

**CH 1: GOALS & GOVERNANCE**

<b>Capital Budgeting (Investment) Decision</b>	Decision about which real assets the firm should acquire
<b>Financing Decision</b>	Decision on how to raise money to pay for investments in real assets
<b>Capital Structure</b>	Firm's mix of long-term financing
<b>Real Assets</b>	Assets used to produce goods and services
<b>Financial Assets (Securities)</b>	Claims to the income generated by real assets
<b>Public Company</b>	Corporation whose shares are listed for trading on a stock exchange
<b>Private Company</b>	Corporation whose shares are privately owned
<b>Corporation</b>	Business owned by shareholders who are not personally liable for the business's liabilities
<b>Limited Liability</b>	Principle that the owners of the corporation are not personally responsible for its obligations
<b>Sole Proprietorship</b>	A business owned and operated by one individual, who has no partners and no shareholders, and is personally liable for all the firm's obligations
<b>Canada Revenue Agency (CRA)</b>	A federal agency that collects taxes and administers tax laws for the Government of Canada and for many of Canada's provinces and territories; the agency also oversees various social and economic benefit and incentive programs through the tax system, as well as laws relating to international trade
<b>Partnership</b>	Business owned by two or more people who are personally responsible for all its liabilities
<b>Treasurer</b>	Manager responsible for financing, cash management, and relationships with financial markets and institutions
<b>Controller</b>	Officer responsible for budgeting, accounting, and auditing
<b>Chief Financial Officer (CFO)</b>	Officer who oversees the treasurer and controller and sets overall financial strategy
<b>Agency Problems</b>	Conflict of interest between the firm's owners and its managers
<b>Stakeholder</b>	Anyone with a financial interest in the firm

**CH 1 Learning Objectives**

1. Give examples of the investment and financing decisions that financial managers make.
2. Distinguish between real and financial assets.
3. Cite some of the advantages and disadvantages of organizing a business as a corporation.
4. Describe the responsibilities of the CFO, the treasurer, and the controller.
5. Explain why maximizing market value is the logical financial goal of the corporation.
6. Explain why value maximization is usually consistent with ethical behaviour.
7. Explain how corporations might mitigate conflicts and encourage cooperative behaviour.

## 1.1 Investment and Financing Decisions

The **financial manager** is responsible for two key decisions:

1. **Investment Decision:** Purchase of real assets
2. **Financial Decision:** Sale of financial assets

**Investment (Capital Budgeting) Decision:** Which real assets the firm should acquire

**Financing Decision:** How to raise money to pay for investments in real assets

- **Equity Investors:** Give cash in exchange for shares (shareholders)
- **Debt Investors:** Give cash in exchange for a fixed rate of interest (lenders)
- **Capital Structure:** Use of debt and equity financing
- **Capital:** Sources of long-term financing



1. Cash is raised from selling financial assets to investors
2. Cash is invested in the firm's operations
3. Cash is generated by the firm's operations
4. Cash is either:
  - a. Reinvested into the firm
  - b. Returned to investors

### Real vs. Financial Assets:

**Real Assets:** Used to produce products and services

- e.g., machinery, factories, offices, technical knowledge, trademarks, patents

**Financial Assets:** Claims to the income generated by real assets

- e.g., shares, bank loan, bonds, other securities

## 1.2 What is a Corporation?

**Public Company:** Corporation whose shares are listed for trading on a stock exchange

**Private Company:** Corporation whose shares are privately owned

**Corporation:** Business owned by shareholders who are not personally liable for the business's liabilities

**Advantages of Incorporating:** Limited liability, separate and distinct legal entity, endless life, access to large amounts of capital

**Disadvantages of Incorporating:** Double taxation, costly, many rules and regulations

**Limited Liability:** Owners of the corporation are not personally responsible for its obligations

**Board of Directors:** Group elected by shareholders to oversee the activities of the firm, including the appointment of management and the monitoring of their performance

### 1.3 Other Forms of Business Organization

**Sole Proprietorship:** A business owned and operated by one individual, who has no partners and no shareholders, and is personally liable for all the firm's obligations

**Advantages of Sole Proprietorships:** Easy to establish, few regulations

**Disadvantages of Sole Proprietorships:** Unlimited liability

**Partnership:** Business owned by two or more people who are personally responsible for all its liabilities

**Partnership Agreement:** Document that sets out how management decisions are to be made and the proportion of the profits to which each partner is entitled

**Advantages of Partnerships:** Lack of taxation on operating profits, pooling of resources

**Disadvantages of Partnerships:** Unlimited liability

#### **Hybrid Forms of Business Organization:**

- **Limited Partnerships** (general partners manage operations and have unlimited personal liability while limited partners cannot manage operations and have limited personal liability)
- **Professional Corporation** (form of organization commonly used by doctors, lawyers, and accountants, where the business has limited liability and is taxed as a corporation but the individual professionals can be sued personally)

## 1.4 Who is the Financial Manager?

**Financial Manager:** Anyone Responsible for a significant corporate investment or financing decision

**Treasurer:** Manager responsible for financing, cash management, and relationships with financial markets and institutions

**Controller:** Officer responsible for budgeting, accounting, tax, and auditing

**Chief Financial Officer:** Officer who oversees the treasurer and controller and sets overall financial strategy



## 1.5 Goals of the Corporation

Shareholders want managers to **maximize the market value** of their investment.

**Profit maximization** is not a well-defined corporate objective because:

1. Which year's profits? Actions can be taken that raise current-year profits at the expense of future-year profits
2. Future profits can be increased by cutting current-year dividends and reinvesting the funds in the firm. This may not be in the shareholders' best interest if this reinvestment generates a very low rate of return.
3. Profit can be calculated in different ways; thus, a decision that improves profits using one set of accounting rules may reduce them using another.

### Do Managers Really Maximize Firm Value?

**Agency Problems:** Conflict of interest between the firm's owners and its managers

- e.g., buying expensive corporate jets for travel, overindulge in expense-account dinners, shying away from risky projects due to concerns about job security,

Agency problems can be reduced by both internal and external **corporate governance**:

#### 1. Internal Corporate Governance:

- **Compensation plans** such as stock options tie corporate performance to management rewards, thereby aligning managers' and shareholders' interests
- The **board of directors** monitor management behaviour and enforce consequence for poor performance or unethical actions

#### 2. External Corporate Governance:

- **Takeovers:** Underperforming firms become takeover targets and managers may lose their jobs and reputation
- **Specialist Monitoring:** Security analysts, banks, and others constantly monitor management performance
- **Shareholder Pressure:** Stockholders take the "**Wall Street Walk**" by selling out and moving on to other instruments in order to send messages to poorly performing firms (if enough shareholders do this, stock prices will plummet and damage top management's reputation and compensation)
- **Legal and Regulatory Requirements:** Bill C-198 in Canada and Sarbanes-Oxley Act in the U.S.

**Ethical Disputes:**

1. **Short Selling:** Betting that securities you do not own will fall in price (done by borrowing the security and selling it in the hopes that you can repurchase it cheaply)
2. **Corporate Raiders:** Targeting companies whose assets can be profitably sold and redeployed (seeking to carve up established firms, leading them with heavy debt burdens, basically in order to get rich quick)
3. **Creative Accounting:** When earnings appear to fall short of expectations, corporations turn to creative accounting to meet expectations (e.g., announcing a price increase in January to get customers to purchase more in December)
4. **Tax Avoidance:** For instance, the use of **backdating** (date of stock option is not the actual date of the option grant but rather a date in the past when the stock price was lower)
5. **Board of Directors:** In light of corporate scandals, there has been a push for the BOD to be more independent. The Sarbanes-Oxley Act required that corporations place more independent directors on the board (i.e., not affiliated with management). Boards also now meet without the CEO present.