1 Introduction to Financial Management

When Mike Lazaridis and Douglas Fregin met in grade school, nobody knew they would become friends and create one of Canada's most successful high-tech companies. Lazaridis and Fregin went on to study engineering at the University of Waterloo and the University of Windsor and while students they developed a video signalling device. This device formed the foundation for their company, Research In Motion (RIM), which the friends started in 1984.

The company went public in 1997 and raised more than $115 million from investors on the Toronto Stock Exchange. The following year, RIM introduced its most successful innovation to date—the BlackBerry, which has reached the same status in the business world as the Walkman, Game Boy and iPod have in the consumer world. The BlackBerry's ability to receive e-mails anywhere in real time became so addictive to some users that it was even nicknamed "Crackberry."

The future of the company became uncertain when NTP, Inc., a Virginia-based patent holding company, brought a patent infringement lawsuit against RIM in the United States. This long-running lawsuit was eventually settled by RIM for US $612.5 million in March 2006. The rest of the year held brighter news for the company. RIM introduced Pearl, which received rave reviews, its co-chief executives, Mike Lazaridis and Jim Balsillie, won Canada's Outstanding CEO of the Year award, and the company was listed among the 50 fastest-growing Canadian tech companies.

Understanding Lazaridis and Fregin's journey from student entrepreneurs to corporate executives takes us into issues involving the corporate form of organization, corporate goals, and corporate control, all of which we discuss in this chapter.

To get the most out of the chapter, when you are finished studying it, make sure you have a good understanding of:

1.1 The main areas of finance and how finance relates to marketing, accounting, and management.

1.2 The basic types of financial management decisions and the role of the financial manager.

1.3 The financial implications of the different forms of business organization.

1.4 The goal of financial management.

1.5 The conflicts of interest that can arise between managers and owners.

1.6 How financial markets work.

To begin our study of financial management, we address two central issues. First: What is corporate, or business, finance and what is the role of the financial manager? Second: What is the goal of financial management?

1.1 FINANCE: A QUICK LOOK

Check out the companion Web site for this text at **www.mcgrawhill.ca/olc/ross**

Before we plunge into our study of "corp. fin.," we think a quick overview of the finance field might be a good idea. Our goal is to clue you in on some of the most important areas in finance and some of the career opportunities available in each area. We also want to illustrate some of the ways finance fits in with other areas such as marketing, accounting, and management.

The Four Basic Areas

Traditionally, financial topics are grouped into four main areas:

1. Corporate finance
2. Investments
3. Financial institutions
4. International finance

We discuss each of these next.

For job descriptions in finance and other areas, visit **www.careers-in-business.com.**

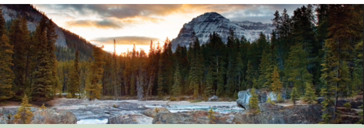
Corporate Finance The first of these four areas, corporate finance, is the main subject of this book. We begin covering this subject with our next section, so we will wait until then to get into any details. One thing we should note is that the term *corporate finance* seems to imply that what we cover is only relevant to corporations, but the truth is that almost all of the topics we consider are much broader than that. Maybe *business finance* would be a little more descriptive, but even this is too narrow because at least half of the subjects we discuss in the pages ahead are really basic financial ideas and principles applicable across all the various areas of finance and beyond.

Investments Broadly speaking, the investments area deals with financial assets such as stocks and bonds. Some of the more important questions include:

1. What determines the price of a financial asset such as a share of stock?
2. What are the potential risks and rewards associated with investing in financial assets?
3. What is the best mixture of the different types of financial assets to hold?

Students who specialize in the investments area have various career opportunities. Being a stockbroker is one of the most common. Stockbrokers often work for large companies such as RBC Dominion Securities, advising customers on what types of investments to consider and helping them make buy and sell decisions. Financial advisers play a similar role, but are not necessarily brokers.

Portfolio management is a second investments-related career path. Portfolio managers, as the name suggests, manage money for investors. For example, individual investors frequently buy into mutual funds. Such funds are simply a means of pooling money that is then invested by a portfolio manager. Portfolio managers also invest and manage money for pension funds, insurance companies, and many other types of institutions.



REALITY BYTES

Three Magic Letters

Have you ever wondered what abbreviations such as CFA, CFP, and CTP mean? They refer to some of almost a dozen professional designations that we find in the finance profession. Different groups benefit from having professional designations. Employers use them as a low-cost screening tool for hiring the best candidates and promoting current employees. Clients look at professional designations to find knowledgeable and experienced professionals they can entrust with their capital. Finally, finance professionals proudly show their designations on business cards as an external validation of their competence.

Two of the most common designations in Canada are the Chartered Financial Analyst (CFA) and the Certified Financial Planner (CFP). While CFA is administered by the U.S.-based CFA Institute, it is one of the very few internationally recognized designations. Every year more than 100,000 candidates from over 150 countries write one of the three levels of CFA exams. The CFA program is primarily designed for people working in the investments area, but a growing number of CFA charterholders work in non-financial corporations, consulting firms, and government agencies. The CFA program accepts students who are still in the final year of a bachelor's degree program. Wilfrid Laurier University and Concordia University offer MBA programs with CFA options. Those who have earned a CFA charter are rewarded in the profession. According to a 2005 compensation survey in Canada, the median total compensation of CFA charterholders with 10 years of experience or more reached $212,000, and was 35 percent higher than that of people in the same jobs who did not have a CFA charter. Interestingly, Canada has the largest number of CFA charterholders per capita in the world, and the Toronto CFA society is one of the largest CFA chapters.

CFP is designed for personal financial planners and is administered by the Financial Planners Standards Council (FPSC). Many countries have similar designations, but unlike the CFA charter, they are not transferable from one country to another. To qualify to write the CFP exam, candidates must complete an education program. Many universities and colleges offer these programs, such as the CFP Qualifying Program at the University of Victoria and the CFP Program at Centennial College in Toronto. In addition to passing the exams, both the CFP and CFA programs have work experience and code of ethics requirements for awarding the designations.

Other financial designations are most often applied in more specific finance fields, such as Certified Treasury Professional (CTP), Certified Business Valuator (CBV), and Fellow of the Canadian Institute of Actuaries (FCIA). To decide which designation is worth pursuing in your chosen field of finance, it is useful to talk to professionals from that area. They can advise you as to which professional designation will be most helpful for a successful career in that field.

Security analysis is a third area. A security analyst researches individual investments, such as stock in a particular company, and makes a determination as to whether the price is right. To do so, an analyst delves deeply into company and industry reports, along with a variety of other information sources. Frequently, brokers and portfolio managers rely on security analysts for information and recommendations.

To learn more about the CFA and CFP designations visit **www.cfainstitute.org** and **www.cfp-ca.org**, respectively.

These investments-related areas, like many areas in finance, share an interesting feature. If they are done well, they can be very rewarding financially (translation: You can make a lot of money). The bad news, of course, is that they can be very demanding and very competitive, so they are definitely not for everybody. To have a successful career, one should think about getting at least one of the many financial professional designations available. Our *Reality Bytes* box above discusses two of the most commonly found designations in Canada.

Financial Institutions Financial institutions are basically businesses that deal primarily in financial matters. Banks and insurance companies would probably be the most familiar to you. Institutions such as these employ people to perform a wide variety of finance-related tasks. For example, a commercial loan officer at a bank would evaluate whether a particular business has a strong enough financial position to warrant extending a loan. At an insurance company, an analyst would decide whether a particular risk was suitable for insuring and what the premium should be.

International Finance International finance isn't so much an area as it is a specialization within one of the main areas we described above. In other words, careers in international finance generally involve international aspects of either corporate finance, investments, or financial institutions. For example, some portfolio managers and security analysts specialize in non-Canadian companies. Similarly, many Canadian businesses have extensive overseas operations and need employees familiar with such international topics as exchange rates and political risk. Banks frequently are asked to make loans across country lines, so international specialists are needed there as well.

Why Study Finance?

Who needs to know finance? In a word, you. In fact, there are many reasons you need a working knowledge of finance even if you are not planning a finance career. We explore some of these next.

Marketing and Finance If you are interested in marketing, you need to know finance because, for example, marketers constantly work with budgets, and they need to understand how to get the greatest payoff from marketing expenditures and programs. Analyzing costs and benefits of projects of all types is one of the most important aspects of finance, so the tools you learn in finance are vital in marketing research, the design of marketing and distribution channels, and product pricing, to name just a few areas.

Financial analysts rely heavily on marketing analysts, and the two frequently work together to evaluate the profitability of proposed projects and products. As we will see in a later chapter, sales projections are a key input in almost every type of new product analysis, and such projections are often developed jointly between marketing and finance.

Beyond this, the finance industry employs marketers to help sell financial products such as bank accounts, insurance policies, and mutual funds. Financial services marketing is one of the most rapidly growing types of marketing, and successful financial services marketers are very well compensated. To work in this area, you obviously need to understand financial products.

Accounting and Finance For accountants, finance is required reading. In smaller businesses in particular, accountants are often required to make financial decisions as well as perform traditional accounting duties. Further, as the financial world continues to grow more complex, accountants have to know finance to understand the implications of many of the newer types of financial contracts and the impact they have on financial statements. Beyond this, cost accounting and business finance are particularly closely related, sharing many of the same subjects and concerns.

Financial analysts make extensive use of accounting information; they are some of the most important end users. Understanding finance helps accountants recognize what types of information are particularly valuable and, more generally, how accounting information is actually used (and abused) in practice.

Management and Finance One of the most important areas in management is strategy. Thinking about business strategy without simultaneously thinking about financial strategy is an excellent recipe for disaster, and, as a result, management strategists must have a very clear understanding of the financial implications of business plans.

In broader terms, management employees of all types are expected to have a strong understanding of how their jobs impact profitability, and they are also expected to be able to work within their areas to improve profitability. This is precisely what studying finance teaches you: What are the characteristics of activities that create value?

You and Finance Perhaps the most important reason to know finance is that you will have to make financial decisions that will be very important to you personally. Today, for example, when you go to work for almost any type of company, you will be asked to decide how you want to invest your retirement funds. We'll see in a later chapter that what you choose to do can make an enormous difference in your future financial well-being. On a different note, is it your dream to start your own business? Good luck if you don't understand basic finance before you start; you'll end up learning it the hard way. Want to know how big your student loan payments are going to be before you take out that next loan? Maybe not, but we'll show you how to calculate them anyway.

These are just a few of the ways that finance will affect your personal and business lives. Whether you want to or not, you are going to have to examine and understand financial issues, and you are going to have to make financial decisions. We want you to do so wisely, so keep reading.

CONCEPT QUESTIONS

1.1a What are the major areas in finance?

1.1b Besides wanting to pass this class, why do you need to understand finance?

1.2 BUSINESS FINANCE AND THE FINANCIAL MANAGER

Now we proceed to define business finance and the financial manager's job.

What Is Business Finance?

Imagine you were to start your own business. No matter what type you started, you would have to answer the following three questions in some form or other:

1. What long-term investments should you take on? That is, what lines of business will you be in and what sorts of buildings, machinery, and equipment will you need?
2. Where will you get the long-term financing to pay for your investment? Will you bring in other owners or will you borrow the money?
3. How will you manage your everyday financial activities, such as collecting from customers and paying suppliers?

These are not the only questions, but they are among the most important. Business finance, broadly speaking, is the study of ways to answer these three questions. We'll be looking at each of them in the chapters ahead.

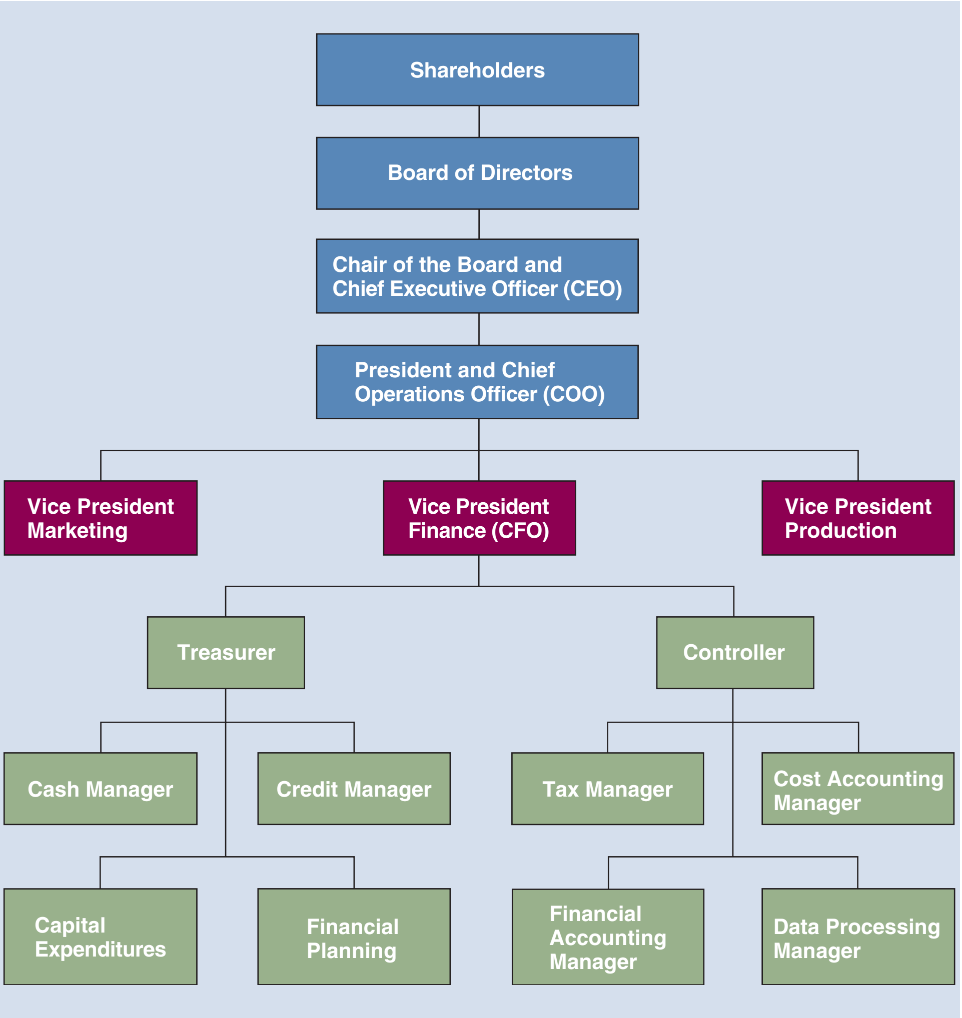
The Financial Manager

For current issues facing CFOs, see www.cfo.com.

The financial management function is usually associated with a top officer of the firm, often called the chief financial officer (CFO) or vice president of finance. Figure 1.1 is a simplified organizational chart that highlights the finance activity in a large firm. As shown, the vice president of finance coordinates the activities of the treasurer and the controller. The controller's office handles cost and financial accounting, tax payments, and management information systems. The treasurer's office is responsible for managing the firm's cash and credit, its financial planning, and its capital expenditures. These treasury activities are all related to the three general questions raised above, and the chapters ahead deal primarily with these issues. Our study thus bears mostly on activities usually

FIGURE 1.1

A simplified organizational chart. The exact titles and organization differ from company to company.



associated with the treasurer's office. In a smaller firm, the treasurer and controller might be the same person, and there would be only one office.

Financial Management Decisions

As our discussion above suggests, the financial manager must be concerned with three basic types of questions. We consider these in greater detail next.

Capital Budgeting The first question concerns the firm's long-term investments. The process of planning and managing a firm's long-term investments is called **capital budgeting.** In capital budgeting, the financial manager tries to identify investment opportunities that are worth more to the firm than they cost to acquire. Loosely speaking, this means that the value of the cash flow generated by an asset exceeds the cost of that asset.

capital budgeting
The process of planning and managing a firm's long-term investments.

Regardless of the specific investment under consideration, financial managers must be concerned with how much cash they expect to receive, when they expect to receive it, and how likely they are to receive it. Evaluating the *size, timing,* and *risk* of future cash flows is the essence of capital budgeting. In fact, whenever we evaluate a business decision, the size, timing, and risk of the cash flows will be, by far, the most important things we will consider.

Capital Structure The second question for the financial manager concerns how the firm obtains the financing it needs to support its long-term investments. A firm's **capital structure** (or financial structure) refers to the specific mixture of long-term debt and equity the firm uses to finance its operations. The financial manager has two concerns in this area. First: How much should the firm borrow? Second: What are the least expensive sources of funds for the firm?

capital structure
The mixture of debt and equity maintained by a firm.

In addition to deciding on the financing mix, the financial manager has to decide exactly how and where to raise the money. The expenses associated with raising long-term financing can be considerable, so different possibilities must be carefully evaluated. Also, corporations borrow money from a variety of lenders in a number of different ways. Choosing among lenders and among loan types is another job handled by the financial manager.

Working Capital Management The third question concerns **working capital** management. The term *working capital* refers to a firm's short-term assets, such as inventory, and its short-term liabilities, such as money owed to suppliers. Managing the firm's working capital is a day-to-day activity that ensures the firm has sufficient resources to continue its operations and avoid costly interruptions. This involves a number of activities related to the firm's receipt and disbursement of cash.

working capital
A firm's short-term assets and liabilities.

Some questions about working capital that must be answered are the following: (1) How much cash and inventory should we keep on hand? (2) Should we sell on credit to our customers? (3) How will we obtain any needed short-term financing? If we borrow in the short term, how and where should we do it? This is just a small sample of the issues that arise in managing a firm's working capital.

Conclusion The three areas of corporate financial management we have described—capital budgeting, capital structure, and working capital management—are very broad categories. Each includes a rich variety of topics, and we have indicated only a few of the questions that arise in the different areas. The chapters ahead contain greater detail.

CONCEPT QUESTIONS

1.2a What is the capital budgeting decision?

1.2b What do you call the specific mixture of long-term debt and equity that a firm chooses to use?

1.2c Into what category of financial management does cash management fall?

1.3 FORMS OF BUSINESS ORGANIZATION

Large firms in Canada, such as Royal Bank of Canada (RBC) and Imperial Oil, are almost all organized as corporations. We examine the three different legal forms of business organization—sole proprietorship, partnership, and corporation—to see why this is so.

Sole Proprietorship

sole proprietorship
A business owned by a single individual.

A **sole proprietorship** is a business owned by one person. This is the simplest type of business to start and is the least regulated form of organization. For this reason, there are more proprietorships than any other type of business, and many businesses that later become large corporations start out as small proprietorships.

The owner of a sole proprietorship keeps all the profits. That's the good news. The bad news is that the owner has *unlimited liability* for business debts. This means that creditors can look to the proprietor's personal assets for payment. Similarly, there is no distinction between personal and business income, so all business income is taxed as personal income.

For more information on forms of business organization and how to start a business in Canada, visit **bsa.cbsc.org.**

The life of a sole proprietorship is limited to the owner's life span, and, importantly, the amount of equity that can be raised is limited to the proprietor's personal wealth. This limitation often means that the business is unable to exploit new opportunities because of insufficient capital. Ownership of a sole proprietorship may be difficult to transfer since this requires the sale of the entire business to a new owner.

Partnership

partnership
A business formed by two or more individuals or entities.

A **partnership** is similar to a proprietorship, except that there are two or more owners (partners). In a *general partnership,* all the partners share in gains or losses, and all have unlimited liability for *all* partnership debts, not just some particular share. The way partnership gains (and losses) are divided is described in the *partnership agreement.* This agreement can be an informal oral agreement, such as "let's start a lawn mowing business," or a lengthy, formal written document.

In a *limited partnership,* one or more *general partners* will run the business and have unlimited liability, but there will also be one or more *limited partners* who do not actively participate in the business. A limited partner's liability for business debts is limited to the amount that partner contributes to the partnership. This form of organization is common in real estate ventures, for example.

Visit the Business Development Bank of Canada Web site at **www.bdc.ca** for more information on its services to small businesses.

The advantages and disadvantages of a partnership are basically the same as those for a proprietorship. Partnerships based on a relatively informal agreement are easy and inexpensive to form. General partners have unlimited liability for partnership debts, and the partnership terminates when a general partner wishes to sell out or dies. All income is taxed as personal income to the partners, and the amount of equity that can be raised is limited to the partners' combined wealth. Ownership by a general partner is not easily transferred because a new partnership must be formed. A limited partner's interest can be sold without dissolving the partnership, but finding a buyer may be difficult.

Because a partner in a general partnership can be held responsible for all partnership debts, having a written agreement is very important. Failure to spell out the rights and duties of the partners frequently leads to misunderstandings later on. Also, if you are a limited partner, you must not become deeply involved in business decisions unless you are willing to assume the obligations of a general partner. The reason is that if things go badly, you may be deemed to be a general partner even though you say you are a limited partner.

Based on our discussion, the primary disadvantages of sole proprietorships and partnerships as forms of business organization are (1) unlimited liability for business debts on the part of the owners, (2) limited life of the business, and (3) difficulty of transferring ownership. These three disadvantages add up to a single, central problem: The ability of such businesses to grow can be seriously limited by an inability to raise cash for investment.

Corporation

The **corporation** is the most important form (in terms of size) of business organization in Canada. A corporation is a legal "person" separate and distinct from its owners, and it has many of the rights, duties, and privileges of an actual person. Corporations can borrow money and own property, can sue and be sued, and can enter into contracts. A corporation can even be a general partner or a limited partner in a partnership, and a corporation can own stock in another corporation.

corporation
A business created as a distinct legal entity owned by one or more individuals or entities.

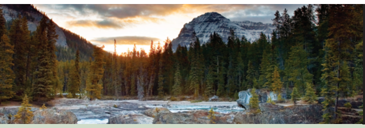
Not surprisingly, starting a corporation is somewhat more complicated than starting the other forms of business organization. Forming a corporation involves preparing *articles of incorporation* (or a charter) and a set of *bylaws.* The articles of incorporation must contain a number of things, including the corporation's name, its intended lifespan (which can be forever), its business purpose, and the number of shares that can be issued. This information must normally be supplied to regulators in the jurisdiction where the firm is incorporated. Canadian firms can be incorporated federally, under the *Canada Business Corporations Act,* or provincially, under the applicable provincial laws.

The bylaws are rules describing how the corporation regulates its own existence. For example, the bylaws describe how directors are elected. The bylaws may be amended or extended from time to time by the stockholders.

In a large corporation, the stockholders and the managers are usually separate groups. The stockholders elect the board of directors, who then select the managers. Management is charged with running the corporation's affairs in the stockholders' interests. In principle, stockholders control the corporation because they elect the directors.

As a result of the separation of ownership and management, the corporate form has several advantages. Ownership (represented by shares of stock) can be readily transferred, and the life of the corporation is therefore not limited. The corporation borrows money in its own name. As a result, the stockholders in a corporation have limited liability for corporate debts. The most they can lose is what they have invested.

The relative ease of transferring ownership, the limited liability for business debts, and the unlimited life of the business are the reasons why the corporate form is superior when it comes to raising cash. If a corporation needs new equity, it can sell new shares of stock and attract new investors. The number of owners can be huge; larger corporations have many thousands or even millions of stockholders. For example, Manulife Financial, a leading Canadian-based financial services company, has about 1.5 billion shares outstanding and more than 900,000 shareholders.



REALITY BYTES

Income Trusts Earn Our Trust

Income trusts. They are everywhere these days, and it seems everyone is talking about them. Even Carmela Soprano, a character in a popular TV series about a mob family "The Sopranos," urges her husband, Tony, to consider investing in income trusts in the opening episode of the fourth season. "There are these things called REITs," she tells Tony Soprano, based on the recommendation of her cousin, a financial advisor. Tony doesn't believe in equity markets. "We don't have those Enron-type connections," he replies.

While income trusts have not earned the trust of the fictional mafia boss, they have definitely succeeded with the Canadian investment public. The market capitalization of income trusts has ballooned from $2 billion at the end of 1994 to almost $190 billion in 2006 and makes up 9 percent of the market capitalization of the Toronto Stock Exchange.

As a rule, income trusts hold mature assets that produce stable income. A significant portion of this income is distributed to unitholders on a monthly basis. A large variety of income trusts exist. They can be classified into four major groups based on the type of businesses they own:

1. Real Estate Investment Trusts (REITs) have been around for more than 20 years. REITs generate income from different types of real estate, such as apartment complexes, office buildings, shopping centres and so on. Some REITs own a blend of income-producing real estate, while others specialize in specific sectors.
2. Royalty Trusts have been around for a long time as well. They exploit natural resources, such as oil, natural gas, coal, or iron ore. Royalty trusts usually offer the highest yields, but are also among the most volatile, as the underlying cash flow is affected by commodity prices.
3. Utility Trusts earn income from regulated public utilities, which include hydro, water, pipelines, and telecommunications. Within the income trust universe, they usually provide the most stable cash flow, and therefore distributions.
4. Business Trusts are the newest, largest and most diverse type of income trusts. They may hold any company that generates stable income. These businesses range from sugar to ice cream, from cold storage facilities to water heaters, from garbage collection to, well, beer.

One of the reasons for the surging popularity of income trusts has been their tax efficiency. Income trusts could usually avoid paying taxes on their earnings as long as most of the earnings were distributed to the unitholders. Thus, cash flows generated by underlying businesses were taxed only once, at the personal level, when they were paid out, not at the corporate level.

This tax advantage mostly disappeared on Halloween 2006, when federal Finance Minister Jim Flaherty announced plans to tax all income trusts, except REITs, like corporations. This rule would apply to newly created income trusts immediately, but would not affect existing trusts until 2011. The legislation passed and the new federal tax treatment has already effectively eliminated the incentive to convert corporations into income trusts.

Despite the recent tax changes, income trusts can still be attractive investments. If you become interested in investing in income trusts, you have several options. You can buy individual income trusts, which trade like stocks on the Toronto Stock Exchange with a ticker symbol extension of ".UN." To decrease the risk, you can spread your money across a large number of trusts through income trust mutual funds or closed-end funds. There are also two income trust exchange-traded funds, which trade under the ticker symbols XTR and XRE.

The corporate form has a significant disadvantage. Since a corporation is a legal person, it must pay taxes. Moreover, money paid out to stockholders in the form of dividends is taxed again as income to those stockholders. This is *double taxation,* meaning that corporate profits are taxed twice: at the corporate level when they are earned and again at the personal level when they are paid out.[1] A form of business organization that until recently could avoid double taxation is the income trust. See our *Reality Bytes* box above to learn more about income trusts.

[1] The dividend tax credit for individual shareholders reduces the "double taxation," but usually does not remove it entirely. The dividend tax credit is discussed in more detail in Chapter 2.

TABLE 1.1
International corporations

Company	Country of Origin	Type of Company	Translation
Bayerische Motoren Werke (BMW) AG	Germany	Aktiengesellschaft	Corporation
Dornier GmbH	Germany	Gesellschaft mit beschränkter Haftung	Company with limited liability
Rolls-Royce PLC	United Kingdom	Public limited company	Public limited company
Shell UK Ltd.	United Kingdom	Limited	Corporation
Unilever NV	Netherlands	Naamloze Vennootschap	Limited liability company
Fiat SpA	Italy	Società per Azioni	Public limited company
Saab AB	Sweden	Aktiebolag	Joint stock company
Peugeot SA	France	Société Anonyme	Joint stock company

A Corporation by Another Name . . .

The corporate form has many variations around the world. Exact laws and regulations differ, of course, but the essential features of public ownership and limited liability remain. These firms are often called *joint stock companies, public limited companies,* or *limited liability companies.*

Table 1.1 gives the names of a few well-known international corporations, their countries of origin, and a translation of the abbreviation that follows the company name.

CONCEPT QUESTIONS

1.3a What are the three forms of business organization?

1.3b What are the primary advantages and disadvantages of sole proprietorships and partnerships?

1.3c What is the difference between a general and a limited partnership?

1.3d Why is the corporate form superior when it comes to raising cash?

1.4 THE GOAL OF FINANCIAL MANAGEMENT

To study financial decision making, we first need to understand the goal of financial management. Such an understanding is important because it leads to an objective basis for making and evaluating financial decisions.

Profit Maximization

Profit maximization would probably be the most commonly cited business goal, but this is not a very precise objective. Do we mean profits this year? If so, then actions such as deferring maintenance, letting inventories run down, and other short-run cost-cutting measures will tend to increase profits now, but these activities aren't necessarily desirable.

The goal of maximizing profits may refer to some sort of "long-run" or "average" profits, but it's unclear exactly what this means. First, do we mean something like accounting net income or earnings per share? As we will see, these numbers may have little to do with what is good or bad for the firm. Second, what do we mean by the long run? As a famous economist once remarked, in the long run, we're all dead! More to the point, this goal doesn't tell us the appropriate trade-off between current and future profits.

The Goal of Financial Management in a Corporation

To find out about the services that Financial Executive International (FEI) Canada offers to its members who are senior financial officers of medium and large organizations, go to **www.feicanada.org.**

The financial manager in a corporation makes decisions for the stockholders of the firm. Given this, instead of listing possible goals for the financial manager, we really need to answer a more fundamental question: From the stockholders' point of view, what is a good financial management decision?

If we assume stockholders buy stock because they seek to gain financially, then the answer is obvious: Good decisions increase the value of the stock, and poor decisions decrease it.

Given our observations, it follows that the financial manager acts in the shareholders' best interests by making decisions that increase the value of the stock. The appropriate goal for the financial manager in a corporation can thus be stated quite easily:

> The goal of financial management is to maximize the current value per share of the existing stock.

The goal of maximizing the value of the stock avoids the problems associated with the different goals we discussed above. There is no ambiguity in the criterion, and there is no short-run versus long-run issue. We explicitly mean that our goal is to maximize the *current* stock value. Of course, maximizing stock value is the same thing as maximizing the market price per share.

A More General Financial Management Goal

Given our goal as stated above (maximize the value of the stock), an obvious question comes up: What is the appropriate goal when the firm has no traded stock? Corporations are certainly not the only type of business, and the stock in many corporations rarely changes hands, so it's difficult to say what the value per share is at any given time.

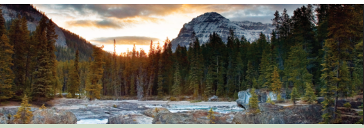
As long as we are dealing with for-profit businesses, only a slight modification is needed. The total value of the stock in a corporation is simply equal to the value of the owners' equity. Therefore, a more general way of stating our goal is:

> Maximize the market value of the existing owners' equity.

With this goal in mind, it doesn't matter whether the business is a proprietorship, a partnership, or a corporation. For each of these, good financial decisions increase the market value of the owners' equity and poor financial decisions decrease it.

For many Canadian resources for business ethics visit **www.businessethics.ca.**

Finally, our goal does not imply that the financial manager should take illegal or unethical actions in the hope of increasing the value of the equity in the firm. What we mean is that the financial manager best serves the owners of the business by identifying goods



REALITY BYTES

Corporate Ethics

Large companies are sometimes guilty of unethical behaviour. This unethical behaviour ranges from misleading financial statements to the shameless stealing of money from a company and its shareholders. In one of the largest corporate fraud cases in history, energy giant Enron Corporation was forced to file for bankruptcy in December 2001 amid allegations that the company's financial statements were deliberately misleading and false. Enron's bankruptcy destroyed not only that company, but its auditor Arthur Andersen as well.

Another company survived an alleged case of unethical behaviour by its top executives. Conrad Black, former CEO and Chairman of Toronto-based Hollinger Inc., and his close associates were charged with stealing millions of dollars and using company money to finance their lavish lifestyles. Black lost his CEO and chairman's positions and was sued by several parties, as well as facing criminal charges, along with his associates, in the U.S. In July 2007, while cleared of many charges, including those related to his lavish lifestyle, Conrad Black was found guilty of receiving the fraudulent payment of US$2.9 million in non-compete fees and of obstruction of justice, and was facing a possible sentence of up to 20 years in prison. An appeal was planned.

Of course, ethical problems are not confined to North American companies. For example, in late 2003 the Italian dairy firm Parmalat SpA announced that it had liquidity problems. What followed was an investigation into the largest corporate fraud scandal in European history. At one point, the company was forced to disclose that it did not actually have a $4.8 billion bank account it had claimed on its financial statements.

The difference between ethical and unethical behaviour can sometimes be murky. A recent corporate activity that has generated much controversy is the practice of outsourcing, or offshoring, jobs to other countries. Canadian corporations engage in this practice when labour costs in another country are substantially lower than they are domestically. This is done to maximize shareholder wealth, but some Canadian workers do lose their jobs when offshoring occurs. For instance, in September 2006, Montreal-based Gildan Activewear announced it was cutting its labour force in Canada and moving more of its operations to lower-cost Honduras and the Dominican Republic. By contrast, many foreign companies, such as Toyota and Honda, "insource" jobs by building plants in Canada. Is it unethical to outsource Canadian jobs while, at the same time, insourcing jobs from other countries?

and services that add value to the firm because they are desired and valued in the free marketplace. Our *Reality Bytes* box above discusses some recent ethical issues and problems faced by well-known corporations.

Sarbanes-Oxley Act

In response to corporate scandals involving companies such as Enron, WorldCom, Tyco, and Adelphia, the U.S. Congress enacted the *Sarbanes-Oxley Act* in 2002. The Act, which is better known as "Sarbox," is intended to strengthen protection against corporate accounting fraud and financial malpractice. In addition to U.S. corporations, Sarbox also applies to a large number of Canadian corporations that issue securities in the United States. Key elements of Sarbox took effect on November 15, 2004.

Sarbox contains a number of requirements designed to ensure that companies tell the truth in their financial statements. For example, the officers of a public corporation must review and sign the annual report. They must attest that the annual report does not contain false statements or material omissions and also that the financial statements fairly represent the company's financial results. In essence, Sarbox makes management personally responsible for the accuracy of a company's financial statements.

To find out more about Sarbanes-Oxley, go to: **www.soxlaw.com.**

Because of its extensive requirements, compliance with Sarbox can be very costly, which has led to some unintended results. For example, in 2003 about 200 public firms chose to "go dark," meaning that their shares would no longer be traded in the major stock markets, in which case Sarbox does not apply. Most of these companies stated that their reason was to avoid the cost of compliance. Ironically, in such cases, the law had the effect of eliminating public disclosure instead of improving it.

CONCEPT QUESTIONS

1.4a What is the goal of financial management?

1.4b What are some shortcomings of the goal of profit maximization?

1.5 THE AGENCY PROBLEM AND CONTROL OF THE CORPORATION

We've seen that the financial manager in a corporation acts in the best interests of the stockholders by taking actions that increase the value of the firm's stock. However, we've also seen that in large corporations ownership can be spread over a huge number of stockholders. This dispersion of ownership arguably means that management effectively controls the firm. In this case, will management necessarily act in the best interests of the stockholders? Put another way, might not management pursue its own goals at the stockholders' expense? We briefly consider some of the arguments below.

Agency Relationships

The relationship between stockholders and management is called an *agency relationship.* Such a relationship exists whenever someone (the principal) hires another (the agent) to represent his or her interest. For example, you might hire someone (an agent) to sell a car that you own while you are away at school. In all such relationships, there is a possibility of conflict of interest between the principal and the agent. Such a conflict is called an **agency problem.**

agency problem
The possibility of conflict of interest between the owners and management of a firm.

Suppose you hire someone to sell your car and you agree to pay her a flat fee when she sells the car. The agent's incentive in this case is to make the sale, not necessarily to get you the best price. If you paid a commission of, say, 10 percent of the sales price instead of a flat fee, then this problem might not exist. This example illustrates that the way an agent is compensated is one factor that affects agency problems.

Management Goals

To see how management and stockholder interests might differ, imagine that a corporation is considering a new investment. The new investment is expected to favourably impact the stock price, but it is also a relatively risky venture. The owners of the firm will wish to take the investment (because the share value will rise), but management may not because there is the possibility that things will turn out badly and management jobs will be lost. If management does not take the investment, then the stockholders may lose a valuable opportunity. This is one example of an *agency cost.*

It is sometimes argued that, left to themselves, managers would tend to maximize the amount of resources over which they have control, or, more generally, business power or wealth. This goal could lead to an overemphasis on business size or growth. For example, cases where management is accused of overpaying to buy another company just to increase the size of the business or to demonstrate corporate power are not uncommon. Obviously, if overpayment does take place, such a purchase does not benefit the owners of the purchasing company.

Our discussion indicates that management may tend to overemphasize organizational survival to protect job security. Also, management may dislike outside interference, so independence and corporate self-sufficiency may be important goals.

Do Managers Act in the Stockholders' Interests?

Whether managers will, in fact, act in the best interests of stockholders depends on two factors. First, how closely are management goals aligned with stockholder goals? This question relates to the way managers are compensated. Second, can management be replaced if they do not pursue stockholder goals? This issue relates to control of the firm. As we will discuss, there are a number of reasons to think that, even in the largest firms, management has a significant incentive to act in the interests of stockholders.

Managerial Compensation Management will frequently have a significant economic incentive to increase share value for two reasons. First, managerial compensation, particularly at the top, is usually tied to financial performance in general and oftentimes to share value in particular. For example, managers are frequently given the option to buy stock at a fixed price. The more the stock is worth, the more valuable is this option. The second incentive managers have relates to job prospects. Better performers within the firm will tend to get promoted. More generally, those managers who are successful in pursuing stockholder goals will be in greater demand in the labour market and thus command higher salaries.

In fact, managers who are successful in pursuing stockholder goals can reap enormous rewards. For example, Hank Swartout, CEO of Calgary-based Precision Drilling Trust, had the highest compensation among the CEOs of Canadian companies in 2005, totalling almost $75 million. He was followed by Hunter Harrison, CEO of the Canadian National Railway Company, who earned more than $56 million. CEOs were not the only ones who enjoyed generous compensation in 2005: Frank Stronach, Chairman of Magna International Inc. was one of the top earners, receiving over $40 million.

Control of the Firm Control of the firm ultimately rests with stockholders. They elect the board of directors, who, in turn, hire and fire management. The mechanism by which unhappy stockholders can act to replace existing management is called a *proxy fight*. A proxy is the authority to vote someone else's stock. A proxy fight develops when a group solicits proxies in order to replace the existing board, and thereby replace existing management.

Another way that management can be replaced is by takeover. Those firms that are poorly managed are more attractive as acquisitions than well-managed firms because a greater profit potential exists. Thus, avoiding a takeover by another firm gives management another incentive to act in the stockholders' interests.

Sometimes it's hard to tell if a company's management is really acting in the shareholders' best interests. Consider the 2005 merger of software giants Oracle and PeopleSoft. PeopleSoft repeatedly rejected offers by Oracle to purchase the company. In November 2004, the board rejected a "best and final" offer, even after 61 percent of PeopleSoft's shareholders voted in favour of it. So was the board really acting in shareholders' best interests? At first, it may not have looked like it, but Oracle then increased its offer price by $2 per share, which the board accepted. So, by holding out, PeopleSoft's management got a much better price for its shareholders.

Conclusion The available theory and evidence are consistent with the view that stockholders control the firm and that stockholder wealth maximization is the relevant goal of the corporation. Even so, there will undoubtedly be times when management goals are pursued at the expense of the stockholders, at least temporarily.

Agency problems are not unique to corporations; they exist whenever there is a separation of ownership and management. This separation is most pronounced in corporations, but it certainly exists in partnerships and proprietorships as well.

Stakeholders

Our discussion thus far implies that management and stockholders are the only parties with an interest in the firm's decisions. This is an oversimplification, of course. Employees, customers, suppliers, and even the government all have a financial interest in the firm.

stakeholder
Someone who potentially has a claim on the cash flows of the firm.

Taken together, these various groups are called **stakeholders** in the firm. In general, a stakeholder is someone who potentially has a claim on the cash flows of the firm. Such groups will also attempt to exert control over the firm, perhaps to the detriment of the owners.

CONCEPT QUESTIONS

1.5a What is an agency relationship?

1.5b What are agency problems and how do they arise? What are agency costs?

1.5c What incentives do managers in large corporations have to maximize share value?

1.6 FINANCIAL MARKETS AND THE CORPORATION

We've seen that the primary advantages of the corporate form of organization are that ownership can be transferred more quickly and easily than with other forms and that money can be raised more readily. Both of these advantages are significantly enhanced by the existence of financial markets, and financial markets play an extremely important role in corporate finance.

Cash Flows to and from the Firm

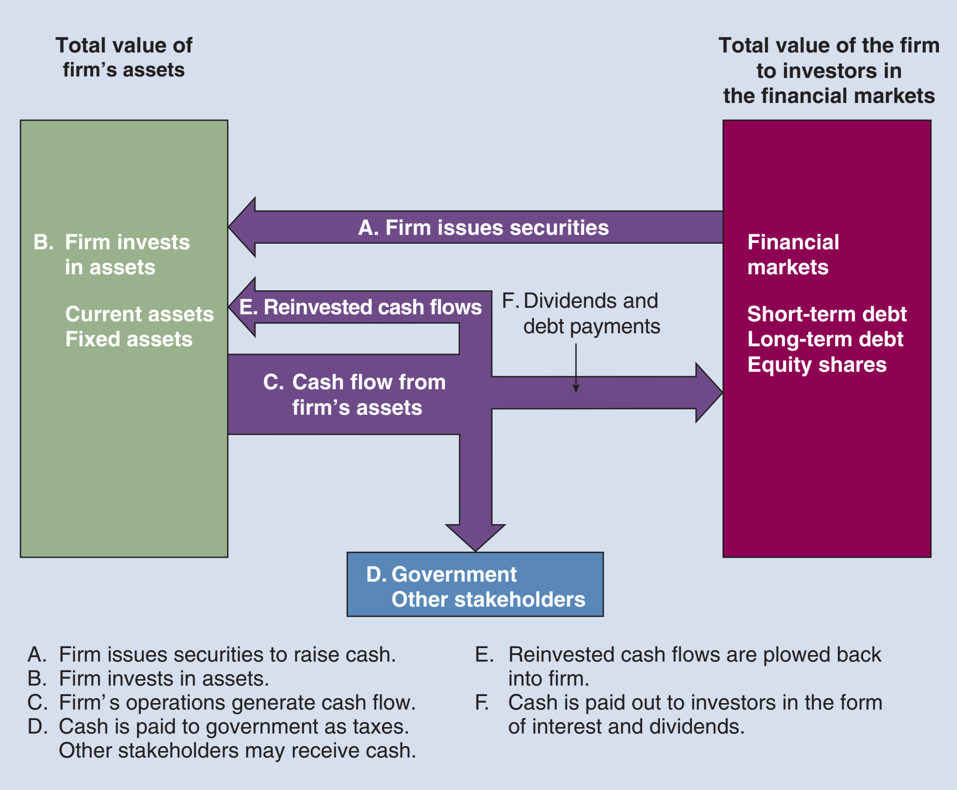
The interplay between the corporation and the financial markets is illustrated in Figure 1.2. The arrows in Figure 1.2 trace the passage of cash from the financial markets to the firm and from the firm back to the financial markets.

Suppose we start with the firm selling shares of stock and borrowing money to raise cash. Cash flows to the firm from the financial markets (A). The firm invests the cash in current and fixed (or long-term) assets (B). These assets generate some cash (C), some of which goes to pay corporate taxes (D). After taxes are paid, some of this cash flow is re-invested in the firm (E). The rest goes back to the financial markets as cash paid to creditors and shareholders (F).

A financial market, like any market, is just a way of bringing buyers and sellers together. In financial markets, debt and equity securities are bought and sold. Financial markets differ in detail, however. The most important differences concern the types of securities that are traded, how trading is conducted, and who the buyers and sellers are. Some of these differences are discussed next.

FIGURE 1.2

Cash flows between the firm and the financial markets



Primary versus Secondary Markets

Financial markets function as both primary and secondary markets for debt and equity securities. The term *primary market* refers to the original sale of securities by governments and corporations. The *secondary markets* are those in which these securities are bought and sold after the original sale. Equities are, of course, issued solely by corporations. Debt securities are issued by both governments and corporations. In the discussion that follows, we focus on corporate securities only.

primary market
The market in which new securities are originally sold to investors.

Primary Markets In a primary-market transaction, the corporation is the seller, and the transaction raises money for the corporation. Corporations engage in two types of primary market transactions: public offerings and private placements. A public offering, as the name suggests, involves selling securities to the general public, whereas a private placement is a negotiated sale involving a specific buyer.

By law, public offerings of debt and equity must be registered with the provincial or territorial securities commissions. The Ontario Securities Commission (OSC) is considered the most significant because it has the largest number of companies and investors under its jurisdiction. Registration requires the firm to disclose a great deal of information before selling any securities. The accounting, legal, and selling costs of public offerings can be considerable.

To learn more about the OSC, visit **www.osc.gov.on.ca**.

Partly to avoid the various regulatory requirements and the expense of public offerings, debt and equity are often sold privately to large financial institutions such as life insurance companies or mutual funds. Such private placements do not have to be registered with the OSC and do not require the involvement of underwriters (investment banks that specialize in selling securities to the public).

secondary market
The market in which previously issued securities are traded among investors.

Secondary Markets A secondary-market transaction involves one owner or creditor selling to another. It is therefore the secondary markets that provide the means for transferring ownership of corporate securities. Although a corporation is only directly involved in a primary-market transaction (when it sells securities to raise cash), the secondary markets are still critical to large corporations. The reason is that investors are much more willing to purchase securities in a primary-market transaction when they know that those securities can later be resold if desired.

Dealer versus auction markets There are two kinds of secondary markets: *auction* markets and *dealer* markets. Generally speaking, dealers buy and sell for themselves, at their own risk. A car dealer, for example, buys and sells automobiles. In contrast, brokers and agents connect buyers and sellers, but they do not actually own the commodity that is bought or sold. A real estate agent, for example, does not normally buy and sell houses.

Dealer markets in stocks and long-term debt are called *over-the-counter* (OTC) markets. Most trading in debt securities takes place over the counter. The expression *over the counter* refers to days of old when securities were literally bought and sold at counters in offices around the country. Today, a significant fraction of the market for stocks and almost all of the market for long-term debt has no central location; the many dealers are connected electronically.

Auction markets differ from dealer markets in two ways. First, an auction market, or exchange, has a physical location (like Bay Street, or Wall Street). Second, in a dealer market, most of the buying and selling is done by the dealer, while the primary purpose of an auction market, on the other hand, is to match those who wish to sell with those who wish to buy. Dealers play a limited role.

Dealers and Brokers

dealer
An agent who buys and sells securities from inventory.

broker
An agent who arranges security transactions among investors.

Because most securities transactions involve dealers and brokers, it is important to understand exactly what is meant by the terms *dealer* and *broker.* A **dealer** maintains an inventory and stands ready to buy and sell at any time. In contrast, a **broker** brings buyers and sellers together, but does not maintain an inventory. Thus, as we said above, when we speak of used car dealers and real estate brokers, we recognize that the used car dealer maintains an inventory, whereas the real estate broker does not.

In the securities markets, a dealer stands ready to buy securities from investors wishing to sell them and sell securities to investors wishing to buy them. The price the dealer is willing to pay is called the bid price. The price at which the dealer will sell is called the ask price (sometimes called the asked, offered, or offering price). The difference between the bid and ask prices is called the spread, and it is the basic source of dealer profits.

Dealers exist in all areas of the economy, not just the stock markets. For example, your local university bookstore is probably both a primary- and a secondary-market textbook dealer. If you buy a new book, this is a primary-market transaction. If you buy a used book, this is a secondary-market transaction, and you pay the store's ask price. If you sell the book back, you receive the store's bid price, often half of the ask price. The bookstore's spread is the difference between the two prices.

In contrast, a securities broker arranges transactions between investors, matching investors wishing to buy securities with investors wishing to sell securities. The distinctive characteristic of securities brokers is that they do not buy or sell securities for their own accounts. Facilitating trades by others is their business.

Security Exchanges

There are four organized exchanges in Canada. Stocks are traded on the Toronto Stock Exchange (TSX) and the TSX Venture Exchange; derivative contracts are traded on the Montreal Exchange; and contracts on agricultural commodities on the Winnipeg Commodities Exchange. All Canadian exchanges operate as electronic auction markets.

For more information about the TSX and the TSX Venture Exchange go to **www.tsx.com.**

Stocks that trade on an organized exchange (or market) are said to be *listed* on that exchange. In order to be listed, firms must meet certain minimum criteria concerning, for example, asset size and number of shareholders. These criteria differ for different exchanges.

The TSX is a senior exchange where shares of large, established companies are listed. To be listed on the TSX, a company is expected to have a market value for its freely tradeable shares of at least $4 million ($10 million for technology companies) and a total of at least 300 shareholders with at least 100 shares each. There are additional minimums on earnings, assets, and cash flow. In March 2007, 1597 companies were listed on the TSX. The TSX Venture Exchange has less stringent requirements, and, therefore, lists shares of small, emerging companies. Almost half of the 2271 companies listed on the TSX Venture Exchange were mining companies. Table 1.2 shows the market value and number of listed companies for the ten largest stock markets in the world, ranked by market value in March 2007. The TSX and the TSX Venture Exchange ranked seventh based on market capitalizations and had the largest number of listed companies among the top ten exchanges.

While listing on the TSX or the TSX Venture Exchange improves a company's ability to raise capital and increases its visibility and prestige, many large Canadian companies also choose to be listed on foreign exchanges. For example, in March 2007, 88 Canadian companies were listed on the New York Stock Exchange (NYSE). Canadian firms can derive several benefits from listing in the U.S., including access to larger capital markets and increased exposure. Similarly, some American companies are listed on the TSX. For example, shares of the U.S. company Magna Entertainment are traded on the TSX.

The United States has several stock exchanges and all of them, regardless of their location, are regulated by the same government agency—the Securities and Exchange Commission (SEC). The equity shares of most of the large firms in the United States trade in organized auction markets. The largest exchange in the world is the NYSE, which accounts for more than 85 percent of all the shares traded in auction markets. It has the most stringent listing requirements. Other auction exchanges include the American Stock Exchange (AMEX) and regional exchanges such as the Chicago Stock Exchange and the Pacific Stock Exchange.

TABLE 1.2

Largest stock markets in the world by market value in March 2007

Markets	Market value of listed companies (in U.S. $ billions)	Number of listed domestic companies	Number of listed foreign companies
NYSE	15,467.7	1,798	451
Tokyo	4,737.5	2,388	25
Nasdaq	3,906.9	2,792	328
Euronext	3,882.2	953	246
London	3,842.6	2,598	647
Deutsche Börse	1,756.0	655	100
TSX and TSX Venture exchange	1,749.6	3,815	53
Hong Kong Exchanges	1,734.1	1,171	9
BME Spanish Exchanges	1,393.6	N/A	N/A
Shanghai	1,297.4	848	0

Source: Used with permission of the World Federation of Exchanges. *www.world-exchanges.org*

Information on world exchanges can be found at the World Federation of Exchanges Web site **www.world-exchanges.org.**

To learn more about NYSE and Nasdaq, visit www.nyse.com and www.nasdaq.com.

The London Stock Exchange: www.londonstockexchange.com.

The Tokyo Stock Exchange in English: www.tse.or.jp/english.

In addition to the stock exchanges, there is a large OTC market for stocks. In 1971, the National Association of Securities Dealers (NASD) made available to dealers and brokers an electronic quotation system called NASDAQ (NASD Automated Quotations system, pronounced "naz-dak"). There are roughly three times as many companies on NASDAQ as there are on NYSE, but they tend to be much smaller in size and trade less actively. There are exceptions, of course. Both Microsoft and Intel trade OTC, for example. Nonetheless, the total value of NASDAQ stocks is significantly less than the total value of NYSE stocks.

There are many large and important financial markets outside North America, of course, and U.S. and Canadian corporations are increasingly looking to these markets to raise cash. The Tokyo Stock Exchange and the London Stock Exchange are two well-known examples. The fact that OTC markets have no physical location means that national borders do not present a great barrier, and there is now a huge international OTC debt market. Because of globalization, financial markets have reached the point where trading in many instruments never stops; it just travels around the world.

CONCEPT QUESTIONS

1.6a What is a dealer market? How do dealer and auction markets differ?

1.6b What is the largest auction market in Canada?

1.6c What does *OTC* stand for? What is the large OTC market for stocks called?

www.mcgrawhill.ca/olc/ross

SUMMARY AND CONCLUSIONS

1. Usually, financial topics are grouped into four main areas:

   a. Corporate finance
   b. Investments
   c. Financial institutions
   d. International finance

   A working knowledge of finance is important even if you are not planning a career in finance.

2. Business finance includes three main areas of concern:

   a. Capital budgeting. What long-term investments should the firm make?
   b. Capital structure. Where will the firm get the long-term financing to pay for its investments? In other words, what mixture of debt and equity should we use to fund our operations?
   c. Working capital management. How should the firm manage its everyday financial activities?

3. The corporate form of organization is superior to other forms when it comes to raising money and transferring ownership interests, but it has the significant disadvantage of double taxation.

4. The goal of financial management in a for-profit business is to make decisions that increase the value of the stock, or, more generally, increase the market value of the equity.

5. Conflicts between stockholders and management may arise in a large corporation. We called these conflicts agency problems and discussed how they might be controlled and reduced.
6. Financial markets function as both primary and secondary markets for debt and equity securities, and secondary markets can be organized as either dealer or auction markets. In Canada the shares of established companies are traded on the Toronto Stock Exchange (TSX), while the shares of emerging companies are traded on the TSX Venture Exchange.

Of the topics we've discussed thus far, the most important is the goal of financial management. Throughout the text, we will be analyzing many different financial decisions, but we always ask the same question: How does the decision under consideration affect the value of the equity in the firm?

CRITICAL THINKING AND CONCEPTS REVIEW

1.1 **Main Areas of Finance.** What are the four main areas of finance? What questions are addressed in the investments area?

1.2 **The Financial Management Decision Process.** What are the three types of financial management decisions? For each type of decision, give an example of a business transaction that would be relevant.

1.3 **Sole Proprietorships and Partnerships.** What are the four primary disadvantages to the sole proprietorship and partnership forms of business organization? What benefits are there to these types of business organization as opposed to the corporate form?

1.4 **Corporations.** What is the primary disadvantage of the corporate form of organization? Name at least two of the advantages of corporate organization.

1.5 **Corporate Finance Organization.** In a large corporation, what are the two distinct groups that report to the chief financial officer? Which group is the focus of corporate finance?

1.6 **Goal of Financial Management.** What goal should always motivate the actions of the firm's financial manager?

1.7 **Agency Problems.** Who owns a corporation? Describe the process whereby the owners control the firm's management. What is the main reason that an agency relationship exists in the corporate form of organization? In this context, what kinds of problems can arise?

1.8 **Primary versus Secondary Markets.** You've probably noticed coverage in the financial press of an initial public offering (IPO) of a company's securities. Is an IPO a primary-market transaction or a secondary-market transaction?

1.9 **Auction versus Dealer Markets.** What does it mean when we say the Toronto Stock Exchange is an auction market? How are auction markets different from dealer markets? What kind of market is Nasdaq?

1.10 **Not-for-Profit Firm Goals.** Suppose you were the financial manager of a not-for-profit business (a not-for-profit hospital, perhaps). What kinds of goals do you think would be appropriate?

1.11 **Ethics and Firm Goals.** Can our goal of maximizing the value of the stock conflict with other goals, such as avoiding unethical or illegal behaviour? In particular, do you think subjects such as customer and employee safety, the environment, and the general good of society fit in this framework, or are they essentially ignored? Try to think of some specific scenarios to illustrate your answer.

1.12 **International Firm Goal.** Would our goal of maximizing the value of the stock be different if we were thinking about financial management in a foreign country? Why or why not?

1.13 **Agency Problems.** Suppose you own stock in a company. The current price per share is $25. Another company has just announced that it wants to buy your company and will pay $35 per share to acquire all the outstanding stock. Your company's management immediately begins fighting off this hostile bid. Is management acting in the shareholders' best interests? Why or why not?

1.14 **Agency Problems and Corporate Ownership.** Corporate ownership varies around the world. Historically, individuals have owned the majority of shares in public corporations in the United States. Canada has a similar situation, but a large group of companies are controlled by one or several majority shareholders, usually founding family members. In Germany and Japan, however, banks, other large financial institutions, and other companies own most of the stock in public corporations. Do you think agency problems are likely to be more or less severe in Germany and Japan than in Canada? Why? In recent years, large financial institutions such as mutual funds and pension funds have been becoming the dominant owners of stock in Canada, and these institutions are becoming more active in corporate affairs. What are the implications of this trend for agency problems and corporate control?

1.15 **Executive Compensation.** Critics have charged that compensation to top management in Canada is simply too high and should be cut back. For example, focusing on large corporations, William Doyle of the Potash Corporation of Saskatchewan earned about $22 million in 2005. Is this amount excessive? In answering, it might be helpful to recognize that superstar athletes such as Steve Nash, top entertainers such as Ontario native Jim Carrey and British Columbia native Pamela Anderson, and many others at the top of their respective fields, earn at least as much, if not a great deal more.

WHAT'S ON THE WEB?

1.1 **Finance careers.** Visit Careers in Business at **www.careers-in-business.com** and explore careers in finance. What are the different career opportunities available in finance? How does a career in corporate finance differ from a career in money management? Go to **www.financejobs.ca** and find a finance position opening close to your home. What are the required skills and experience?

1.2 **Listing requirement.** This chapter discussed some of the listing requirements for the TSX and the TSX Venture Exchange. Find the complete listing requirements for these exchanges at **www.tsx.com**. Which has more stringent listing requirements? Why don't they have the same listing requirements?

1.3 **Exchange listing.** In March 2007, 88 Canadian companies were listed on the NYSE. Go to the New York Stock Exchange at **www.nyse.com** and find out how many Canadian companies are listed there now. Why do you think some Canadian companies decide to list on the NYSE?