as

they choose securities for their investment portfolios; and (3) *financial management*, or “business finance,” which involves decisions within firms. The career opportunities within each field are many and varied, but financial managers must have a knowledge of all three areas if they are to do their jobs well.

## MONEY AND CAPITAL MARKETS

Many finance majors go to work for financial institutions, including banks, insurance companies, mutual funds, and investment banking firms. For success here, one needs a knowledge of valuation techniques, the factors that cause interest rates to rise and fall, the regulations to which financial institutions are subject, and the various types of financial instruments (mortgages, auto loans, certificates of deposit, and so on). One also needs a general knowledge of all aspects of business administration, because the management of a financial institution involves accounting, marketing, personnel, and computer systems, as well as financial management. An ability to communicate, both orally and in writing, is important, and “people skills,” or the ability to get others to do their jobs well, are critical.

## INVESTMENTS

Finance graduates who go into investments often work for a brokerage house such as Merrill Lynch, either in sales or as a security analyst. Others work for banks, mutual funds, or insurance companies in the management of their investment portfolios; for financial consulting firms advising individual investors or pension funds on how to invest their capital; for investment banks whose primary function is to help businesses raise new capital; or as financial planners whose job is to help individuals develop long-term financial goals and portfolios. The three main functions in the investments area are sales, analyzing individual securities, and determining the optimal mix of securities for a given investor.

## FINANCIAL MANAGEMENT

Financial management is the broadest of the three areas, and the one with the most job opportunities. Financial management is important in all types of businesses, including banks and other financial institutions, as well as industrial and retail firms. Financial management is also important in governmental operations, from schools to hospitals to highway departments. The job opportunities in financial management range from making decisions regarding plant expansions to choosing what types of securities to issue when financing expansion. Financial managers also have the responsibility for deciding the credit terms under which customers may buy, how much inventory the firm should carry, how much cash to keep on hand, whether to acquire other firms (merger analysis), and how much of the firm’s earnings to plow back into the business versus pay out as dividends.

Regardless of which area a finance major enters, he or she will need a knowledge of all three areas. For example, a bank lending officer cannot do his or her



Consult <http://www.careers-in-business.com> for an excellent site containing information on a variety of business career areas, listings of current jobs, and a variety of other reference materials.

job well without a good understanding of financial management, because he or she must be able to judge how well a business is being operated. The same thing holds true for Merrill Lynch's security analysts and stockbrokers, who must have an understanding of general financial principles if they are to give their customers intelligent advice. Similarly, corporate financial managers need to know what their bankers are thinking about, and they also need to know how investors judge a firm's performance and thus determine its stock price. So, if you decide to make finance your career, you will need to know something about all three areas.

But suppose you do not plan to major in finance. Is the subject still important to you? Absolutely, for two reasons: (1) You need a knowledge of finance to make many personal decisions, ranging from investing for your retirement to deciding whether to lease versus buy a car. (2) Virtually all important business decisions have financial implications, so important decisions are generally made by teams from the accounting, finance, legal, marketing, personnel, and production departments. Therefore, if you want to succeed in the business arena, you must be highly competent in your own area, say, marketing, but you must also have a familiarity with the other business disciplines, including finance.

*Thus, there are financial implications in virtually all business decisions, and nonfinancial executives simply must know enough finance to work these implications into their own specialized analyses.*<sup>1</sup> Because of this, every student of business, regardless of his or her major, should be concerned with financial management.

#### SELF-TEST QUESTIONS

What are the three main areas of finance?

If you have definite plans to go into one area, why is it necessary that you know something about the other areas?

Why is it necessary for business students who do not plan to major in finance to understand the basics of finance?

## FINANCIAL MANAGEMENT IN THE NEW MILLENNIUM

When financial management emerged as a separate field of study in the early 1900s, the emphasis was on the legal aspects of mergers, the formation of new firms, and the various types of securities firms could issue to raise capital. During the Depression of the 1930s, the emphasis shifted to bankruptcy and reorganization, corporate liquidity, and the regulation of security markets. During the 1940s and early 1950s, finance continued to be taught as a descriptive, institutional subject, viewed more from the standpoint of an outsider rather than that of a manager. However, a movement toward theoretical analysis began during the late 1950s, and the focus shifted to managerial decisions designed to maximize the value of the firm.

<sup>1</sup> It is an interesting fact that the course "Financial Management for Nonfinancial Executives" has the highest enrollment in most executive development programs.

The focus on value maximization continues as we begin the 21st century. However, two other trends are becoming increasingly important: (1) the globalization of business and (2) the increased use of information technology. Both of these trends provide companies with exciting new opportunities to increase profitability and reduce risks. However, these trends are also leading to increased competition and new risks. To emphasize these points throughout the book, we regularly profile how companies or industries have been affected by increased globalization and changing technology. These profiles are found in the boxes labeled “Global Perspectives” and “Technology Matters.”

## GLOBALIZATION OF BUSINESS

Many companies today rely to a large and increasing extent on overseas operations. Table 1-1 summarizes the percentage of overseas revenues and profits for 10 well-known corporations. Very clearly, these 10 “American” companies are really international concerns.

Four factors have led to the increased globalization of businesses: (1) Improvements in transportation and communications lowered shipping costs and made international trade more feasible. (2) The increasing political clout of consumers, who desire low-cost, high-quality products. This has helped lower trade barriers designed to protect inefficient, high-cost domestic manufacturers and their workers. (3) As technology has become more advanced, the costs of developing new products have increased. These rising costs have led to joint ventures between such companies as General Motors and Toyota, and to global operations for many firms as they seek to expand markets and thus spread development costs over higher unit sales. (4) In a world populated with multinational firms able to shift production to wherever costs are lowest, a firm whose manufacturing operations are restricted to one country cannot compete unless costs in its home country happen to be low, a condition that does not



Check out <http://www.nummi.com/home.htm> to find out more about New United Motor Manufacturing, Inc. (NUMMI), the joint venture between Toyota and General Motors. Read about NUMMI's history and organizational goals.

TABLE 1 - 1

**Percentage of Revenue and Net Income from Overseas Operations for 10 Well-Known Corporations**

COMPANY	PERCENTAGE OF REVENUE ORIGINATED OVERSEAS	PERCENTAGE OF NET INCOME GENERATED OVERSEAS
Chase Manhattan	23.9	21.9
Coca-Cola	61.2	65.1
Exxon Mobil	71.8	62.7
General Electric	31.7	22.8
General Motors	26.3	55.3
IBM	57.5	49.6
McDonald's	61.6	60.9
Merck	21.6	43.4
Minn. Mining & Mfg.	52.1	27.2
Walt Disney	15.4	16.6

SOURCE: *Forbes* Magazine's 1999 Ranking of the 100 Largest U.S. Multinationals; *Forbes*, July 24, 2000, 335-338.





## COKE RIDES THE GLOBAL ECONOMY WAVE

During the past 20 years, Coca-Cola has created tremendous value for its shareholders. A \$10,000 investment in Coke stock in January 1980 would have grown to nearly \$600,000 by mid-1998. A large part of that impressive growth was due to Coke's overseas expansion program. Today nearly 75 percent of Coke's profit comes from overseas, and Coke sells roughly half of the world's soft drinks.

More recently, Coke has discovered that there are also risks when investing overseas. Indeed, between mid-1998 and January 2001, Coke's stock fell by roughly a third—which means that the \$600,000 stock investment decreased in value to \$400,000 in about 2.5 years. Coke's poor performance during this period was due in large part to troubles overseas. Weak economic conditions in Brazil, Germany, Japan, Southeast Asia, Venezuela, Colombia, and Russia, plus a quality scare in Belgium and France, hurt the company's bottom line.

Despite its recent difficulties, Coke remains committed to its global vision. Coke is also striving to learn from these difficulties. The company's leaders have acknowledged that Coke may have become overly centralized. Centralized control enabled Coke to standardize quality and to capture operating efficiencies, both of which initially helped to establish its brand name throughout the world. More recently, however, Coke has become concerned

that too much centralized control has made it slow to respond to changing circumstances and insensitive to differences among the various local markets it serves.

Coke's CEO, Douglas N. Daft, reflected these concerns in a recent editorial that was published in the March 27, 2000, edition of *Financial Times*. Daft's concluding comments appear below:

So overall, we will draw on a long-standing belief that Coca-Cola always flourishes when our people are allowed to use their insight to build the business in ways best suited to their local culture and business conditions.

We will, of course, maintain clear order. Our small corporate team will communicate explicitly the clear strategy, policy, values, and quality standards needed to keep us cohesive and efficient. But just as important, we will also make sure we stay out of the way of our local people and let them do their jobs. That will enhance significantly our ability to unlock growth opportunities, which will enable us to consistently meet our growth expectations.

In our recent past, we succeeded because we understood and appealed to global commonalities. In our future, we'll succeed because we will also understand and appeal to local differences. The 21st century demands nothing less.



For more information about the Coca-Cola Company, go to <http://www.thecoca-colacompany.com/world/index.html>, where you can find profiles of Coca-Cola's presence in foreign countries. You may follow additional links to Coca-Cola web sites in foreign countries.

necessarily exist for many U.S. corporations. As a result of these four factors, survival requires that most manufacturers produce and sell globally.

Service companies, including banks, advertising agencies, and accounting firms, are also being forced to "go global," because these firms can best serve their multinational clients if they have worldwide operations. There will, of course, always be some purely domestic companies, but the most dynamic growth, and the best employment opportunities, are often with companies that operate worldwide.

Even businesses that operate exclusively in the United States are not immune to the effects of globalization. For example, the costs to a homebuilder in rural Nebraska are affected by interest rates and lumber prices — both of which are determined by worldwide supply and demand conditions. Furthermore, demand for the homebuilder's houses is influenced by interest rates and also by conditions in the local farm economy, which depend to a large extent on foreign demand for wheat. To operate efficiently, the Nebraska builder must be able to forecast the demand for houses, and that demand depends on worldwide events. So, at least some knowledge of global economic conditions is important to virtually everyone, not just to those involved with businesses that operate internationally.

## INFORMATION TECHNOLOGY

As we advance into the new millennium, we will see continued advances in computer and communications technology, and this will continue to revolutionize the way financial decisions are made. Companies are linking networks of personal



### eTOYS TAKES ON TOYS “Я” US

The toy market illustrates how electronic commerce is changing the way firms operate. Over the past decade, this market has been dominated by Toys “Я” Us, although Toys “Я” Us has faced increasing competition from retail chains such as Wal-Mart, Kmart, and Target. Then, in 1997, Internet startup eToys Inc. began selling and distributing toys through the Internet.

When eToys first emerged, many analysts believed that the Internet provided toy retailers with a sensational opportunity. This point was made amazingly clear in May 1999 when eToys issued stock to the public in an initial public offering (IPO). The stock immediately rose from its \$20 offering price to \$76 per share, and the company’s market capitalization (calculated by multiplying stock price by the number of shares outstanding) was a mind-blowing \$7.8 billion.

To put this valuation in perspective, eToys’ market value at the time of the offering (\$7.8 billion) was 35 percent greater than that of Toys “Я” Us (\$5.7 billion). eToys’ valuation was particularly startling given that the company had yet to earn a profit. (It lost \$73 million in the year ending March 1999.) Moreover, while Toys “Я” Us had nearly 1,500 stores and revenues in excess of \$11 billion, eToys had no stores and revenues of less than \$35 million.

Investors were clearly expecting that an increasing number of toys will be bought over the Internet. One analyst estimated at the time of the offering that eToys would be worth \$10 billion within a decade. His analysis assumed that in 10 years the toy market would total \$75 billion, with \$20 billion

coming from online sales. Indeed, online sales do appear to be here to stay. For many customers, online shopping is quicker and more convenient, particularly for working parents of young children, who purchase the lion’s share of toys. From the company’s perspective, Internet commerce has a number of other advantages. The costs of maintaining a web site and distributing toys online may be smaller than the costs of maintaining and managing 1,500 retail stores.

Not surprisingly, Toys “Я” Us did not sit idly by — it recently announced plans to invest \$64 million in a separate online subsidiary, Toysrus.com. The company also announced an online partnership with Internet retailer Amazon.com. In addition, Toys “Я” Us is redoubling its efforts to make traditional store shopping more enjoyable and less frustrating.

While the Internet provides toy companies with new and interesting opportunities, these companies also face tremendous risks as they try to respond to the changing technology. Indeed, in the months following eToys’ IPO, Toys “Я” Us’ stock fell sharply, and by January 2000, its market value was only slightly above \$2 billion. Since then, Toys “Я” Us stock has rebounded, and its market capitalization was once again approaching \$5 billion. The shareholders of eToys were less fortunate. Concerns about inventory management during the 1999 holiday season and the collapse of many Internet stocks spurred a tremendous collapse in eToys’ stock — its stock fell from a post-IPO high of \$76 a share to \$0.31 a share in January 2001. Two months later, eToys declared bankruptcy.

computers to one another, to the firms’ own mainframe computers, to the Internet and the World Wide Web, and to their customers’ and suppliers’ computers. Thus, financial managers are increasingly able to share information and to have “face-to-face” meetings with distant colleagues through video teleconferencing. The ability to access and analyze data on a real-time basis also means that quantitative analysis is becoming more important, and “gut feel” less sufficient, in business decisions. As a result, the next generation of financial managers will need stronger computer and quantitative skills than were required in the past.

Changing technology provides both opportunities and threats. Improved technology enables businesses to reduce costs and expand markets. At the same time, however, changing technology can introduce additional competition, which may reduce profitability in existing markets.

The banking industry provides a good example of the double-edged technology sword. Improved technology has allowed banks to process information much more efficiently, which reduces the costs of processing checks, providing credit, and identifying bad credit risks. Technology has also allowed banks to serve customers better. For example, today bank customers use automatic teller machines (ATMs) everywhere, from the supermarket to the local mall. Today,



many banks also offer products that allow their customers to use the Internet to manage their accounts and to pay bills. However, changing technology also threatens banks' profitability. Many customers no longer feel compelled to use a local bank, and the Internet allows them to shop worldwide for the best deposit and loan rates. An even greater threat is the continued development of electronic commerce. Electronic commerce allows customers and businesses to transact directly, thus reducing the need for intermediaries such as commercial banks. In the years ahead, financial managers will have to continue to keep abreast of technological developments, and they must be prepared to adapt their businesses to the changing environment.

### SELF-TEST QUESTIONS

What two key trends are becoming increasingly important in financial management today?

How has financial management changed from the early 1900s to the present?

How might a person become better prepared for a career in financial management?

## THE FINANCIAL STAFF'S RESPONSIBILITIES

The financial staff's task is to acquire and then help operate resources so as to maximize the value of the firm. Here are some specific activities:

- 1. Forecasting and planning.** The financial staff must coordinate the planning process. This means they must interact with people from other departments as they look ahead and lay the plans that will shape the firm's future.
- 2. Major investment and financing decisions.** A successful firm usually has rapid growth in sales, which requires investments in plant, equipment, and inventory. The financial staff must help determine the optimal sales growth rate, help decide what specific assets to acquire, and then choose the best way to finance those assets. For example, should the firm finance with debt, equity, or some combination of the two, and if debt is used, how much should be long term and how much short term?
- 3. Coordination and control.** The financial staff must interact with other personnel to ensure that the firm is operated as efficiently as possible. All business decisions have financial implications, and all managers — financial and otherwise — need to take this into account. For example, marketing decisions affect sales growth, which in turn influences investment requirements. Thus, marketing decision makers must take account of how their actions affect and are affected by such factors as the availability of funds, inventory policies, and plant capacity utilization.
- 4. Dealing with the financial markets.** The financial staff must deal with the money and capital markets. As we shall see in Chapter 5, each firm affects and is affected by the general financial markets where funds are

raised, where the firm's securities are traded, and where investors either make or lose money.

- 5. Risk management.** All businesses face risks, including natural disasters such as fires and floods, uncertainties in commodity and security markets, volatile interest rates, and fluctuating foreign exchange rates. However, many of these risks can be reduced by purchasing insurance or by hedging in the derivatives markets. The financial staff is responsible for the firm's overall risk management program, including identifying the risks that should be managed and then managing them in the most efficient manner.

In summary, people working in financial management make decisions regarding which assets their firms should acquire, how those assets should be financed, and how the firm should conduct its operations. If these responsibilities are performed optimally, financial managers will help to maximize the values of their firms, and this will also contribute to the welfare of consumers and employees.

#### SELF-TEST QUESTION

What are some specific activities with which a firm's finance staff is involved?

## ALTERNATIVE FORMS OF BUSINESS ORGANIZATION

There are three main forms of business organization: (1) sole proprietorships, (2) partnerships, and (3) corporations, plus several hybrid forms. In terms of numbers, about 80 percent of businesses are operated as sole proprietorships, while most of the remainder are divided equally between partnerships and corporations. Based on the dollar value of sales, however, about 80 percent of all business is conducted by corporations, about 13 percent by sole proprietorships, and about 7 percent by partnerships and hybrids. Because most business is conducted by corporations, we will concentrate on them in this book. However, it is important to understand the differences among the various forms.

### SOLE PROPRIETORSHIP

#### Sole Proprietorship

An unincorporated business owned by one individual.

A **sole proprietorship** is an unincorporated business owned by one individual. Going into business as a sole proprietor is easy — one merely begins business operations. However, even the smallest businesses normally must be licensed by a governmental unit.

The proprietorship has three important advantages: (1) It is easily and inexpensively formed, (2) it is subject to few government regulations, and (3) the business avoids corporate income taxes.

The proprietorship also has three important limitations: (1) It is difficult for a proprietorship to obtain large sums of capital; (2) the proprietor has unlimited personal liability for the business's debts, which can result in losses that

exceed the money he or she has invested in the company; and (3) the life of a business organized as a proprietorship is limited to the life of the individual who created it. For these three reasons, sole proprietorships are used primarily for small-business operations. However, businesses are frequently started as proprietorships and then converted to corporations when their growth causes the disadvantages of being a proprietorship to outweigh the advantages.

## PARTNERSHIP

### Partnership

An unincorporated business owned by two or more persons.

A **partnership** exists whenever two or more persons associate to conduct a noncorporate business. Partnerships may operate under different degrees of formality, ranging from informal, oral understandings to formal agreements filed with the secretary of the state in which the partnership was formed. The major advantage of a partnership is its low cost and ease of formation. The disadvantages are similar to those associated with proprietorships: (1) unlimited liability, (2) limited life of the organization, (3) difficulty of transferring ownership, and (4) difficulty of raising large amounts of capital. The tax treatment of a partnership is similar to that for proprietorships, which is often an advantage, as we demonstrate in Chapter 2.

Regarding liability, the partners can potentially lose all of their personal assets, even assets not invested in the business, because under partnership law, each partner is liable for the business's debts. Therefore, if any partner is unable to meet his or her pro rata liability in the event the partnership goes bankrupt, the remaining partners must make good on the unsatisfied claims, drawing on their personal assets to the extent necessary. The partners of the national accounting firm Laventhol and Horwath, a huge partnership that went bankrupt as a result of suits filed by investors who relied on faulty audit statements, learned all about the perils of doing business as a partnership. Thus, a Texas partner who audits a business that goes under can bring ruin to a millionaire New York partner who never went near the client company.

The first three disadvantages — unlimited liability, impermanence of the organization, and difficulty of transferring ownership — lead to the fourth, the difficulty partnerships have in attracting substantial amounts of capital. This is generally not a problem for a slow-growing business, but if a business's products or services really catch on, and if it needs to raise large amounts of capital to capitalize on its opportunities, the difficulty in attracting capital becomes a real drawback. Thus, growth companies such as Hewlett-Packard and Microsoft generally begin life as a proprietorship or partnership, but at some point their founders find it necessary to convert to a corporation.

## CORPORATION

### Corporation

A legal entity created by a state, separate and distinct from its owners and managers, having unlimited life, easy transferability of ownership, and limited liability.

A **corporation** is a legal entity created by a state, and it is separate and distinct from its owners and managers. This separateness gives the corporation three major advantages: (1) *Unlimited life*. A corporation can continue after its original owners and managers are deceased. (2) *Easy transferability of ownership interest*. Ownership interests can be divided into shares of stock, which, in turn, can be transferred far more easily than can proprietorship or partnership interests. (3) *Limited liability*. Losses are limited to the actual funds invested. To illustrate limited liability, suppose you invested \$10,000 in a partnership that then went

bankrupt, owing \$1 million. Because the owners are liable for the debts of a partnership, you could be assessed for a share of the company's debt, and you could be held liable for the entire \$1 million if your partners could not pay their shares. Thus, an investor in a partnership is exposed to unlimited liability. On the other hand, if you invested \$10,000 in the stock of a corporation that then went bankrupt, your potential loss on the investment would be limited to your \$10,000 investment.<sup>2</sup> These three factors—unlimited life, easy transferability of ownership interest, and limited liability—make it much easier for corporations than for proprietorships or partnerships to raise money in the capital markets.

The corporate form offers significant advantages over proprietorships and partnerships, but it also has two disadvantages: (1) Corporate earnings may be subject to double taxation—the earnings of the corporation are taxed at the corporate level, and then any earnings paid out as dividends are taxed again as income to the stockholders. (2) Setting up a corporation, and filing the many required state and federal reports, is more complex and time-consuming than for a proprietorship or a partnership.

A proprietorship or a partnership can commence operations without much paperwork, but setting up a corporation requires that the incorporators prepare a charter and a set of bylaws. Although personal computer software that creates charters and bylaws is now available, a lawyer is required if the fledgling corporation has any nonstandard features. The *charter* includes the following information: (1) name of the proposed corporation, (2) types of activities it will pursue, (3) amount of capital stock, (4) number of directors, and (5) names and addresses of directors. The charter is filed with the secretary of the state in which the firm will be incorporated, and when it is approved, the corporation is officially in existence.<sup>3</sup> Then, after the corporation is in operation, quarterly and annual employment, financial, and tax reports must be filed with state and federal authorities.

The *bylaws* are a set of rules drawn up by the founders of the corporation. Included are such points as (1) how directors are to be elected (all elected each year, or perhaps one-third each year for three-year terms); (2) whether the existing stockholders will have the first right to buy any new shares the firm issues; and (3) procedures for changing the bylaws themselves, should conditions require it.

The value of any business other than a very small one will probably be maximized if it is organized as a corporation for the following three reasons:

1. Limited liability reduces the risks borne by investors, and, other things held constant, *the lower the firm's risk, the higher its value.*
2. A firm's value is dependent on its *growth opportunities*, which in turn are dependent on the firm's ability to attract capital. Since corporations can attract capital more easily than can unincorporated businesses, they are better able to take advantage of growth opportunities.

<sup>2</sup> In the case of small corporations, the limited liability feature is often a fiction, because bankers and other lenders frequently require personal guarantees from the stockholders of small, weak businesses.

<sup>3</sup> Note that more than 60 percent of major U.S. corporations are chartered in Delaware, which has, over the years, provided a favorable legal environment for corporations. It is not necessary for a firm to be headquartered, or even to conduct operations, in its state of incorporation.

3. The value of an asset also depends on its *liquidity*, which means the ease of selling the asset and converting it to cash at a “fair market value.” Since an investment in the stock of a corporation is much more liquid than a similar investment in a proprietorship or partnership, this too enhances the value of a corporation.

As we will see later in the chapter, most firms are managed with value maximization in mind, and this, in turn, has caused most large businesses to be organized as corporations.

## HYBRID FORMS OF ORGANIZATION

### Limited Partnership

A hybrid form of organization consisting of general partners, who have unlimited liability for the partnership’s debts, and limited partners, whose liability is limited to the amount of their investment.

### Limited Liability Partnership (Limited Liability Company)

A hybrid form of organization in which all partners enjoy limited liability for the business’s debts. It combines the limited liability advantage of a corporation with the tax advantages of a partnership.

### Professional Corporation (Professional Association)

A type of corporation common among professionals that provides most of the benefits of incorporation but does not relieve the participants of malpractice liability.

Although the three basic types of organization — proprietorships, partnerships, and corporations — dominate the business scene, several hybrid forms are gaining popularity. For example, there are some specialized types of partnerships that have somewhat different characteristics than the “plain vanilla” kind. First, it is possible to limit the liabilities of some of the partners by establishing a **limited partnership**, wherein certain partners are designated *general partners* and others *limited partners*. In a limited partnership, the limited partners are liable only for the amount of their investment in the partnership, while the general partners have unlimited liability. However, the limited partners typically have no control, which rests solely with the general partners, and their returns are likewise limited. Limited partnerships are common in real estate, oil, and equipment leasing ventures. However, they are not widely used in general business situations because no one partner is usually willing to be the general partner and thus accept the majority of the business’s risk, while would-be limited partners are unwilling to give up all control.

The **limited liability partnership (LLP)**, sometimes called a **limited liability company (LLC)**, is a relatively new type of partnership that is now permitted in many states. In both regular and limited partnerships, at least one partner is liable for the debts of the partnership. However, in an LLP, all partners enjoy limited liability with regard to the business’s liabilities, and, in that regard, they are similar to shareholders in a corporation. In effect, the LLP form of organization combines the limited liability advantage of a corporation with the tax advantages of a partnership. Of course, those who do business with an LLP as opposed to a regular partnership are aware of the situation, which increases the risk faced by lenders, customers, and others who deal with the LLP.

There are also several different types of corporations. One type that is common among professionals such as doctors, lawyers, and accountants is the **professional corporation (PC)**, or in some states, the **professional association (PA)**. All 50 states have statutes that prescribe the requirements for such corporations, which provide most of the benefits of incorporation but do not relieve the participants of professional (malpractice) liability. Indeed, the primary motivation behind the professional corporation was to provide a way for groups of professionals to incorporate and thus avoid certain types of unlimited liability, yet still be held responsible for professional liability.

Finally, note that if certain requirements are met, particularly with regard to size and number of stockholders, one (or more) individual can establish a corporation but elect to be taxed as if the business were a proprietorship or partnership. Such firms, which differ not in organizational form but only in how

their owners are taxed, are called *S corporations*. Although S corporations are similar in many ways to limited liability partnerships, LLPs frequently offer more flexibility and benefits to their owners — so many that large numbers of S corporation businesses are converting to this relatively new organizational form.

### SELF-TEST QUESTIONS

What are the key differences between sole proprietorships, partnerships, and corporations?

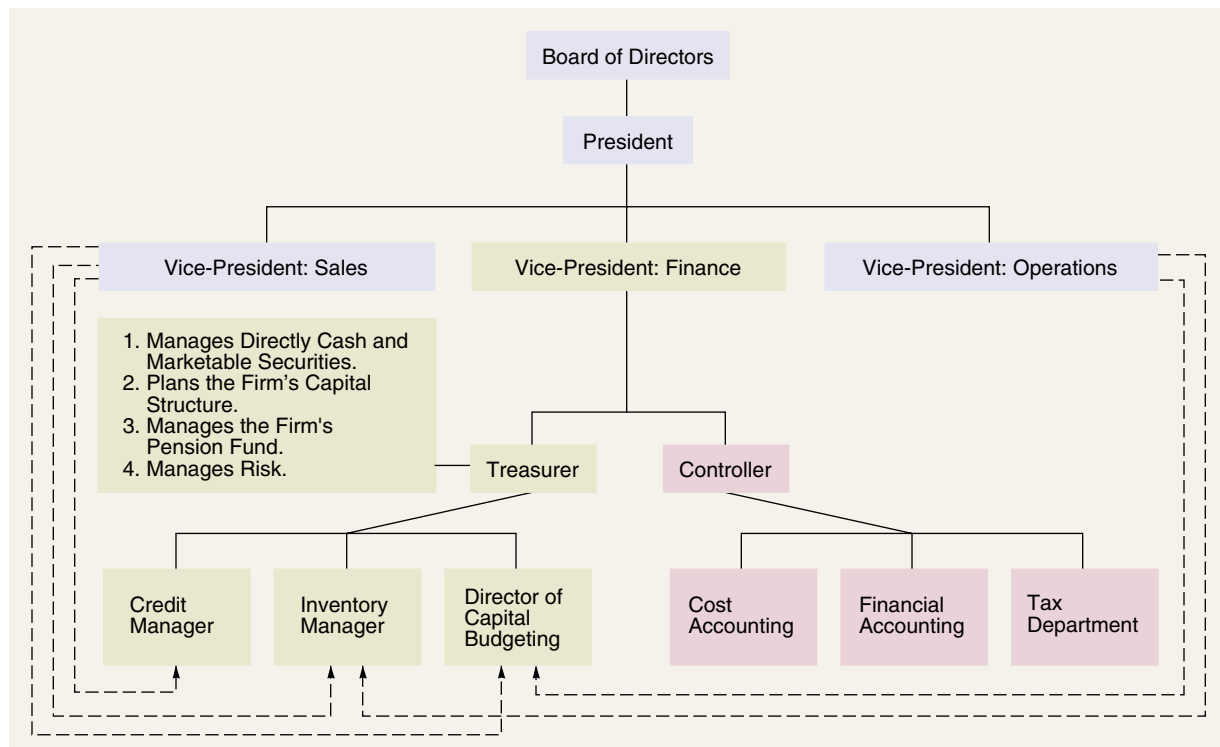
Why will the value of any business other than a very small one probably be maximized if it is organized as a corporation?

## FINANCE IN THE ORGANIZATIONAL STRUCTURE OF THE FIRM

Organizational structures vary from firm to firm, but Figure 1-1 presents a fairly typical picture of the role of finance within a corporation. The chief financial officer (CFO) generally has the title of vice-president: finance, and he

FIGURE 1-1

Role of Finance in a Typical Business Organization





or she reports to the president. The financial vice-president's key subordinates are the treasurer and the controller. In most firms the treasurer has direct responsibility for managing the firm's cash and marketable securities, for planning its capital structure, for selling stocks and bonds to raise capital, for overseeing the corporate pension plan, and for managing risk. The treasurer also supervises the credit manager, the inventory manager, and the director of capital budgeting (who analyzes decisions related to investments in fixed assets). The controller is typically responsible for the activities of the accounting and tax departments.

#### SELF-TEST QUESTION

Identify the two primary subordinates who report to the firm's chief financial officer, and indicate the primary responsibilities of each.

## THE GOALS OF THE CORPORATION

### Stockholder Wealth Maximization

The primary goal for management decisions; considers the risk and timing associated with expected earnings per share in order to maximize the price of the firm's common stock.

Shareholders are the owners of a corporation, and they purchase stocks because they are looking for a financial return. In most cases, shareholders elect directors, who then hire managers to run the corporation on a day-to-day basis. Since managers are working on behalf of shareholders, it follows that they should pursue policies that enhance shareholder value. Consequently, throughout this book we operate on the assumption that management's primary goal is **stockholder wealth maximization**, which translates into *maximizing the price of the firm's common stock*. Firms do, of course, have other objectives—in particular, the managers who make the actual decisions are interested in their own personal satisfaction, in their employees' welfare, and in the good of the community and of society at large. Still, for the reasons set forth in the following sections, *stock price maximization is the most important goal for most corporations*.

### MANAGERIAL INCENTIVES TO MAXIMIZE SHAREHOLDER WEALTH

Stockholders own the firm and elect the board of directors, which then selects the management team. Management, in turn, is supposed to operate in the best interests of the stockholders. We know, however, that because the stock of most large firms is widely held, managers of large corporations have a great deal of autonomy. This being the case, might not managers pursue goals other than stock price maximization? For example, some have argued that the managers of large, well-entrenched corporations could work just hard enough to keep stockholder returns at a "reasonable" level and then devote the remainder of their effort and resources to public service activities, to employee benefits, to higher executive salaries, or to golf.

It is almost impossible to determine whether a particular management team is trying to maximize shareholder wealth or is merely attempting to keep

stockholders satisfied while managers pursue other goals. For example, how can we tell whether employee or community benefit programs are in the long-run best interests of the stockholders? Similarly, are huge executive salaries really necessary to attract and retain excellent managers, or are they just another example of managers taking advantage of stockholders?

It is impossible to give definitive answers to these questions. However, we do know that the managers of a firm operating in a competitive market will be forced to undertake actions that are reasonably consistent with shareholder wealth maximization. If they depart from that goal, they run the risk of being removed from their jobs, either by the firm's board of directors or by outside forces. We will have more to say about this in a later section.

## SOCIAL RESPONSIBILITY

### Social Responsibility

The concept that businesses should be actively concerned with the welfare of society at large.

### Normal Profits and Rates of Return

Those profits and rates of return that are close to the average for all firms and are just sufficient to attract capital.

Another issue that deserves consideration is **social responsibility**: Should businesses operate strictly in their stockholders' best interests, or are firms also responsible for the welfare of their employees, customers, and the communities in which they operate? Certainly firms have an ethical responsibility to provide a safe working environment, to avoid polluting the air or water, and to produce safe products. However, socially responsible actions have costs, and not all businesses would voluntarily incur all such costs. If some firms act in a socially responsible manner while others do not, then the socially responsible firms will be at a disadvantage in attracting capital. To illustrate, suppose all firms in a given industry have close to **"normal" profits and rates of return on investment**, that is, close to the average for all firms and just sufficient to attract capital. If one company attempts to exercise social responsibility, it will have to raise prices to cover the added costs. If other firms in its industry do not follow suit, their costs and prices will be lower. The socially responsible firm will not be able to compete, and it will be forced to abandon its efforts. Thus, any voluntary socially responsible acts that raise costs will be difficult, if not impossible, in industries that are subject to keen competition.

What about oligopolistic firms with profits above normal levels — cannot such firms devote resources to social projects? Undoubtedly they can, and many large, successful firms do engage in community projects, employee benefit programs, and the like to a greater degree than would appear to be called for by pure profit or wealth maximization goals.<sup>4</sup> Furthermore, many such firms contribute large sums to charities. Still, publicly owned firms are constrained by capital market forces. To illustrate, suppose a saver who has funds to invest is considering two alternative firms. One devotes a substantial part of its resources to social actions, while the other concentrates on profits and stock prices. Many investors would shun the socially oriented firm, thus putting it at a disadvantage in the capital market. After all, why should the stockholders of one corporation subsidize society to a greater extent than those of other businesses? For this reason, even highly profitable firms (unless they are closely

<sup>4</sup> Even firms like these often find it necessary to justify such projects at stockholder meetings by stating that these programs will contribute to long-run profit maximization.

held rather than publicly owned) are generally constrained against taking unilateral cost-increasing social actions.

Does all this mean that firms should not exercise social responsibility? Not at all. But it does mean that most significant cost-increasing actions will have to be put on a *mandatory* rather than a voluntary basis to ensure that the burden falls uniformly on all businesses. Thus, such social benefit programs as fair hiring practices, minority training, product safety, pollution abatement, and antitrust actions are most likely to be effective if realistic rules are established initially and then enforced by government agencies. Of course, it is critical that industry and government cooperate in establishing the rules of corporate behavior, and that the costs as well as the benefits of such actions be estimated accurately and then taken into account.

In spite of the fact that many socially responsible actions must be mandated by government, in recent years numerous firms have voluntarily taken such actions, especially in the area of environmental protection, because they helped sales. For example, many detergent manufacturers now use recycled paper for their containers, and food companies are packaging more and more products in materials that consumers can recycle or that are biodegradable. To illustrate, McDonald's replaced its styrofoam boxes, which take years to break down in landfills, with paper wrappers that are less bulky and decompose more rapidly. Some companies, such as The Body Shop and Ben & Jerry's Ice Cream, go to great lengths to be socially responsible. According to the president of The Body Shop, the role of business is to promote the public good, not just the good of the firm's shareholders. Furthermore, she argues that it is impossible to separate business from social responsibility. For some firms, socially responsible actions may not de facto be costly—the companies heavily advertise their actions, and many consumers prefer to buy from socially responsible companies rather than from those that shun social responsibility.



Go to <http://www.the-body-shop.com/usa/aboutus/values.html> to see the corporate values The Body Shop embraces.

## STOCK PRICE MAXIMIZATION AND SOCIAL WELFARE

If a firm attempts to maximize its stock price, is this good or bad for society? In general, it is good. Aside from such illegal actions as attempting to form monopolies, violating safety codes, and failing to meet pollution control requirements, *the same actions that maximize stock prices also benefit society*. First, note that stock price maximization requires efficient, low-cost businesses that produce high-quality goods and services at the lowest possible cost. Second, stock price maximization requires the development of products and services that consumers want and need, so the profit motive leads to new technology, to new products, and to new jobs. Finally, stock price maximization necessitates efficient and courteous service, adequate stocks of merchandise, and well-located business establishments—these are the factors that lead to sales, which in turn are necessary for profits. Therefore, most actions that help a firm increase the price of its stock also benefit society at large. This is why profit-motivated, free-enterprise economies have been so much more successful than socialistic and communistic economic systems. Since financial management plays a crucial role in the operations of successful firms, and since successful firms are absolutely necessary for a healthy,



## LEVI STRAUSS TRIES TO BLEND PROFITS WITH SOCIAL ACTIVISM



**L**evi Strauss & Company has been around for nearly 150 years. Well known for its Dockers and 501 jeans, the firm has also been recognized for its commitment to social values. Indeed, when Levi Strauss first issued stock to the public in 1971, it took the unusual step of warning potential investors that the company's dedication to social activism was so deep that it might compromise corporate profits.

Levi Strauss' words and actions continually reflect this strong devotion to social causes. In 1987, CEO Bob Haas developed the company's Mission and Aspiration Statement, which highlighted an emphasis on diversity, teamwork, and integrity. A few years later, the company created a 10-day course for employees that focused on ethical decision making. As one of the course developers put it: "It was about asking, 'How do I find meaning in the workplace?' It was about seeing that work is noble, that we're more than getting pants out the door."

Moreover, the company's philosophy had a profound effect on its business decisions. For example, it withdrew its investments in China to protest human rights violations. This action contrasted sharply with those of most other companies, which continued making investments in China in order to enhance shareholder value.

Levi Strauss has received considerable praise and numerous awards for its vision, and until recently, the company was able to practice social activism while maintaining strong profitability. However, the company's profitability has fallen recently, causing many to argue that it must rethink its vision if it is to survive. In the face of huge losses, it is not surprising that tension has arisen between the conflicting goals of social activism and profitability. Peter Jacobi, who recently retired as president of Levi Strauss, summarized this tension when he was quoted in a recent *Fortune* magazine article:

The problem is [that] some people thought the values were an end in themselves. You have some people who say, "Our objective is to be the most enlightened work environment in the world." And then you have others that say, "Our objective is to make a lot of money." The value-based [socially oriented] people look at the commercial folks as heathens; the commercial people look at the values people as wusses getting in the way.

Despite these concerns, Levi Strauss' recent problems may not be solely or even predominantly attributed to its social activism. The company has been slow to respond to fashion trends and to changing distribution system technology. Despite large investments, the company is still way behind its competitors in managing inventory and getting product to market.

To be sure, all is not completely bleak for Levi Strauss. The company still has a very strong brand name, and it still continues to generate a lot of cash. For example, in 1998, the company generated cash flow of \$1.1 billion, more than either Gap or Nike.

One factor that makes Levi Strauss unique is its ownership structure. The Haas family has long controlled the company. Moreover, after completing a leveraged buyout in 1996, the company is once again privately held. As part of the buyout agreement, investors who wanted to maintain their ownership stake had to grant complete power for 15 years to four family members led by Bob Haas. This ownership structure has enabled Levi Strauss to pursue its social objectives without facing the types of pressure that a more shareholder-oriented company would face. Arguably, however, the lack of external pressure helps explain why the company has been so slow to adapt to changing technology and market conditions.

SOURCE: "How Levi's Trashed a Great American Brand," *Fortune*, April 12, 1999, 82-90.



Go to [http://www.levistrauss.com/index\\_about.html](http://www.levistrauss.com/index_about.html) to take a look at Levi Strauss & Co.'s vision statement, history, other general information about the company, and its ideals.

productive economy, it is easy to see why finance is important from a social welfare standpoint.<sup>5</sup>

<sup>5</sup> People sometimes argue that firms, in their efforts to raise profits and stock prices, increase product prices and gouge the public. In a reasonably competitive economy, which we have, prices are constrained by competition and consumer resistance. If a firm raises its prices beyond reasonable levels, it will simply lose its market share. Even giant firms such as General Motors lose business to the Japanese and German automakers, as well as to Ford, if they set prices above levels necessary to cover production costs plus a "normal" profit. Of course, firms *want* to earn more, and they constantly try to cut costs, to develop new products, and so on, and thereby to earn above-normal profits. Note, though, that if they are indeed successful and do earn above-normal profits, those very profits will attract competition, which will eventually drive prices down, so again the main long-term beneficiary is the consumer.

### SELF-TEST QUESTIONS

What is management's primary goal?

What actions could be taken to remove a management team if it departs from the goal of maximizing shareholder wealth?

What would happen if one firm attempted to exercise costly socially responsible programs but its competitors did not follow suit?

How does the goal of stock price maximization benefit society at large?

## BUSINESS ETHICS

### Business Ethics

A company's attitude and conduct toward its employees, customers, community, and stockholders.

The word *ethics* is defined in Webster's dictionary as "standards of conduct or moral behavior." **Business ethics** can be thought of as a company's attitude and conduct toward its employees, customers, community, and stockholders. High standards of ethical behavior demand that a firm treat each party that it deals with in a fair and honest manner. A firm's commitment to business ethics can be measured by the tendency of the firm and its employees to adhere to laws and regulations relating to such factors as product safety and quality, fair employment practices, fair marketing and selling practices, the use of confidential information for personal gain, community involvement, bribery, and illegal payments to obtain business.

Most firms today have in place strong codes of ethical behavior, and they also conduct training programs designed to ensure that employees understand the correct behavior in different business situations. However, it is imperative that top management—the chairman, president, and vice-presidents—be openly committed to ethical behavior, and that they communicate this commitment through their own personal actions as well as through company policies, directives, and punishment/reward systems.

When conflicts arise between profits and ethics, sometimes the ethical considerations are so strong that they clearly dominate. However, in many cases the choice between ethics and profits is not clear cut. For example, suppose Norfolk Southern's managers know that its coal trains are polluting the air along its routes, but the amount of pollution is within legal limits and preventive actions would be costly. Are the managers ethically bound to reduce pollution? Similarly, suppose a medical products company's own research indicates that one of its new products may cause problems. However, the evidence is relatively weak, other evidence regarding benefits to patients is strong, and independent government tests show no adverse effects. Should the company make the potential problem known to the public? If it does release the negative (but questionable) information, this will hurt sales and profits, and possibly keep some patients who would benefit from the new product from using it. There are no obvious answers to questions such as these, but companies must deal with them on a regular basis, and a failure to handle the situation properly can lead to huge product liability suits, which could push a firm into bankruptcy.

### SELF-TEST QUESTIONS

How would you define “business ethics”?

Is “being ethical” good for profits in the long run? In the short run?

## AGENCY RELATIONSHIPS

It has long been recognized that managers may have personal goals that compete with shareholder wealth maximization. Managers are empowered by the owners of the firm — the shareholders — to make decisions, and that creates a potential conflict of interest known as *agency theory*.

An *agency relationship* arises whenever one or more individuals, called *principals*, hire another individual or organization, called an *agent*, to perform some service and delegate decision-making authority to that agent. In financial management, the primary agency relationships are those between (1) stockholders and managers and (2) managers and debtholders.<sup>6</sup>

### STOCKHOLDERS VERSUS MANAGERS

#### Agency Problem

A potential conflict of interests between the agent (manager) and (1) the outside stockholders or (2) the creditors (debtholders).

A potential **agency problem** arises whenever the manager of a firm owns less than 100 percent of the firm’s common stock. If the firm is a proprietorship managed by its owner, the owner-manager will presumably operate so as to maximize his or her own welfare, with welfare measured in the form of increased personal wealth, more leisure, or perquisites.<sup>7</sup> However, if the owner-manager incorporates and then sells some of the stock to outsiders, a potential conflict of interests immediately arises. Now the owner-manager may decide to lead a more relaxed lifestyle and not work as strenuously to maximize shareholder wealth, because less of this wealth will accrue to him or her. Also, the owner-manager may decide to consume more perquisites, because some of those costs will be borne by the outside shareholders. In essence, the fact that the owner-manager will neither gain all the benefits of the wealth created by his or her efforts nor bear all of the costs of perquisites will increase the incentive to take actions that are not in the best interests of other shareholders.

In most large corporations, potential agency conflicts are important, because large firms’ managers generally own only a small percentage of the stock. In this situation, shareholder wealth maximization could take a back seat to any number of conflicting managerial goals. For example, people have argued that some managers’ primary goal seems to be to maximize the size of their firms. By creating a large, rapidly growing firm, managers (1) increase their job security, because a hostile takeover is less likely; (2) increase their

<sup>6</sup> The classic work on the application of agency theory to financial management was by Michael C. Jensen and William H. Meckling, “Theory of the Firm, Managerial Behavior, Agency Costs, and Ownership Structure,” *Journal of Financial Economics*, October 1976, 305–360.

<sup>7</sup> *Perquisites* are fringe benefits such as luxurious offices, executive assistants, expense accounts, limousines, corporate jets, generous retirement plans, and the like.





## ARE CEOs OVERPAID?

**B**usiness Week's annual survey of executive compensation recently reported that the average large-company CEO made \$12.4 million in 1999, up from \$2 million in 1990. This dramatic increase can be attributed to the fact that CEOs increasingly receive most of their compensation in the form of stock and stock options, which skyrocketed in value because of a strong stock market in the 1990s.

Heading the pack on the *Business Week* list was Computer Associates International Inc.'s Charles Wang, who in 1999 made \$655.4 million, mostly from stock options. Rounding out the top five were L. Dennis Kozlowski of Tyco International (\$170.0 million), David Pottruck of Charles Schwab (\$127.9 million), John Chambers of Cisco Systems (\$121.7 million), and Stephen Case of America Online (\$117.0 million). It is worth noting that these payouts occurred in large part because the executives exercised stock options granted in earlier years. Thus, their 1999 reported compensation overstated their average compensation over time. More importantly, note that their stock options provided these CEOs with an incentive to raise their companies' stock prices. Indeed, most observers believe there is a strong

causal relationship between CEO compensation procedures and stock price performance.

However, some critics argue that although performance incentives are entirely appropriate as a method of compensation, the overall level of CEO compensation is just too high. The critics ask such questions as these: Would these CEOs have been unwilling to take their jobs if they had been offered only half as many stock options? Would they have put forth less effort, and would their firms' stock prices have not gone up as much? It is hard to say. Other critics lament that the exercise of stock options has dramatically increased the compensation of not only truly excellent CEOs, but it has also dramatically increased the compensation of some pretty average CEOs, who were lucky enough to have had the job during a stock market boom that raised the stock prices of even companies with rather poor performance. Another problem is that the huge CEO salaries are widening the gap between top executives and middle manager salaries. This is leading to employee discontent and a decrease in employee morale and loyalty.

own power, status, and salaries; and (3) create more opportunities for their lower- and middle-level managers. Furthermore, since the managers of most large firms own only a small percentage of the stock, it has been argued that they have a voracious appetite for salaries and perquisites, and that they generously contribute corporate dollars to their favorite charities because they get the glory but outside stockholders bear the cost.<sup>8</sup>

Managers can be encouraged to act in stockholders' best interests through incentives that reward them for good performance but punish them for poor performance. Some specific mechanisms used to motivate managers to act in shareholders' best interests include (1) managerial compensation, (2) direct intervention by shareholders, (3) the threat of firing, and (4) the threat of takeover.

- 1. Managerial compensation.** Managers obviously must be compensated, and the structure of the compensation package can and should be designed to meet two primary objectives: (a) to attract and retain able managers and (b) to align managers' actions as closely as possible with the

<sup>8</sup> An excellent article that reviews the effectiveness of various mechanisms for aligning managerial and shareholder interests is Andrei Shleifer and Robert Vishny, "A Survey of Corporate Governance," *Journal of Finance*, June 1997, 737–783. Another paper that looks at managerial stockholding worldwide is Rafael La Porta, Florencio Lopez-De-Silanes, and Andrei Shleifer, "Corporate Ownership Around the World," *Journal of Finance*, April 1999, 471–517.

### Performance Shares

Stock that is awarded to executives on the basis of the company's performance.

### Executive Stock Option

An option to buy stock at a stated price within a specified time period that is granted to an executive as part of his or her compensation package.

interests of stockholders, who are primarily interested in stock price maximization. Different companies follow different compensation practices, but a typical senior executive's compensation is structured in three parts: (a) a specified annual salary, which is necessary to meet living expenses; (b) a bonus paid at the end of the year, which depends on the company's profitability during the year; and (c) options to buy stock, or actual shares of stock, which reward the executive for long-term performance.

Managers are more likely to focus on maximizing stock prices if they are themselves large shareholders. Often, companies grant senior managers **performance shares**, where the executive receives a number of shares dependent upon the company's actual performance and the executive's continued service. For example, in 1991 Coca-Cola granted one million shares of stock worth \$81 million to its CEO at the time, the late Roberto Goizueta. The award was based on Coke's performance under Goizueta's leadership, but it also stipulated that Goizueta would receive the shares only if he stayed with the company for the remainder of his career.

Most large corporations also provide **executive stock options**, which allow managers to purchase stock at some future time at a given price. Obviously, a manager who has an option to buy, say, 10,000 shares of stock at a price of \$10 during the next 5 years will have an incentive to help raise the stock's value to an amount greater than \$10.

The number of performance shares or options awarded is generally based on objective criteria. Years ago, the primary criteria were accounting measures such as earnings per share (EPS) and return on equity (ROE). Today, though, the focus is more on the market value of the firm's shares or, better yet, on the performance of its shares relative to other stocks in its industry. Various procedures are used to structure compensation programs, and good programs are relatively complicated. Still, it has been thoroughly established that a well-designed compensation program can do wonders to improve a company's financial performance.

**2. Direct intervention by shareholders.** Years ago most stock was owned by individuals, but today the majority is owned by institutional investors such as insurance companies, pension funds, and mutual funds. Therefore, the institutional money managers have the clout, if they choose to use it, to exercise considerable influence over most firms' operations. First, they can talk with a firm's management and make suggestions regarding how the business should be run. In effect, institutional investors act as lobbyists for the body of stockholders. Second, any shareholder who has owned at least \$2,000 of a company's stock for one year can sponsor a proposal that must be voted on at the annual stockholders' meeting, even if the proposal is opposed by management. Although shareholder-sponsored proposals are nonbinding and are limited to issues outside of day-to-day operations, the results of such votes are clearly heard by top management.<sup>9</sup>

**3. The threat of firing.** Until recently, the probability of a large firm's management being ousted by its stockholders was so remote that it posed

<sup>9</sup> A recent article that provides a detailed investigation of shareholder proposals during 1997 is Cynthia J. Campbell, Stuart L. Gillan, and Cathy M. Niden, "Current Perspectives on Shareholder Proposals: Lessons from the 1997 Proxy Season," *Financial Management*, Spring 1999, 89-98.

little threat. This situation existed because the shares of most firms were so widely distributed, and management's control over the voting mechanism was so strong, that it was almost impossible for dissident stockholders to get the votes needed to overthrow a management team. However, as noted above, that situation is changing.

Consider the case of Eckhard Pfeiffer, who recently lost his job as CEO of Compaq Computer Corporation. Under Pfeiffer's leadership, Compaq became the world's largest computer manufacturer. However, the company has struggled in recent years to maintain profitability in a time of rapidly falling computer prices. Soon after Compaq announced another sub-par quarterly earnings report for the first quarter of 1999, the board of directors told Pfeiffer that they wanted new leadership. Pfeiffer resigned the following day.

Indeed, in recent years the top executives at Mattel, Coca-Cola, Lucent, Gillette, Procter & Gamble, Maytag, and Xerox have resigned or been fired after serving as CEO only a short period of time. Most of these departures were no doubt due to their companies' poor performance.

### Hostile Takeover

The acquisition of a company over the opposition of its management.

4. **The threat of takeovers.** **Hostile takeovers** (when management does not want the firm to be taken over) are most likely to occur when a firm's stock is undervalued relative to its potential because of poor management. In a hostile takeover, the managers of the acquired firm are generally fired, and any who manage to stay on lose status and authority. Thus, managers have a strong incentive to take actions designed to maximize stock prices. In the words of one company president, "If you want to keep your job, don't let your stock sell at a bargain price."

## STOCKHOLDERS (THROUGH MANAGERS) VERSUS CREDITORS

In addition to conflicts between stockholders and managers, there can also be conflicts between creditors and stockholders. Creditors have a claim on part of the firm's earnings stream for payment of interest and principal on the debt, and they have a claim on the firm's assets in the event of bankruptcy. However, stockholders have control (through the managers) of decisions that affect the profitability and risk of the firm. Creditors lend funds at rates that are based on (1) the riskiness of the firm's existing assets, (2) expectations concerning the riskiness of future asset additions, (3) the firm's existing capital structure (that is, the amount of debt financing used), and (4) expectations concerning future capital structure decisions. These are the primary determinants of the riskiness of a firm's cash flows, hence the safety of its debt issues.

Now suppose stockholders, acting through management, cause a firm to take on a large new project that is far riskier than was anticipated by the creditors. This increased risk will cause the required rate of return on the firm's debt to increase, and that will cause the value of the outstanding debt to fall. If the risky project is successful, all the benefits go to the stockholders, because creditors' returns are fixed at the old, low-risk rate. However, if the project is unsuccessful, the bondholders may have to share in the losses. From the stock-

holders' point of view, this amounts to a game of "heads I win, tails you lose," which is obviously not good for the creditors. Similarly, suppose its managers borrow additional funds and use the proceeds to repurchase some of the firm's outstanding stock in an effort to "leverage up" stockholders' return on equity. The value of the debt will probably decrease, because more debt will have a claim against the firm's cash flows and assets. In both the riskier asset and the increased leverage situations, stockholders tend to gain at the expense of creditors.

Can and should stockholders, through their managers/agents, try to expropriate wealth from creditors? In general, the answer is no, for unethical behavior is penalized in the business world. First, creditors attempt to protect themselves against stockholders by placing restrictive covenants in debt agreements. Moreover, if creditors perceive that a firm's managers are trying to take advantage of them, they will either refuse to deal further with the firm or else will charge a higher-than-normal interest rate to compensate for the risk of possible exploitation. Thus, firms that deal unfairly with creditors either lose access to the debt markets or are saddled with high interest rates and restrictive covenants, all of which are detrimental to shareholders.

In view of these constraints, it follows that to best serve their shareholders in the long run, managers must play fairly with creditors. As agents of both shareholders and creditors, managers must act in a manner that is fairly balanced between the interests of the two classes of security holders. Similarly, because of other constraints and sanctions, management actions that would expropriate wealth from any of the firm's other *stakeholders*, including its employees, customers, suppliers, and community, will ultimately be to the detriment of its shareholders. In our society, stock price maximization requires fair treatment for all parties whose economic positions are affected by managerial decisions.

### SELF-TEST QUESTIONS

What are agency costs, and who bears them?

What are some mechanisms that encourage managers to act in the best interests of stockholders? To not take advantage of bondholders?

Why should managers not take actions that are unfair to any of the firm's stakeholders?

## MANAGERIAL ACTIONS TO MAXIMIZE SHAREHOLDER WEALTH

What types of actions can managers take to maximize the price of a firm's stock? To answer this question, we first need to ask, "What factors determine the price of a company's stock?" While we will address this issue in detail in

Chapter 9, we can lay out three basic facts here. (1) Any financial asset, including a company's stock, is valuable only to the extent that the asset generates cash flows. (2) The timing of the cash flows matters — cash received sooner is better, because it can be reinvested to produce additional income. (3) Investors are generally averse to risk, so all else equal, they will pay more for a stock whose cash flows are relatively certain than for one with relatively risky cash flows. Because of these three factors, managers can enhance their firms' value (and the stock price) by increasing expected cash flows, speeding them up, and reducing their riskiness.

Within the firm, managers make investment decisions regarding the types of products or services produced, as well as the way goods and services are produced and delivered. Also, managers must decide *how to finance the firm* — what mix of debt and equity should be used, and what specific types of debt and equity securities should be issued? In addition, the financial manager must decide what percentage of current earnings to pay out as dividends rather than retain and reinvest; this is called the **dividend policy decision**. Each of these investment and financing decisions is likely to affect the level, timing, and riskiness of the firm's cash flows, and therefore the price of its stock. Naturally, managers should make investment and financing decisions designed to maximize the firm's stock price.

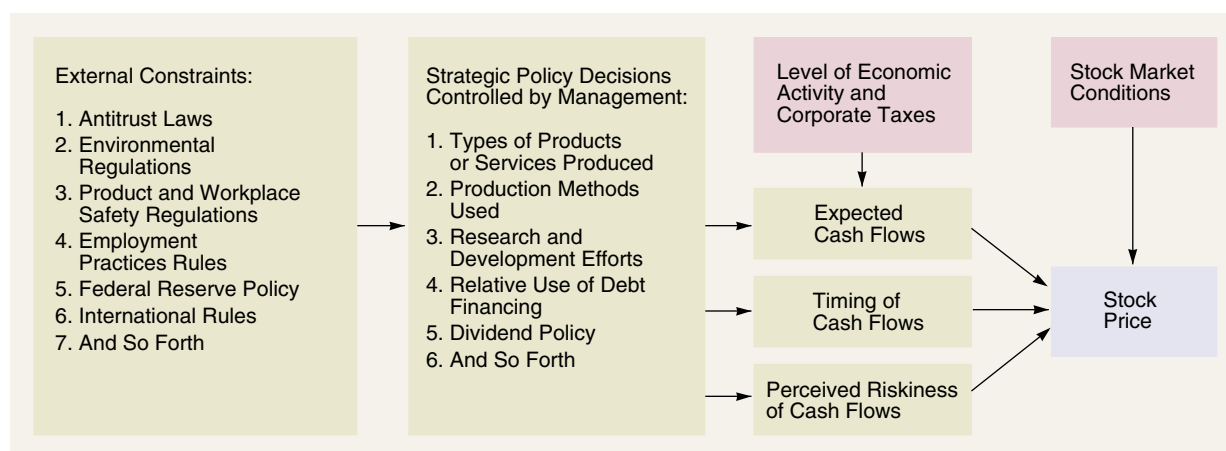
Although managerial actions affect the value of a firm's stock, stock prices are also affected by such external factors as legal constraints, the general level of economic activity, tax laws, interest rates, and conditions in the stock market. Figure 1-2 diagrams these general relationships. Working within the set of external constraints shown in the box at the extreme left, management makes a set of long-run strategic policy decisions that chart a future course for the firm. These policy decisions, along with the general level of economic activity and the level of corporate income taxes, influence the firm's expected cash flows, their timing, their eventual payment to stockholders as dividends, and their

### Dividend Policy Decision

The decision as to how much of current earnings to pay out as dividends rather than retain for reinvestment in the firm.

FIGURE 1 - 2

Summary of Major Factors Affecting Stock Prices



riskiness. These factors all affect the price of the stock, but so does another factor, conditions in the stock market as a whole.

#### SELF-TEST QUESTION

Identify some factors beyond a firm's control that influence its stock price.

### DOES IT MAKE SENSE TO TRY TO MAXIMIZE EARNINGS PER SHARE?

#### Profit Maximization

The maximization of the firm's net income.

#### Earnings Per Share (EPS)

Net income divided by the number of shares of common stock outstanding.

In arguing that managers should take steps to maximize the firm's stock price, we have said nothing about the traditional objective, **profit maximization**, or the maximization of **earnings per share (EPS)**. However, while a growing number of analysts rely on cash flow projections to assess performance, at least as much attention is still paid to accounting measures, especially EPS. The traditional accounting performance measures are appealing because (1) they are easy to use and understand; (2) they are calculated on the basis of more or less standardized accounting practices, which reflect the accounting profession's best efforts to measure financial performance on a consistent basis both across firms and over time; and (3) net income is supposed to be reflective of the firm's potential to produce cash flows over time.

Generally, there is a high correlation between EPS, cash flow, and stock price, and all of them generally rise if a firm's sales rise. Nevertheless, as we will see in subsequent chapters, stock prices depend not just on today's earnings and cash flows—future cash flows and the riskiness of the future earnings stream also affect stock prices. Some actions may increase earnings and yet reduce stock price, while other actions may boost stock price but reduce earnings. For example, consider a company that undertakes large expenditures today that are designed to improve future performance. These expenditures will likely reduce earnings per share, yet the stock market may respond positively if it believes that these expenditures will significantly enhance future earnings. By contrast, a company that undertakes actions today to enhance its earnings may see a drop in its stock price, if the market believes that these actions compromise future earnings and/or dramatically increase the firm's risk.

Even though the level and riskiness of current and future cash flows ultimately determine stockholder value, financial managers cannot ignore the effects of their decisions on reported EPS, because earnings announcements send messages to investors. Say, for example, a manager makes a decision that will ultimately enhance cash flows and stock price, yet the short-run effect is to lower this year's profitability and EPS. Such a decision might be a change in inventory accounting policy that increases reported expenses but also increases cash flow because it reduces current taxes. In this case, it makes sense for the manager to adopt the policy because it generates additional cash, even though it reduces reported profits. Note, though, that management must communicate the reason for the earnings decline, for otherwise the company's stock price will probably decline after the lower earnings are reported.



### SELF-TEST QUESTIONS

Is profit maximization an appropriate goal for financial managers?

Should financial managers concentrate strictly on cash flow and ignore the impact of their decisions on EPS?

## ORGANIZATION OF THE BOOK

The primary goal of all managers is to maximize the value of the firm. To achieve this goal, all managers must have a general understanding of how businesses are organized, how financial markets operate, how interest rates are determined, how the tax system operates, and how accounting data are used to evaluate a business's performance. In addition, managers must have a good understanding of such fundamental concepts as the time value of money, risk measurement, asset valuation, and evaluation of specific investment opportunities. This background information is essential for *anyone* involved with the kinds of decisions that affect the value of a firm's securities.

The organization of this book reflects these considerations, so the five chapters of Part I present some important background material. Chapter 1 discusses the goals of the firm and the "philosophy" of financial management. Chapter 2 describes the key financial statements, discusses what they are designed to do, and then explains how our tax system affects earnings, cash flows, stock prices, and managerial decisions. Chapter 3 shows how financial statements are analyzed, while Chapter 4 develops techniques for forecasting financial statements. Chapter 5 discusses how financial markets operate and how interest rates are determined.

Part II considers two of the most fundamental concepts in financial management. First, Chapter 6 explains how risk is measured and how it affects security prices and rates of return. Next, Chapter 7 discusses the time value of money and its effects on asset values and rates of return.

Part III covers the valuation of stocks and bonds. Chapter 8 focuses on bonds, and Chapter 9 considers stocks. Both chapters describe the relevant institutional details, then explain how risk and time value jointly determine stock and bond prices.

Part IV, "Investing in Long-Term Assets: Capital Budgeting," applies the concepts covered in earlier chapters to decisions related to fixed asset investments. First, Chapter 10 explains how to measure the cost of the funds used to acquire assets, or the cost of capital. Next, Chapter 11 shows how this information is used to evaluate potential capital investments by answering this question: Can we expect a project to provide a higher rate of return than the cost of the funds used to finance it? Only if the expected return exceeds the cost of capital will accepting a project increase stockholders' wealth. Chapter 12 goes into more detail on capital budgeting decisions, looking at relevant cash flows, new (expansion) projects, and project risk analysis.

Part V discusses how firms should finance their long-term assets. First, Chapter 13 examines capital structure theory, or the issue of how much debt

versus equity the firm should use. Then, Chapter 14 considers dividend policy, or the decision to retain earnings versus paying them out as dividends.

In Part VI, our focus shifts from long-term, strategic decisions to short-term, day-to-day operating decisions and multinational financial management. In Chapter 15, we see how cash, inventories, and accounts receivable are managed and the best way of financing these current assets. Chapter 16 discusses multinational financial management issues such as exchange rates, exchange rate risk, and political risk.

It is worth noting that some instructors may choose to cover the chapters in a different sequence from their order in the book. The chapters are written to a large extent in a modular, self-contained manner, so such reordering should present no major difficulties.

## TYING IT ALL TOGETHER

This chapter has provided an overview of financial management. The key concepts covered are listed below.

- Finance consists of three interrelated areas: (1) **money and capital markets**, (2) **investments**, and (3) **financial management**.
- In recent years the two most important trends in finance have been the **increased globalization of business** and the growing use of **computers and information technology**. These trends are likely to continue in the future.
- The **financial staff's** task is to **obtain and use funds** so as to **maximize the value of the firm**.
- The three main forms of business organization are the **sole proprietorship**, the **partnership**, and the **corporation**.
- Although each form of organization offers advantages and disadvantages, **most business is conducted by corporations because this organizational form maximizes larger firms' values**.
- The primary goal of management should be to **maximize stockholders' wealth**, and this means **maximizing the firm's stock price**. Note, though, that actions that maximize stock prices also increase social welfare.
- An **agency problem** is a potential conflict of interests that can arise between a principal and an agent. Two important agency relationships are (1) those between the owners of the firm and its management and (2) those between the managers, acting for stockholders, and the debtholders.
- There are a number of ways to **motivate managers to act in the best interests of stockholders**, including (1) properly structured **managerial compensation**, (2) **direct intervention by stockholders**, (3) the **threat of firing**, and (4) the **threat of takeovers**.
- The **price of a firm's stock** depends on the **cash flows paid to shareholders**, the **timing of the cash flows**, and their **riskiness**. The level and

riskiness of cash flows are affected by the **financial environment** as well as by **investment**, **financing**, and **dividend policy decisions** made by financial managers.

## QUESTIONS

- 1-1 What are the three principal forms of business organization? What are the advantages and disadvantages of each?
- 1-2 Would the “normal” rate of return on investment be the same in all industries? Would “normal” rates of return change over time? Explain.
- 1-3 Would the role of a financial manager be likely to increase or decrease in importance relative to other executives if the rate of inflation increased? Explain.
- 1-4 Should stockholder wealth maximization be thought of as a long-term or a short-term goal—for example, if one action would probably increase the firm’s stock price from a current level of \$20 to \$25 in 6 months and then to \$30 in 5 years but another action would probably keep the stock at \$20 for several years but then increase it to \$40 in 5 years, which action would be better? Can you think of some specific corporate actions that might have these general tendencies?
- 1-5 Drawing on your background in accounting, can you think of any accounting differences that might make it difficult to compare the relative performance of different firms?
- 1-6 Would the management of a firm in an oligopolistic or in a competitive industry be more likely to engage in what might be called “socially conscious” practices? Explain your reasoning.
- 1-7 What’s the difference between stock price maximization and profit maximization? Under what conditions might profit maximization *not* lead to stock price maximization?
- 1-8 If you were the president of a large, publicly owned corporation, would you make decisions to maximize stockholders’ welfare or your own personal interests? What are some actions stockholders could take to ensure that management’s interests and those of stockholders coincided? What are some other factors that might influence management’s actions?
- 1-9 The president of Southern Semiconductor Corporation (SSC) made this statement in the company’s annual report: “SSC’s primary goal is to increase the value of the common stockholders’ equity over time.” Later on in the report, the following announcements were made:
  - a. The company contributed \$1.5 million to the symphony orchestra in Birmingham, Alabama, its headquarters city.
  - b. The company is spending \$500 million to open a new plant in Mexico. No revenues will be produced by the plant for 4 years, so earnings will be depressed during this period versus what they would have been had the decision not been made to open the new plant.
  - c. The company is increasing its relative use of debt. Whereas assets were formerly financed with 35 percent debt and 65 percent equity, henceforth the financing mix will be 50-50.
  - d. The company uses a great deal of electricity in its manufacturing operations, and it generates most of this power itself. Plans are to utilize nuclear fuel rather than coal to produce electricity in the future.
  - e. The company has been paying out half of its earnings as dividends and retaining the other half. Henceforth, it will pay out only 30 percent as dividends.Discuss how each of these actions would be reacted to by SSC’s stockholders and customers, and then how each action might affect SSC’s stock price.
- 1-10 Assume that you are serving on the board of directors of a medium-sized corporation and that you are responsible for establishing the compensation policies of senior management. You believe that the company’s CEO is very talented, but your concern is that

she is always looking for a better job and may want to boost the company's short-run performance (perhaps at the expense of long-run profitability) to make herself more marketable to other corporations. What effect would these concerns have on the compensation policy you put in place?

- 1-11** If the overall stock market is extremely volatile, and if many analysts foresee the possibility of a stock market crash, how might these factors influence the way corporations choose to compensate their senior executives?
- 1-12** Teacher's Insurance and Annuity Association–College Retirement Equity Fund (TIAA–CREF) is the largest institutional shareholder in the United States. Traditionally, TIAA–CREF has acted as a passive investor. However, TIAA–CREF announced a tough new corporate governance policy beginning October 5, 1993.  
In a statement mailed to all 1,500 companies in which it invests, TIAA–CREF outlined a policy designed to improve corporate performance, including a goal of higher stock prices for the \$52 billion in stock assets it holds, and to encourage corporate boards to have a majority of independent (outside) directors. TIAA–CREF wants to see management more accountable to shareholder interests, as evidenced by its statement that the fund will vote against any director “where companies don’t have an effective, independent board which can challenge the CEO.”  
Historically, TIAA–CREF did not quickly sell poor-performing stocks. In addition, the fund invested a large part of its assets to match performance of the major market indexes locking TIAA–CREF into ownership of certain companies. Further complicating the problem, TIAA–CREF owns stakes of from 1 percent to 10 percent in several companies, and selling such large blocks of stock would depress their prices.  
Common stock ownership confers a right to sponsor initiatives to shareholders regarding the corporation. A corresponding voting right exists for shareholders.
- Is TIAA–CREF an ordinary shareholder?
  - Due to its asset size, TIAA–CREF assumes large positions with which it plans to actively vote. However, who owns TIAA–CREF?
  - Should the investment managers of a fund like TIAA–CREF determine the voting practices of the fund's shares, or should the voting rights be passed on to TIAA–CREF's stakeholders?
- 1-13** The senior managers of Hancock Oil are evaluating a new oil exploration project. The project requires a large amount of capital and is quite risky, but it has the possibility of being extremely profitable. In a separate action, the company's managers are also considering increasing Hancock's dividend payout ratio. The proposed project and proposed dividend increase are both expected to increase the company's stock price.
- How would the proposed exploration project affect Hancock's outstanding bondholders?
  - How would the proposed dividend increase affect Hancock's outstanding bondholders?
  - Should Hancock's managers go ahead with the proposed project and dividend increase?
  - What steps can bondholders take to protect themselves against managerial decisions that reduce the value of their bonds?
- 1-14** Stewart Web Design currently operates an unincorporated partnership with 75 employees. The partners are contemplating organizing as a corporation. How might each of the following actions affect the firm's decision to incorporate?
- Congress is considering a tax bill that would reduce individual tax rates but increase corporate tax rates.
  - Congress is considering a bill that would extend the coverage of a large number of environmental and labor regulations to now include companies that have more than 50 employees. Presently, companies with fewer than 200 employees are excluded from these regulations.
- 1-15** Edmund Enterprises recently made a large investment in upgrading its technology. While the technology improvements will not have much of an impact on performance in the short run, they are expected to produce significant cost savings over the next several years. What impact will this investment have on Edmund Enterprises' earnings per share this year? What impact might this investment have on the company's stock price?

## SELF-TEST PROBLEM (SOLUTION APPEARS IN APPENDIX B)

### ST-1 Key terms

- Define each of the following terms:
- Sole proprietorship; partnership; corporation
  - Limited partnership; limited liability partnership; professional corporation
  - Stockholder wealth maximization
  - Social responsibility; business ethics
  - Normal profits; normal rate of return
  - Agency problem
  - Performance shares; executive stock options
  - Hostile takeover
  - Profit maximization
  - Earnings per share
  - Dividend policy decision

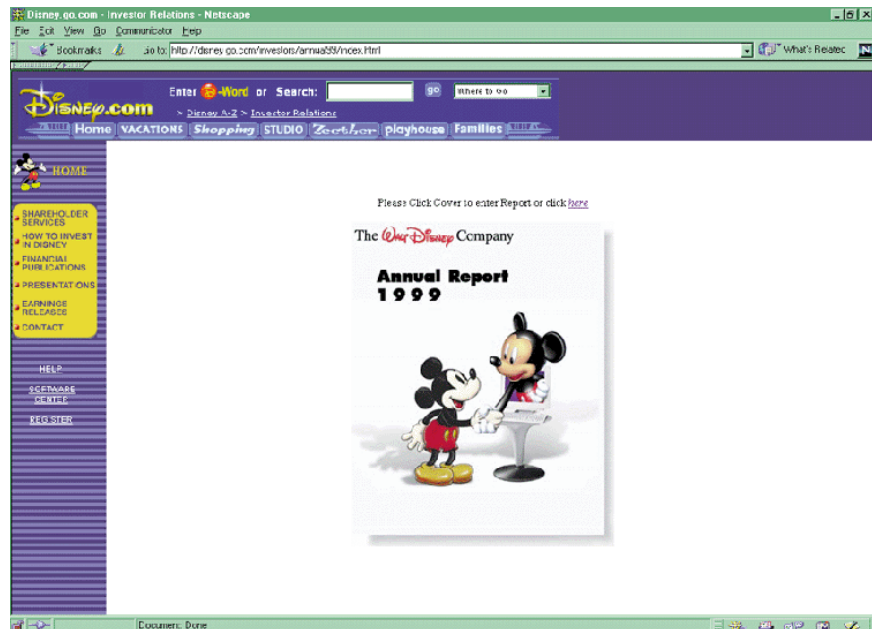


*The information related to the cyberproblems is likely to change over time, due to the release of new information and the ever-changing nature of the World Wide Web. With these changes in mind, we will periodically update these problems on the textbook's web site. To avoid problems, please check for these updates before proceeding with the cyberproblems.*

### 1-1 Overview of financial management

Management's primary goal is to maximize stockholder wealth. Firms often award stock options and bonuses on the basis of management performance, thus linking management's personal wealth with the firm's financial performance. The better the job managers do in maximizing share price, the greater their compensation.

Walt Disney's CEO, Michael Eisner, draws a compensation package in part based on the net income and return on shareholder equity of The Walt Disney Company. In 1994, he attracted a lot of attention when he exercised stock options on 5.4 million Disney shares for a net profit (after taxes and brokerage expenses) of around \$127



million. At the time, he had also earned another 8 million stock options, then valued at about \$161 million. Year after year, Eisner ranks among the most highly compensated CEOs in America. In 1999, Michael Eisner's total compensation from Walt Disney Co. totaled \$50.7 million in salary and exercised stock options.

Let's see if Mr. Eisner deserves such generous bonuses and stock options. Look at Disney's 1999 Annual Report on the web at <http://disney.go.com/investors/annual99/index.html> to answer the following questions:

- Click on the page and then click on Financial Review. Describe how Disney's three main business segments have been divided into five distinct operating segments. What percentage of operating income did each contribute to the firm?
- If on November 30, 1984, you invested \$1,000 in Disney stock and reinvested all your dividends, how much would you have had on November 30, 1999?
- How does the compound annual return on your Disney stock during this 15-year period compare to the return earned on the S&P 500 during this same period?
- If you had purchased 100 shares of Disney stock for \$2,500 in the company's initial public offering 59 years ago and had purchased no additional Disney shares, how many shares would you have, and how much would they be worth, as of November 30, 1999?
- What is the compound annual growth rate of the stock's value over this 59-year period?
- On the basis of the company's performance through 1999, do you think that Mr. Eisner and his management team have done a good job? Has this impression changed based on the company's recent performance?



## INTEGRATED CASE

### TAKE A DIVE

**1-2 Financial Management Overview** Kato Summers opened Take A Dive 17 years ago; the store is located in Malibu, California, and sells surfing-related equipment. Today, Take a Dive has 50 employees including Kato and his daughter Amber, who works part time in the store to help pay for her college education.

Kato's business has boomed in recent years, and he is looking for new ways to take advantage of his increasing business opportunities. Although Kato's formal business training is limited, Amber will soon graduate with a degree in finance. Kato has offered her the opportunity to join the business as a full-fledged partner. Amber is interested, but she is also considering other career opportunities in finance.

Right now, Amber is leaning toward staying with the family business, partly because she thinks it faces a number of interesting challenges and opportunities. Amber is particularly interested in further expanding the business and then incorporating it. Kato is intrigued by her ideas, but he is also concerned that her plans might change the way in which he does business. In particular, Kato has a strong commitment to social activism, and he has always tried to strike a balance between work and pleasure. He is worried that these goals will be compromised if the company incorporates and brings in outside shareholders.

Amber and Kato plan to take a long weekend off to sit down and think about all of these issues. Amber, who is highly organized, has outlined a series of questions for them to address:

- What kinds of career opportunities are open to finance majors?
- What are the primary responsibilities of a corporate financial staff?
- What are the most important financial management issues today?
- (1) What are the alternative forms of business organization?  
(2) What are their advantages and disadvantages?
- What is the primary goal of the corporation?  
(1) Do firms have any responsibilities to society at large?  
(2) Is stock price maximization good or bad for society?  
(3) Should firms behave ethically?
- What is an agency relationship?  
(1) What agency relationships exist within a corporation?  
(2) What mechanisms exist to influence managers to act in shareholders' best interests?  
(3) Should shareholders (through managers) take actions that are detrimental to bondholders?
- Is maximizing stock price the same thing as maximizing profit?
- What factors affect stock prices?
- What factors affect the level and riskiness of cash flows?